

A “Small Business”

Legislative and administrative small-business definitions arise from the need to separate an included group of businesses (or their owners) from an excluded group of businesses (or their owners). Since “small” is a relative term, no self-evident demarcation exists. The result is that any definition employed for public policy purposes is arbitrary. The definition is neither right nor wrong, though it may be better or worse. However, its arbitrary nature should not obscure the need for a definition that is concise, comprehensible, meaningful, clearly inclusive and exclusive, and intuitively satisfying.¹

The Small Business Act of 1953 considers a small business as one that is “independently owned and operated and not dominant in its field of operation.”² The Office of Advocacy at the U.S. Small Business Administration (SBA) is more specific. It defines “small business” as a “firm with less than 500 employees.”³ The 500 employee mark has become the recognized, if unofficial, small business definition in the United States. Many feel the 500 employee level is too expansive for most purposes or otherwise inappropriate. Few legislative or administrative definitions employ it. Nevertheless, the 500 employee definition is used as the basis for statistics quantifying American small business, meaning that fewer than 500 employees is the basis for our understanding of the phenomenon.

Employment size is the most frequent criterion used to define “small business” because it is a clear, simple measure that remains constant over time and is applicable to all small businesses in all cases. Gross (annual) revenues, asset size, and relative size within an industry are other measures sometimes used. But, gross revenues and asset size change with the value of the dollar, change that creates year to year comparability problems particularly in times of rapid inflation. For example, if small business had been defined in 1972 as annually grossing less than one million dollars, one decade later it could gross no more than \$433,000 in real terms and still qualify. The real gross receipts figure would

have fallen to \$298,000 by 1992. As a result, the maximum size of a business qualifying as “small” would have shrunk by over two-thirds, effectively changing the meaning of “small business.” In contrast, a 10-employee firm in 1972 was the same size firm in 1982, 1992 and will be in the year 2002.

Measures other than employment, annual revenues, and assets can also define “small business.” Examples include shareholders or product volume.⁴ These “other” measures are usually applicable or relevant to comparatively few business, and then, only in specific circumstances. However, their use should not be shunned even though they may be unfamiliar or unusual measuring criteria to the affected group. Unfamiliarity of measuring criteria or similar potential problems should simply be factors, albeit important ones, in creating a definition.

Some do not feel that the use of a single criterion to define “small business” is appropriate. They argue that a single criterion makes small business homogenous when it is in reality quite heterogenous.⁵ For example, a metal fabricating firm with 25 employees is likely very different from a restaurant with 25 employees in terms of gross receipts, payroll, customer base, cash flow, competitive position, and so on. An accounting firm with one million dollars in assets is very different than a wholesaler with one million dollars in assets; the former is much larger relatively and its assets will include minimal inventory while

Unusual Definitions!

Which of the following has NOT been used to define “small business?”

- a. No expatriate management and/or technicians and any special built facility must be less than 2,000 square feet,
- b. The owner/manager personally knows his/her employees,
- c. No more than 20 PCs on a single local area network (LAN),
- d. Annual sales of not less than 70,000 times the current minimum wage, or
- e. Independently owned and operated and not dominant in its field.

See endnotes for the answer.

the latter may be no more than one individual with a cell phone brokering nothing but its inventory. The Size Standards Division at the U.S. Small Business Administration, the division charged with establishing definitions of small business for SBA programs, is the group that is perhaps most preoccupied with multiple criteria to define small business. To define small business for its purposes, the division considers economic structure of an industry including degree of competitiveness, average size of firm, start-up costs and entry barriers, and size distribution of all firms in the industry, technological changes, competition from other industries, growth trends, historical factors in the industry, unique factors, and domination of a firm(s) in an industry.⁶ The result is a two criteria classification: the first is a four digit SIC (soon, a six digit NAIC), i.e., industry. The second is almost always a specific number of employees or a specific amount of annual gross receipts.

Implicit in many definitions of small business is the idea of an “independent” business entity, i.e., a business not publicly held or held by a firm that is publicly held. In fact, the criterion for membership in the National Federation of Independent Business (NFIB) is that the member owns an independent enterprise, not a small one. The implicit idea behind the distinction is that ownership distinguishes business more fundamentally than does size. But, the two are practically synonymous. A few large privately held firms and a few small publicly held firms are the exceptions.

