IS SMALL BEAUTIFUL? IS BIGGER BETTER?

SMALL AND BIG BUSINESS BOTH HAVE THEIR DRAWBACKS

BY CHRIS TILLY

Beginning in the late 1980s, the United States has experienced a small, but significant boom in small business. While big businesses have downsized, small enterprises have proliferated. Should we be glad? Absolutely, declare the advocates of small business. Competition makes small businesses entrepreneurial, innovative, and responsive to customers.

Not so fast, reply big business's boosters. Big corporations grew big because they were efficient, and tend to stay efficient because they are big—and thus able to invest in research and upgrading of technology and workforce skills.

But each side in this debate omits crucial drawbacks. Small may be beautiful for consumers, but it's often oppressive for workers. And while big businesses wield the power to advance technology, they also often wield the market power to bash competitors and soak consumers. In the end, the choices are quite limited.

BIG AND SMALL

Is the United States a nation of big businesses, or of small ones? There are two conventional ways to measure business size. One is simply to count the number of employees per firm. By this measure, small businesses (say, business establishments with less than 20 employees) make up the vast majority of businesses (Table 1). But they provide only a small fraction of the total number of jobs.

The other approach gauges market share—each firm's share of total sales in a given industry. Industries range between two extremes: what economists call "perfect competition" (many firms selling a standardized product, each too tiny to affect the market price) and monopoly (one business controls all sales in an industry). Economy-wide, as with employment, small businesses are most numerous, but control only a small slice of total sales. Sole proprietorships account for 73% of established businesses, far outnumbering corporations, which are 20% of the total (the remainder are partnerships). But corporations ring up a hefty 90% of all sales, leaving sole proprietors with only 6%. It takes a lot of mom and pop stores to equal General Motors' 1999 total of $177 billion in sales.

Industry by industry, the degree of competition varies widely. Economists consider an industry concentrated when its top four companies account for more than 40% of total sales in the industry (Table 2). At the high end of the spectrum are the cigarette, beer, and aircraft industries, where four firms account for the bulk of U.S. production.

No market comes close to meeting the textbook specifications for perfect competition, but one can still find industries in which a large number of producers compete for sales. The clothing and restaurant industries, for example, remain relatively competitive. Overall, about one-third of U.S. goods are manufactured in concentrated industries, about one fifth are made in competitive industries, and the rest fall somewhere in between.

TABLE 1
SMALL BUSINESS NATION?

Most businesses are small, but most employees work for big businesses

Company size (number of employees)	*Percent of all firms*	*Percent of all workers*
1–4	54%	6%
5–9	20%	8%
10–19	13%	11%
20–49	8%	16%
50–99	3%	13%
100–249	2%	16%
250–499	0.4%	10%
500–999	0.2%	7%
1,000 or more	0.1%	13%

Note: "Businesses" refers to establishments, meaning business locations.

Source: County Business Patterns, 1998.

BEATING THE COMPETITION

Those who tout the benefits of small, competitive business make a broad range of claims on its behalf. In addition to keeping prices low, they say the quality of the product is constantly improving, as companies seek a competitive edge. The same desire, they claim, drives firms toward technological innovations, leading to productivity increases.

The real story is not so simple. Competition does indeed keep prices low. Believe it or not, clothing costs us less—in real terms—than it cost our parents. Between 1960 and 1999, while the overall price level and hourly wages both increased nearly sixfold, apparel prices didn't even triple. And small businesses excel at offering variety, whether it is the ethnic restaurants that dot cities or the custom machine-tool work offered by small shops. Furthermore, however powerful small business lobbies may be in Washington, they do not influence the legislative process as blatantly as do corporate giants.

But those low prices often have an ugly underside. Our sportswear is cheap in part because the garment industry increasingly subcontracts work to sweatshops—whether they be export assembly plants in Haiti paying dollar-a-day wages, or the "underground" Los Angeles stitcheries that employ immigrant women in virtual slavery. Struggling to maintain razor-thin profit margins, small businesses cut costs any way they can—which usually translates into low wages and onerous working conditions.

"There is a rule of survival for small business," Bill Ryan, president of Ryan Transfer Corporation, commented some years ago. "There are certain things you want to have [in paying workers] and certain things you can afford. You had better go with what you can afford." Bottom line, workers in companies employing 500 or more people enjoy average wages 30% higher than their counterparts in small businesses.

Part of this wage gap results from differences other than size—unionization, the education of the workforce, the particular jobs and industries involved. But University of Michigan economist Charles Brown and his colleagues controlled for all these differences and more, and still found a 10% premium for big business's employees. A note of caution, however: Other recent research indicates that this wage bonus is linked to long-term employment and job ladders. To the extent that corporations dissolve these long-term ties—as they seem to be rapidly doing—the pay advantage may dissolve as well.

