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The Role of Small Business

A Tale of Two Cities

Economic researchers and policy makers have debated the importance of small business to an area's economic health for nearly two decades. Findings from two recent W. E. Upjohn Institute research studies in Cleveland,¹ and in Kalamazoo, Michigan, provide new evidence on the role of small businesses in local economics and offer a more complete demographic profile of small-business owners. These two studies show that small-business owners in these two different areas share similar characteristics, face similar obstacles, but differ slightly in their opinions of what small-business assistance programs would be the most beneficial. Furthermore, the studies suggest that the economic development effect of small business may have been overemphasized in earlier studies. The findings further suggest that small-business development strategies may offer a more useful avenue for neighborhood/community development.

The two studies examined the role of small business in these two very different metropolitan statistical areas (MSAs) by using a special employment tabulation from the U.S. Census Bureau for the 1989 to 1992 period, data from the Public Use Microdata Sample (PUMS) from the 1990 Census, one-on-one interviews, and similar questionnaires mailed to existing businesses employing fewer than 100 workers.

Trends in Job Creation in Small Businesses

Jobs are created through new business openings and expansions of existing establishments and are lost through closures and contractions. In both studies, these four components of employment growth in very small establishments (those employing 20 or fewer workers) were compared to those in a similar group of MSAs. Cleveland was compared with 9 other large metropolitan areas, and the smaller Kalamazoo-Battle Creek MSA was compared with 23 similar MSAs.

Employment growth among small establishments in both the Cleveland and Kalamazoo-Battle Creek MSAs ranked both areas in the middle of their comparison groups. One of the more interesting observations from these studies is that the major difference between metropolitan areas with a fast-growing small-business sector and those with a stagnant small-business sector is the employment growth due to start-ups and expansions. As can be seen in Table 1, small businesses in Minneapolis and Beaumont-Port Arthur, Texas, enjoyed much greater employment growth due to start-ups than those in the slower-growing areas but had approximately the same percentage loss of employment due to closures and contractions. Employment losses in the small-business sector because of closures and contractions are fairly uniform between the faster- and slower-growing MSAs.

Table 1. Components of Employment Change in Small Business^a
(% of 1989 base)

Metropolitan Area	Start-ups	Closures	Expansions	Contractions	Total
Minneapolis (lg)	52.7	-19.5	34.3	-13.2	54.3
Beaumont-Port Arthur TX (sm)	54.8	-29.4	47.9	-12.2	70.1
Cleveland	39.4	-16.6	30.0	-14.1	38.7
Kalamazoo	37.4	-17.0	35.6	-12.5	43.5
Detroit (lg)	40.8	-19.9	29.2	-15.0	35.1
Springfield, MA (sm)	27.3	-18.8	20.5	-18.3	10.7

SOURCE: U.S. Census special tabulation

a. Small business = employing fewer than 20 workers

(lg) = MSA used in the Cleveland study; (sm) = MSA used in the Kalamazoo study.

These results, which are confirmed in other studies, suggest that it may be more fruitful to create an environment encouraging small-business start-ups and expansions than to allocate resources to retention efforts (i.e., preventing struggling businesses from failing). The former would encourage entrepreneurs seeking to explore new markets and to provide better services, while the latter could result in scarce economic development resources being (mis)used in supporting the continued production of obsolete products or uncompetitive services.

Characteristics of Small-Business Owners

Similar questionnaires were mailed to small-business owners (employing fewer than 100 workers) in the greater Cleveland area and in Kalamazoo County. Cleveland-area small businesses returned 590 usable surveys (a 24.6 percent response rate), while in Kalamazoo County, small businesses mailed back 763 usable surveys (a strong 43.0 percent response rate). These survey results, in addition to data acquired from the 1990 PUMS, suggest the following.

- Small businesses account for only a minor share of an area's economic base. Areas grow principally through the expansion of their economic base, which is composed of businesses that sell their goods or services to customers outside the region. In general, small businesses serve local customers and thus represent a small share of an area's economic base.² In Kalamazoo County, 74 percent of the surveyed small businesses had a market area no larger than the county's limits. In the Cleveland area, 63 percent of the surveyed firms sold to customers in the multi-county northeast Ohio region. While small-business start-ups and expansions may provide useful services to area customers, their overall economic impact is partially offset by the resulting employment reductions at the area's enterprises that lost market share.
- Most small businesses start small and stay small. For many entrepreneurs, job satisfaction and having an independent lifestyle are the overriding objectives of owning their own business. For these individuals, expansion is not their major objective. In

Kalamazoo County, the fastest-growing 5 percent of the small firms surveyed accounted for more than the total employment growth that occurred in the survey sample from 1993 to 1996. In Cleveland, the top 5 percent accounted for 50.2 percent of employment growth recorded during the same time period. Moreover, successful small businesses are found across all industries in both areas.