An associated idea is that a firm, and its “affiliated” entities, together are modest enough to be considered a small business. An affiliated entity is essentially one business controlled by another, though the

Size Standards Division of the Small Business Administration needs over two pages of federal regulations to define it for SBA program purposes.⁷ Two examples of complications with affiliated entities are franchises and multiple businesses owned by American Indian tribes.

As a practical matter, various laws and regulations provide different implicit and explicit definitions of small business. Listed below are a few examples including three from the States to demonstrate the range of possibilities:⁸

- Family and Medical Leave Act — an employer for purposes of the Act is one who is engaged in commerce and employs 50 or fewer employees for each working day in 20 or more weeks in the current or preceding year.
- White House Conference on Small Business — to run as a delegate for the 1995 White House Conference on Small Business an individual must have been an owner, corporate officer, or employee of a business employing fewer than 500 people.
- New Jersey Travel Demand Management Program — any employer with 100 or more employees is required to monitor and alter employee commuting activities to reduce ozone pollution.
- Nevada Child Care Study — a 1997 amendment requires employers with 300 or more employees at one location to study the desirability and need for child care as well as the feasibility of providing on or near-site child care, reimbursing employees for their child care expenses and furnishing child care for persons with

disabilities.

- SIMPLE Pension Plan — the Savings Incentive Match Plan for Employees (SIMPLE) allows firms with fewer than 100 employees to offer a less administratively burdensome pension plan.
- Minnesota Minimum Wage Rate — the Minnesota minimum wage rate in 1997 was \$5.15 per hour among businesses with at or over \$500,000 in annual gross and \$4.90 per hour among those with less.
- Expensing Capital Assets — businesses will be able to deduct up to \$25,000 in equipment in the year of purchase for Federal income tax purposes beginning in the year 2003. Greater amounts must be depreciated.
- Small Quantity Generators — businesses (and other entities) are conditionally exempt small generators under RECRA if they generate no more than 100 kg of hazardous waste in a calendar month.⁹
- IRS for Internal Operations — all farmers and sole proprietorships, partnerships, S-corporations, and corporations that annually report less than \$5 million in assets.¹⁰
- Eligibility for Small Business Administration Programs —¹¹
 - SIC 2052 (Cookies and Crackers Manufacturers), 750 or fewer employees;
 - SIC 3572 (Computer Storage Device Manufacturers), 1,000 or fewer employees;
 - SIC 4911 (Electric Services), 4 million megawatt hours or less;
 - SIC 5021 (Furniture Wholesalers), 100 employees or less;
 - SIC 6023 (State Banks, Not Member of Federal Reserve, Insured by FDIC), \$100 million or less in assets;
 - SIC 7217 (Carpet and Upholstery Cleaning), \$3.5 million annual gross or less;
 - SIC 7822 (Motion Picture and Video Tape Distribution), \$21.5 million annual gross or less.

What is an SME?

Most members of the Organization for Economic Cooperation and Development (OECD) employ a three part classification for what Americans call “small business.” The smallest concerns in this classification scheme are micro-enterprises or craft businesses, e.g., artisans, solo professionals. The second class in the scheme includes small businesses. The final group consists of medium businesses. Hence the common internationally used term, *SME* (small and medium enterprises) or sometimes, *SMME* (small, medium and micro enterprises). The European Commission recommends to its member states that micro enterprises have 0-9 employees and one of two financial measures; small enterprises have 10-49 employees and a maximum of seven million ECUs (roughly equivalent to the dollar); medium enterprises have 50-249 employees. Member states often do not adhere to the recommended levels.

Source: Robert Van Der Horst, Andre Nijsen, and Selcuk Gulhan, “Regulatory Policies and Their Impact on SMEs in Europe: The Case of Administrative Burdens,” *The Blackwell Handbook of Entrepreneurship*, (eds.) Donald L. Sexton and Hans Landström, Blackwell Publishers, Oxford, UK, 2000.

- Small Business Corporation (S-corporation) — 75 or fewer shareholders

Small business can be and has been defined in a variety of ways for public policy purposes. The variety causes confusion among the public policy-maker, and small-business owners. That often makes the effect of policy inconsistent and untidy. Yet, the vagary represents the practical downside of an arbitrary process and political compromise. The alternative, i.e., a fixed definition, makes little policy sense other than to establish a common frame of reference. Moreover, it threatens to either trivialize the sector or make it impossible for the smallest to be separated from the smaller.