Small business gurus make extravagant claims about small businesses' job-generation capacity. An oft-quoted 1987 report by consultant David Birch claimed that businesses with fewer than 20 employees create 88% of new jobs. The reality is more mundane: over the long run, businesses with 19 or fewer workers account for about one quarter of net new jobs. One reason why Birch's statistics are misleading is that new small businesses are created in great numbers, but they also fail at a high rate. The result is that the *net* gain in jobs is much smaller than the number created in business start-ups.

For companies in very competitive markets, the same "whip of competition" that keeps prices down undermines many of competition's other supposed benefits. The flurry of competition in the airline industry following deregulation, for example, hardly resulted in a higher quality product. Flying became temporarily cheaper, but also less comfortable, reliable, and safe.

Technological innovation from competition is also more myth than reality. Small firms in competitive industries do very little research and development. They lack both the cash needed to make long-term investments and the market power to guarantee a return on that investment. In fact, many of them can't even count on surviving to reap the rewards: only one-third to one-half of small business startups survive for five years, and only about one in five makes it to ten years. A 1988 Census Bureau survey concluded that in manufacturing, "technology use is positively correlated with plant size." Agriculture may be the exception that proves the rule. That highly competitive industry has made marked productivity gains, but

TABLE 2
WHO COMPETES, WHO DOESN'T

Industry	*Percent of sales by top four firms*
Light truck and utility vehicle manufacturing	99%
Breweries	90%
Breakfast cereal manufacturing	83%
Home center stores	75%
General book stores	68%
Lawn equipment manufacturing	64%
Cable networks	61%
Credit card issuing	54%
Computer and software stores	35%
Sock manufacturing	26%
Hotels and motels	16%
Gas stations	7%
Real estate	3%
Bars	1%

its research is supported by the taxpayer, and its risks are reduced by government price supports.

Of course, the biggest myth about competition is that it is in any way a 'natural state' for capitalism. In fact, in most markets the very process of competing for high profits or a bigger market share tends to create a concentrated, rather than a competitive, market structure. This process occurs in several ways. Big firms sometimes drive their smaller competitors out of business by selectively cutting prices to the bone. The smaller firms may lack the financial resources to last out the low prices. In the 1960s, several of IBM's smaller competitors sued it for cutting prices in a pattern that was designed to drive the smaller firms out of the market. Large corporations can also gain a lock on scarce resources: for example, large airlines like United and American operate the comprehensive, computerized information and reservation systems that travel agents tap into—and you can bet that each airline's system lists their own flights first. Or businesses may exploit an advantage in one market to dominate another, as Microsoft used its control of the computer operating system market to seize market share for its Internet browser.

Other firms eliminate competitors by buying them out—either in a hostile takeover or a friendly merger. Either way, a former competitor is neutralized. This strategy used to be severely limited by strict antitrust guidelines that prohibited most horizontal mergers—those between two firms that formerly competed in the same market. The Reagan administration's team at the Justice Department, however, loosened the merger guidelines significantly in the early 1980s. Since that time, many large mergers between former competitors have been allowed to go through, most notably in the airline industry.

THE POWER OF CONCENTRATION

Concentration, then, is as natural to market economies as competition. And bigness, like smallness, is a mixed bag for us as consumers and workers. For workers, bigness is on the whole a plus. Whereas competition forces small businesses to be stingy, big firms are on average more generous, offering employees higher wages, greater job security, and more extensive fringe benefits. In 1993, 97% of businesses with 500 or more workers provided health insurance; only 43% of businesses with 25 or fewer employees did so. Large firms also provide much more employee training. The strongest unions, as well, have historically been in industries where a few firms control large shares of their markets, and can pass along increased costs to consumers—auto, steel, and tires, for example. When profits are threatened, though, firms in concentrated markets also have more resources with which to fight labor. They are better able to weather a strike, oppose unionization, and make agreements with rivals not to take advantage of each other's labor troubles. In addition, large companies, not surprisingly, score low on workplace autonomy.

What about consumers? Corporations in industries where there are few competitors may compete, but the competitive clash is seldom channeled into prolonged price wars. The soft drink industry is a classic example. David McFarland, a University of North Carolina economist, likens soft drink competition to professional wrestling. "They make a lot of sounds and groans and bounce on the mat, but they know who is going to win," he remarked.

Coke and Pepsi introduce new drinks and mount massive ad campaigns to win market share, but the net result is not lower prices. In fact, because competition between industry giants relies more on product differentiation than price, companies pass on their inflated advertising expenses to consumers. In the highly concentrated breakfast cereal market, the package frequently costs more than the contents. And of every dollar you pay for a box, nearly 20 cents goes for advertising.