- Small business owners are better educated and have experience in the industry. In both MSAs, small business ownership is an employment opportunity typically taken by experienced, well-educated workers in their middle-to-late thirties who are long-term residents of their community.

Based on the PUMS data from the 1990 Census, an estimated 48.6 percent of the self-employed workers in Kalamazoo have earned a bachelor's degree or higher, compared with only 23.6 percent of the area's wage and salary workers. In the Cleveland MSA, 30.8 percent of the self-employed and 22.1 percent of the area's wage and salary workers have earned a bachelor's degree or higher. The Institute's mail survey yielded similar findings, with 52.6 percent of the Cleveland MSA's small-business owners and 51.8 percent of the Kalamazoo County small-business owners having obtained a bachelor's degree or higher.

In the Cleveland area, 86.4 percent of the surveyed small-business owners had prior experience in the industry of their business. In Kalamazoo County, 74.3 percent of the owners surveyed had such experience. Moreover, 44.5 percent of the surveyed owners in Cleveland and 40.9 percent in Kalamazoo County reported having previous management experience.

Finally, the average age of the surveyed Cleveland area small-business owners at the time that they started their business was 36 years, and as of the survey date, they had resided in the Cleveland area for an average of 41 years. Similar findings were reported in the Kalamazoo study.

Barriers and Solutions

Finding acceptable financing, developing a customer base, finding qualified workers, and dealing with government regulations are the major barriers facing individuals wanting to start a business, according to our survey of small-business owners in the two MSAs (Table 2). However, more than two-thirds of the small-business owners surveyed in both areas indicated that they did not face any major barriers when starting their business. In financing the start-up of their small business, 66.1 percent of the surveyed owners in Cleveland and 51.8 percent in Kalamazoo used their personal savings.

Table 2. Major Barriers Facing New Small-Business Owners
(% responding)

Barrier	Cleveland Survey	Kalamazoo Survey
Finding acceptable financing	20.6	23.5
Developing a customer base	12.7	30.5
Finding qualified workers	22.3	27.7
Government regulations	13.6	16.0

Small-business owners in the two MSAs did not agree about what business assistance programs would be the most beneficial for new small-business owners (Table 3). A market-rate loan program with lower than standard commercial-bank collateral requirements earned the strongest response in Kalamazoo and was a close second in the Cleveland area. Small-business owners in Cleveland listed a below-market-rate loan program with standard collateral requirements as first by a hair. In the smaller Kalamazoo County area, assistance in developing a business plan was the second most beneficial program.

Table 3. Most Beneficial Programs
(% responding)

Program	Cleveland	Kalamazoo
Below-market loan with std. collateral requirements	31.7	27.1
Market-rate loan with lower-than-std. collateral requirements	30.5	44.5
Seminars on key issues/topics	15.5	33.0
Buyer-seller linkage problems	16.7	27.6
Assistance in developing a business plan	14.3	37.0

Accompanying the mail surveys, interviews of small-business owners, individuals striving to start their own business, and owners of failed small businesses were conducted in both areas. The common themes heard during these one-on-one interviews were that a focused and well-researched business plan is vital for the success of a business endeavor and that the stress of running a small business exceeded expectations. In many instances, the telling difference between a successful and an unsuccessful entrepreneur was the understanding that following an effective marketing strategy is just as important as producing a good product or service. Too many entrepreneurs focus solely on their product or service and shirk their marketing duties. These comments suggest that business planning assistance and the provision of business mentors/counselors are services that could be highly beneficial to many individuals wanting to start a business.

In summary, the overall regional economic impact of small business may be small due to 1) the displacement impact of start-ups or expansions on other less-competitive area firms and 2) the fact that most small businesses stay small. Still, the neighborhood impact of a new dry cleaner, car wash, restaurant, or print shop can be very positive. For example, the community and social impacts of a new grocery store moving into an abandoned site in an inner-city neighborhood may more than offset the resulting loss of employment and business at an existing store located outside the neighborhood. In such instances, small-business assistance may be an effective community development tool, while having little to no impact on the larger economy of the area.

NOTES

1. The Cleveland study was completed in association with the Greater Cleveland Growth Association, the Federal Reserve Bank of Cleveland, the U.S. Small Business Administration, and the Council of Smaller Enterprises.

2. It is true that areas can also expand when local firms provide goods and services that were formerly shipped into the area. However, since most of an area's imports are goods or services that simply cannot be efficiently produced in the local area, import substitution opportunities are limited.

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