Farmers, Entrepreneurs, and Family Businesses

Production agriculture, i.e., farming and ranching, entities are usually not included in definitions of small business. In contrast, landscaping services, forestry and fishing operations, animal breeders, and crop harvesters usually are included (if they fit other size criteria). The distinction in these agriculture-based entities is tradition rather than logic. Farms are obviously businesses, if only in a single industry. One of the few exceptions to the general rule that farms are not businesses is the IRS's definition for internal administrative purposes. It includes farms and farmers. The irony is that IRS business statistics usually cover non-farm businesses except in the cases of partnerships and corporations where no distinction exists.

a. Entrepreneurs and Small-Business Owners

The term “small-business owner,” “small-business owner/operator,” or “small-business man/woman” and the term “entrepreneur” are used interchangeably. Though the overlap has limited consequences outside the academic community, their interchangeable use is not technically correct. The terms “small business” and “entrepreneur” are different.¹² The term “small business owner” refers to the owner/operator of any small business. It also has the connotation

of a manager. The term “entrepreneur” refers to someone initiating economic innovation. Entrepreneurs are commonly associated with growth firms.

b. Family Businesses

The public's most popular broad definition of a small business is a “family business.”¹³ Unfortunately, the term “family business” itself has over 20 different definitions.¹⁴ Most involve the concepts of family ownership, involvement, control and/or the intention to pass on the firm.¹⁵ But the concept of “family business,” no matter how defined, is almost never used for policy purposes. The major exception is the composition of a qualifying family member and business for purposes of the death (estate and gift) tax. A qualifying family member in the Internal Revenue Code is defined as “an ancestor, spouse or lineal descendent of the decedent or the lineal descendent of the decedent's spouse or parent or the spouse of any lineal descendent.”¹⁶ Legally adopted children are treated as blood.

Conclusion

“Small business” is defined in many ways for public policy purposes. Most definitions are highly pragmatic in the sense that they are created to apply to specific situations. But they are likely to use an employee-based measuring criterion and assume private ownership.

Endnotes to “A Small Business”

1. William J. Dennis, Jr., “What is a Small Business?” NFIB Staff Working Paper, National Federation of Independent Business, Washington, DC, January, 1982 mimeo.

2. 15 U.S.C. Sec. 632(a)(1).

3. “Small Business Answer Card 1998,” Office of Advocacy, U.S. Small Business Administration, Washington, D.C., 1998.

4. An example of the former is an S-Corporation and the latter EPA’s impact estimates of its Organic Chemicals, Plastics, and Synthetic Fibers Effluent regulations.

5. Rowena Barrett, “The Possible Effects of Adopting a Grounded Definition in Small Firm Research,” presented at Small Enterprise Association of Australia and New Zealand (SEAAANZ) annual conference, Fremantle, Australia, September, 1996.

6. 13 CFR Ch. 1 §121.102

7. 13 CFR Ch. 1 §121.103

8. Dana Barbieri, “Legislative Definitions of Small Business,” NFIB, Washington, D.C., June, 1998, mimeo.

9. 40 CFR Ch. 1 §261.5

10. *Tax Administration: Tax Requirements of Small Business*, GAO/GGD-99-133, U.S. General Accounting Office, Washington DC, August, 1999.

11. 13 CFR Ch. 1 §121.201

12. James W. Carland, Frank Hoy, William R. Boulton, and Jo Ann C. Carland, “Differentiating Entrepreneurs from Small Business Owners,” *The Academy of Management Review*, April, 1984.

13. Robert A. Peterson, Gerald Albaum, and George Kozmetsky, “The Public’s Definition of Small Business,” *Journal of Small Business Management*, July, 1986.

14. Max S. Wortman, Jr., “Critical Issues in Family Business,” *Proceedings*, ICSB (International Council for Small Business) 40th Annual World Conference, Sydney, Australia, 1995.

15. Nancy B. Upton and Ramona K. Z. Heck, “The Family Business Dimension of Entrepreneurship,” *Entrepreneurship 2000*, (eds.) Donald L. Sexton and Raymond W. Smilor, Upstart Publishing Company, Chicago, IL, 1997.

16. 26 U.S.C. Sec. 2032A(e)(2)

Answer to the quiz - Answer c. to the best of our knowledge. a. has been used in Gambia, a small African country. b. was offered by Peter Drucker. d. is a product of Brazil several years ago. e. is the definition in the Small Business Act of 1953 (noted prominently in the text).

Source: Dennis, “What is a Small Business?” op. cit.