The value proposition of small businesses: economic engines for job creation

Ray M. Valadez
Pepperdine University

ABSTRACT

The purpose of this paper is to provide researchers, policy makers, and political proponents some insights on the value proposition of small businesses and the positive impact they can have on an economy. For the purposes of this paper, small business is defined in the traditional way of having less than 500 employees. The small business has a unique economic freedom to market contemporary products and services and provide wages through jobs for society.

The small business serves as the catalyst of economic stimulus and has become the fundamental unit or building block of business creation. In the United States as well as most industrialized nations, small businesses account for the majority of jobs in the economy. More importantly, they account for the growth and creation of new jobs in the economy. Accordingly, more emphasis should be placed on assisting and supporting small businesses during economic recoveries as well as during recessions.

This paper covers some differences between big and small businesses and points to the value of small business as not only the biggest creator of jobs but also as an alternative in job displacement. It suggests that beyond jobs, small businesses contribute to the fiber of a free market and feed the economy with innovation, talent, and creativity.

Keywords: Small businesses, job creation, net employment, business births and deaths, job gains

INTRODUCTION

A small business is the fundamental unit (building block) of business creation. It is like a stem cell in the development of the human body; it can self-generate and differentiate itself into different structured forms. Small businesses can cross into multiple industries, countries, and communities, providing jobs along the way. According to the Office of Advocacy of the Small Business Administration of the United States, from 1993 to 2008 approximately 64 percent of the net jobs created in the U.S. came from businesses with less than 500 employees (Sargeant, 2011, p.28). In some countries, such as Australia, a small business is one that has less than 20 employees (Kryger, 2000). Even with this size limitation, small businesses still account for the majority of employment growth in Australia (p.2). It was tempting to use the U.S. records involving employers with less than 20 employees in this paper because the numbers would support an even better story for business start-ups. However, to maintain consistency with the U.S. government reports, a small business is defined as having less than 500 employees in this paper.

The small business in a market economy is free to be creative, innovative, explore and try new ideas, and take risks, whereas, big business may be limited by its own political culture and obsession to be efficient. The bigger the business, the bigger the challenge will be to take on new, untried ideas and unproven methods. Some say that the culture in big business perpetuates an attitude we often hear: There is a right way, a wrong way, and our company way! This type of attitude existed openly throughout the later decades of the 20th century, and is still hidden today in most big business hallways.

Two of the fundamental things that small businesses do for an economy are to allow individual freedom of action and originate the engine of economic growth as measured by different dimensions including but not limited to employment and wages. Jobs and wages are critical success factors for any government whether they be totalitarian or democratic in ideology.

Recent economic international debates have been centered on fiscal responsibility and national debts. Most policy makers and central bankers have been focused on preventing further economic downturns and stimulating their respective economies as well as those of their members through one of the worst recessions of modern times. Governments throughout Europe have concerns over the national debts of countries such as Greece, Italy, Spain, Portugal, and even Ireland and Great Britain. Germany and France have been the most vocal and demanding for these countries to become more fiscally responsible. The real emphasis should be on creating policies and measures that produce jobs and increase spending wages. The primary focus at the Aug. 26, 2011 economic conference in Jackson Hole, Wyoming, was on jobs. The Federal Reserve Chairman Ben Bernanke suggested that while long-term deficit reduction is necessary, "future economic health could be jeopardized if hiring and growth are not strengthened now" (The Associated Press, 2011). He further urged the Congress of the United States to promote growth through tax, trade, and regulatory policies. All of these business concerns affect small and big businesses no matter what part of the world you exist or the type of government in place. However, these factors seem to affect small businesses earlier and with more lethal blows.

DIFFERENCES BETWEEN SMALL AND BIG BUSINESSES

While one cannot begin to cover all the distinguishing aspects between small and big business, the focus here will be on risk-aversion tendencies and efficiency aims of each. In terms of risk, big business will explore all aspects of an idea to minimize risk, often to the detriment of timely introduction of a product or service needed or wanted by the consumer. Small businesses are more reactive to current business dynamics and will take on calculated risk more readily than big business. Their approach is more intuitive and less research-oriented. This may be why the majority of them fail within the first couple of years. However, those that succeed in capturing a new market or expanding one will become the employers of tomorrow.