It takes resources to develop and market a new idea, which gives large corporations distinct advantages in innovation. The original idea for the photocopier may have come from a patent lawyer who worked nights in his basement, but Xerox spent $16 million before it had a product it could sell. RCA invested $65 million developing the color television. RCA could take this gamble because its dominance in the television market ensured that it would not be immediately undercut by some other firm.

But market dominance can also translate into complacency. The steel industry illustrates the point. A few major producers earned steady profits through the 1950s and 1960s but were caught off-guard when new technologies vaulted foreign steel-makers to the top of the industry in the 1970s. Similarly, when IBM dominated the computer industry in the 1960s and early 1970s, innovation proceeded quite slowly, particularly compared to the frantic scramble in that industry today. With no competitors to worry about, it was more profitable for IBM to sit tight, since innovation would only have made its own machines obsolete.

And large corporations can also put their deep pockets and technical expertise to work to short-circuit public policy. In the 1980s, when Congress changed corporate liability laws to make corporate executives criminally liable for some kinds of offenses, General Electric's lobbyists and legal staff volunteered to help draft the final regulations, in order to minimize the damage.

Big businesses sometimes hide their lobbying behind a "citizen" smokescreen. The largest-spending lobby in Washington in 1986 was Citizens for the Control of Acid Rain. These good citizens had been organized by coal and electric utility companies to oppose tighter pollution controls. Along the same lines, the Coalition for Vehicle

Choice (now, who could be against that?) was set up by Ford and General Motors in 1990 to fight higher fuel efficiency standards.

CONCENTRATION OR CONGLOMERATION

Over the last couple of decades, the mix of big and small businesses has changed, but the changes are small and—at first glance—contradictory. Over time, employment has shifted toward smaller firms, though the shift has been subtle, not revolutionary. Meanwhile, the overall level of industry-by-industry sales concentration in the economy has increased, but only slightly. As older industries become more concentrated, newer, more competitive ones crop up, leaving overall concentration relatively steady. In his book Lean and Mean, economist Bennett Harrison points out that there is actually no contradiction between the small business employment boomlet and big firms' continued grip on markets. Big businesses, it turns out, are orchestrating much of the flowering of small business, through a variety of outsourcing and subcontracting arrangements.

But if industry-by-industry concentration has changed little over the decades, conglomeration is a different matter. Corporate ownership of assets has become much more concentrated over time, reflecting the rise in conglomerates—corporations doing business in a variety of industries. Five decades ago, the top 200 manufacturing firms accounted for 48% of all sales in the U.S. economy. By 1993, the 200 biggest industrial businesses controlled 65% of sales.

Most mainstream economists see these groupings as irrelevant for the competitive structure of the economy. Antitrust laws place no restrictions on firms from different industries banding together under one corporate roof. But sheer size can easily affect competition in the markets of the individual firms involved. A parent company can use one especially profitable subsidiary to subsidize start-up costs for a new venture, giving it a competitive edge. And if one board of directors controls major interests in related industries, it can obviously influence any of those markets more forcefully.

A case in point is the mega-merger of Time Inc. and Warner, which will soon be joining with America Online. The resulting conglomerate will control massive sections of the home entertainment business, bringing together Time's journalists, film and television producers, and authors, Warner's entertainment machine, which includes Home Box Office, the nation's largest pay television channel, and AOL's huge share of the Internet access market. The conglomerate can influence the entertainment business from the initial point—the actors, writers, and directors—up to the point where the finished products appear on people's televisions or computers. Conglomeration also multiplies the political clout of large corporations. No wonder Disney and other entertainment giants have also hopped on the conglomeration bandwagon.

CHOOSE YOUR POISON

Competition, concentration, or conglomeration: The choice is an unsavory one indeed. Opting for lots of tiny, competing firms leaves labor squeezed and sacrifices the potential technological advantages that come with concentrated resources. Yet the big monopolies tend to dominate their markets, charge high prices, and waste countless resources on glitzy ad campaigns and trivial product differentiation. And the big conglomerate firms, while not necessarily dominant in any single market, wield a frightening amount of political and economic power, with budgets larger than those of most countries.

Of course, we don't have much to say about the choice, no matter how much "shopping for a better world" we engage in. Market competition rolls on—sometimes cutthroat, other times genteel. Industries often start out as monopolies (based on new inventions), go through a competitive phase, but end up concentrating as they mature. As long as bigness remains profitable and the government maintains a hands-off attitude, companies in both competitive and concentrated industries will tend to merge with firms in other industries. This will feed a continuing trend toward conglomeration. Since bigness and smallness both have their drawbacks, the best we can do is to use public policies to minimize the disadvantages of each.

Resources: *Lean and Mean: The Changing Landscape of Corporate Power in the Age of Flexibility*, Bennett Harrison, 1994; *Employers Large and Small*, Charles Brown, James Hamilton, and James Medoff, 1990.