As small businesses become successful, they will be absorbed, lose their trained management to big business, or become big businesses themselves. However, there is a co-existence between big and small businesses as well. Often, big businesses outsource or use small businesses as vendors until they either are able to duplicate the product or service or make it more cost effective on their own.

The business schools of the world are training executives with tools and methods to make their businesses more efficient. Recent trends to pay for executives to get their advance degrees promote a payback for businesses by making them more efficient. Because big business employs large numbers, they are more visible and hold more political clout. They have more money to invest in research and attract bright minds and lobby their governments more effectively. They merge and acquire other business and reduce redundancies in workflows. More importantly, they can afford to layoff and rehire without having as great of re-training costs when compared with small businesses. "Unlike big companies, small businesses rely on each individual employee much more to keep their companies running. In addition, many small companies use their history of never firing people as an essential tool to attract and retain workers" (Flandez, WSJ, ¶ 2). Accordingly, a small business is less likely to lay off its employees during economic slowdowns because of the fear of losing them forever and the cost of re-training their replacements once there is an upswing in business.

An article by Kelly Edmiston, a senior economist at the Federal Reserve Bank of Kansas City suggests that encouraging large business to locate in an area may have the opposite effect of positive economic growth (Edmiston, 2007). A study revealed that a large firm "often retards the growth of the existing enterprises or discourages the establishment of enterprises that would otherwise have located [Georgia, USA]" (p.75). The article concludes, "given the role of small businesses in employment growth, supporting entrepreneurs and budding businesses is … likely to be an effective strategy" (p. 91)

ECONOMIC FREEDOM

Traditionally, market economies have been associated with democracies. However, more and more totalitarian governments have been making the transition to market economies, sometimes referred to as a capitalistic system. According to Daniels, Radebaugh, and Sullivan (2011), "For nearly two decades, the collapse of communism signified the triumph of capitalism, particularly in the mode of maximizing economic freedom" (p. 160). William Beach and Marc Miles (2005) define economic freedom as the "absence of government coercion and constraint on the production, distribution, or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself….people are free to work, produce, consume, and invest in the ways they feel are most productive" (Beach and Miles, as cited by

Daniels, et al., 2011, p. 161). Small businesses flourish in democracies because of the economic freedom of the environment. The U.S. Department of Energy follows this mantra in using the theme, **"**Securing Our Economic Freedom – Empowering Small Business" in setting their 20 years goals (Avillar-Speake, 2005)

The Heritage Foundation and *The Wall Street Journal* produce an Economic Freedom Index (EFI) that measures 10 components of economic freedom to conduct business. It measures not only the extent to which government constrains free choice and free enterprise, but goes beyond protective measures to ease of doing business in a country. Figure 1 in the Appendix shows that countries/regions scoring greater than 60 on the index are considered unbound from government interference in the economy. Scores from 60 to 60.9 are considered moderately free. Whereas, scores from 70 to 70.9 are considered mostly free, and scores from 80 to 100 are considered totally free.

As one can observe from Figure 1, the countries with scores of 60 and above have over 1.6 billion citizens free to start their own businesses with an infrastructure conducive of running business. A review of the Heritage Foundation's website shows Hong Kong at almost 90 points out of a possible 100 even though it is not a country and is now under the Chinese government control. This is because China's communist government has kept Hong Kong as a free trade zone. China recognized that the economic freedom enjoyed by Hong Kong under British rule as being economically healthy.

According to a report from the Organization of Economic Co-operation and Development (OCED), "It is apparent that SMEs [businesses with <500 employees] play an important role in all OECD economies: they make up over 95 percent of enterprises and account for 60 to 70 percent of jobs in most OECD countries" (OCED, 1998, p. 7). Besides lacking access to technology and capital, they remain burdened with regulatory issues. The OCED concludes the following: "*Regulatory burdens* remain a major obstacle for SMEs as these firms tend to be poorly equipped to deal with the problems arising from regulations. Access to information about regulations should be made available to SMEs at minimum cost. Policy makers must ensure that the compliance procedures associated with, e.g. R&D [Research and Development] and new technologies, are not unnecessarily costly, complex or lengthy" (OCED, 1998, p. 3).

THE ISSUE

In a recent press release statement by Commissioner Keith Hall of the Bureau of Labor Statistics before the United States Congress he said, "Of the 13.9 million persons unemployed in July, 44.4 percent had been out of work for 27 weeks or longer" (Hall, 2011). He further stated that these numbers have not changed over the past month (July), or even the past year (2010-2011). These are very disheartening facts and a very sad commentary for the U.S. economy. The unemployment rate sits at 9.1 percent (July 2011). Further, the 27 weeks is somewhat understated because the duration is based on the number of weeks unemployed before becoming employed. This may mean there are tens of thousands who simply have left the workplace altogether who are unaccounted for. Figure 2 in the Appendix shows the unemployment rate at the beginning of the greatest recession since the great depression of the 1930s to be at approximately 4.6 (July 2007) percent and rising to 10.1 by October 2010.

The mystery of economic growth lies in the basic variable of consumer spending. Approximately 70 percent of Gross Domestic Product of most free economies is consumer driven. If the consumers do not have jobs and decent wages, they will not spend and consume. The whole aspect of economic growth multipliers is based on the concept of perpetuated expenditures within an economic system. These multipliers are affected by confidence within the system. The recent U.S. consumer confidence index fell to a two-year low to 44.5 the weakest since April 2009 (Homan, 2011).

The recent downgrade of the United States Government's credit rating by Standard and Poor's has created much trepidation in financial markets. The primary reason given for the downgrade was due to the indecision and debate over raising the debt ceiling, which was shadowed by political infighting over the national budget allocations and constraints. The legislators did not contemplate the damage that would ensue in the equity and financial markets based on their political infighting, indecision, and bipartisan behavior. According to Standard and Poor's, "We lowered our long-term rating on the U.S. because we believe that the prolonged controversy over raising the statutory debt ceiling and the related fiscal policy debate indicate that further near-term progress containing the growth in public spending, especially on entitlements, or on reaching an agreement on raising revenues is less likely than we previously assumed and will remain a contentious and fitful process" (Swann, 2011). In the two weeks following the downgrade, the New York Stock Market tumbled with the Dow Jones Industrials (DJI) shedding more than 600 points or 5 percent of its value and the two-, five-, 10-, and 30-year treasuries rates tumbled on an average of approximately 13 basis points to levels we have not seen in decades (Riley, 2011). The new two-year treasury yield rate has become the overnight rate and the new five-year rate is now what the two-year treasury yield rate was before the downgrade. In addition, Deven Sharma, the president of S&P, resigned 18 days after the downgrade (Blade, 2011).

Bonds yields and interest rates affect investments made both by consumers and businesses. Businesses may invest in research and development of new products, technology, equipment, or capital assets to expand their businesses. However, the cost of money is only one aspect of economic development; the access to capital is another important factor. Presently, the challenge for most businesses is access to financial capital even if they are confident about the future economic upswing. This brings to focus the confidence levels of stakeholders.

The confidence of consumers, business owners, and lenders has a greater impact than the cost of money, especially when the world-leading nation's credit worthiness is questioned, as S&P did with its downgrade of the United States government. What is needed is an effort to rebuild the trust level across all three players: consumer, business owner, and lender. It primarily starts with consumer demand. Consumer demand starts with having a job. Consumer spending begins by having confidence in being able to pay for necessities. Business confidence takes effect once the cash registers are ringing. This confidence sparks borrowing by not only consumers and business owners, but by lenders believing that the borrowers can service their debt. Unable to get employment, people may turn to self-employment. However, access to capital may be required to secure longevity.

Having access to capital may advance the alternative to layoffs. According to a USAToday reporter, Laura Petrecca (2009), "In 2008, an average of 320 out of 100,000 adults created a business each month — representing about 530,000 new businesses a month. That's a slight increase from 2007" (¶ 20). To increase jobs, government needs to promote investment in the private sector and promote access to capital for small businesses as suggested by James Sherk (2010), Senior Policy Analyst in Labor Economics at The Heritage Foundation.

JOB CREATION

In addition to small to medium-sized businesses accounting for most of the jobs in free market economies, "they also account for a *disproportionately large share of new jobs*, especially in those countries which have displayed a strong employment record, including the United States and the Netherlands" (OCED, 1998, p. 3). However, what firm size was included in their study? Internationally, small to medium-sized (SME) is defined using the same parameter of less than 500 employees that is being used to define a small business in this paper. Beyond size, the use of firm or establishment may make a difference in the statistics. A 1996 publication by Paul Schreyer of OCED began the attempt to distinguish between a firm-level and an establishment-level when referring to firms in their data counts (Schreyer, 1996). The use of firm or establishment may make a difference in the statistics.

As previously noted, 64 percent of new jobs in the United States from 1993-2008 were attributed to small businesses (Sargeant, 2011). However, during an economic slowdown or recession, they have the greatest job losses. The Office of Advocacy reported, "In the first three quarters of 2009, small businesses accounted for almost 60 percent of the net job losses, with the greatest losses in the first quarter" (p. 5).

Whether it's due to ignorance or big business political influence, many of our legislators are not aware that jobs are created in the private sector in businesses with less than 500 employees. From previous statistics, most of the jobs are created in companies with less than 20 employees in the U.S. as is the case in Australia. The Bureau of Labor Statistics (BLS), working with state agencies, has been focusing on the job creation issue, creating a review of where jobs are being created in the U.S. economy. Figure 3 in the Appendix shows the job gains and losses during the last decade using the Business Employment Dynamics (BED) method. Notice the deep declines of job gains and the steep climbs of job losses during the last two recessions. The BLS used a different data set in creating this chart from previous ones used—the differences are laid out in the report where this chart appears.

A further study of the last three recessions by Konigsberg, Spletzer, and Talan (2009) reveals that during the recession small businesses account for most of the new jobs created. The net new jobs created during the recessions of the early 1990s, 2001, and the last one ending 2009 are shown in Figure 4 of the Appendix. According to James Sherk (2010), "While layoffs increased during this recession [2007-2009], they are not the primary cause of the nearly 10 percent unemployment rate. The main factor driving the unemployment rate so high during this recession was … the sharp drop in creation of new jobs" (Abstract).

The BED report was started in 2008 in an effort to make the calculations of job creation more longitudinal. After comparison confusion on the job creation changes by size, the BLS on a news release dated August 2, 2011 provided an explanation of a longitudinal approach, known as the BED, which is a federal-state cooperative program─combining Quarterly Census of Employment and Wages as reported in the Unemployment Insurance reports (QCEW) (Anonymous, 2011). Further explanation for the tabulations by size of employment change can be found in a publication by Sheryl Konigsberg, James Sletzer, and David Talan (Konigsberg, Spletzer, & Talan, 2009). Brian Headd (2010) of the Office of Advocacy provided some insight on the matter and produced the pie charts as showed in Figure 5 of the appendix revealing two approaches in calculating net new jobs. Additionally, the BLS also uses another measure called the Current Employment Statistics (CES) that uses different parameters.

Different measures are used depending on the coverage, estimation procedure, and publication product goals. For example, in Table 1 of the Appendix, the author used the Small Business Administration's (SBA) website and extracted data that had been used by the Office of Advocacy, which cites the BLS as a source and supports previous SBA reports that small businesses accounted for 88 percent of new jobs in the U.S. As revealed in Table 1, small businesses accounted for 88.5 percent of all new jobs from 1993 to 2008. However, it was previously reported as accounting for 64 percent of all new jobs in the 2010 Report to the President. The 64 percent may be more accurate based on the BED methodology used.

Nonetheless, whether one uses 64 percent or 88 percent, the results clearly demonstrate that the major increase in job creation comes from small businesses in the United States.

CONCLUSION AND RECOMMENDATIONS

The value proposition of small business is clearly worthy of investment in any economy. It has proven itself not only in the United States but throughout the world as the best economic entity to create jobs. Beyond job creation it serves as the free market template where ideas, innovation, creativity, and entrepreneurship come together to bring about product change and service to society as well as an unemployment alternative during high unemployment periods. This gestation of initiatives, when combined with freedom of action gives birth to a business. These new businesses grow, get absorbed, or die, depending on management's ability to create and maintain a customer, the company's access to talent, capital, and technology, its ability to navigate government regulation, and a judicial system that protects property rights. It serves big business by becoming part of the business supply chain; thus, allowing big business to become more efficient. It works in harmony with big business to produce goods and services for society.

Different countries and entities measure both size and employment change differently. The OECD on the international side and the BLS on the United States' part are reviewing ways to more accurately report by size and what constitutes an employment change within a system due to their important role as a bellwether of the economy. Consequently, best practices for gathering relevant, timely, and comparable data using standard statistical methods need to be established across agencies and nations. International comparability will be a greater challenge than has already been discovered just within the United States. Gathering data in standardized format without creating more bureaucracy for businesses and maintaining their privacy is critical.

Above all the barriers to high growth for small businesses are market failures in the capital markets as we saw in the financial meltdown in the fall of 2007. For a period of time in the fall of 2007 and beginning of 2008, banks weren't even lending to each other. Finally, the normal barrier of having access to qualified staff and skilled workers is paramount to any business. Our policy decision makers have to focus on getting the economy back on track by removing bureaucratic barriers, providing access to capital, and reducing the taxation of small businesses.

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APPENDIX

Figure 1: World Economic Freedom

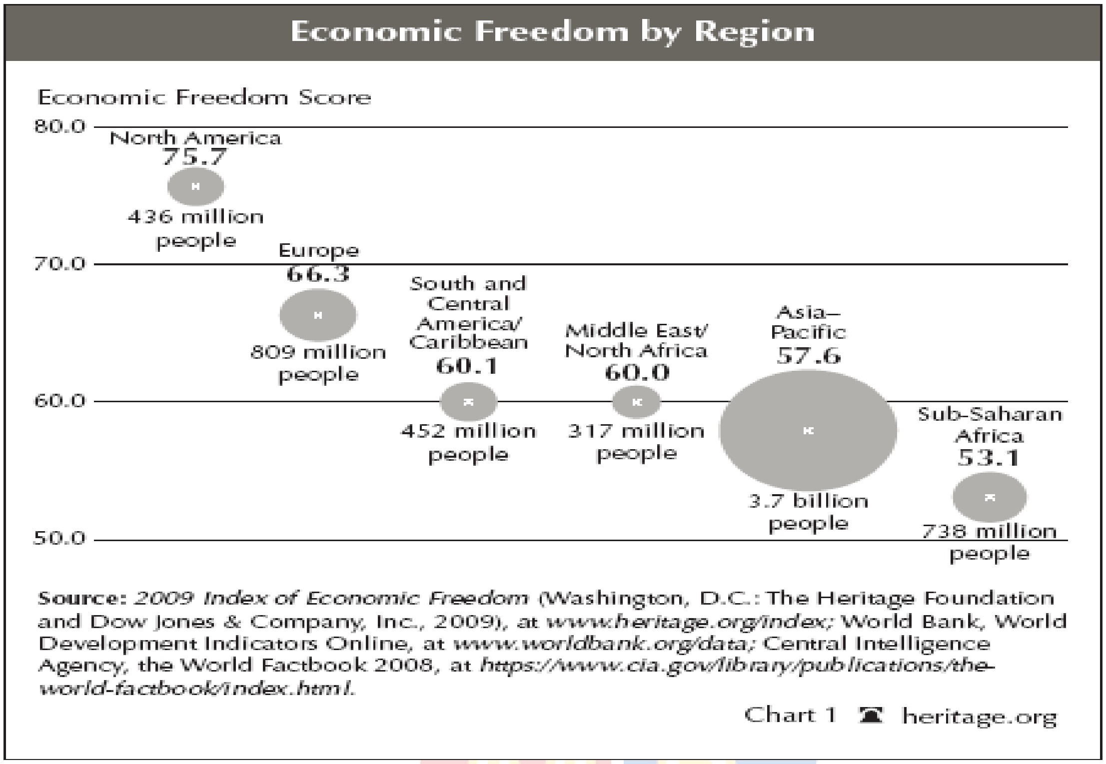
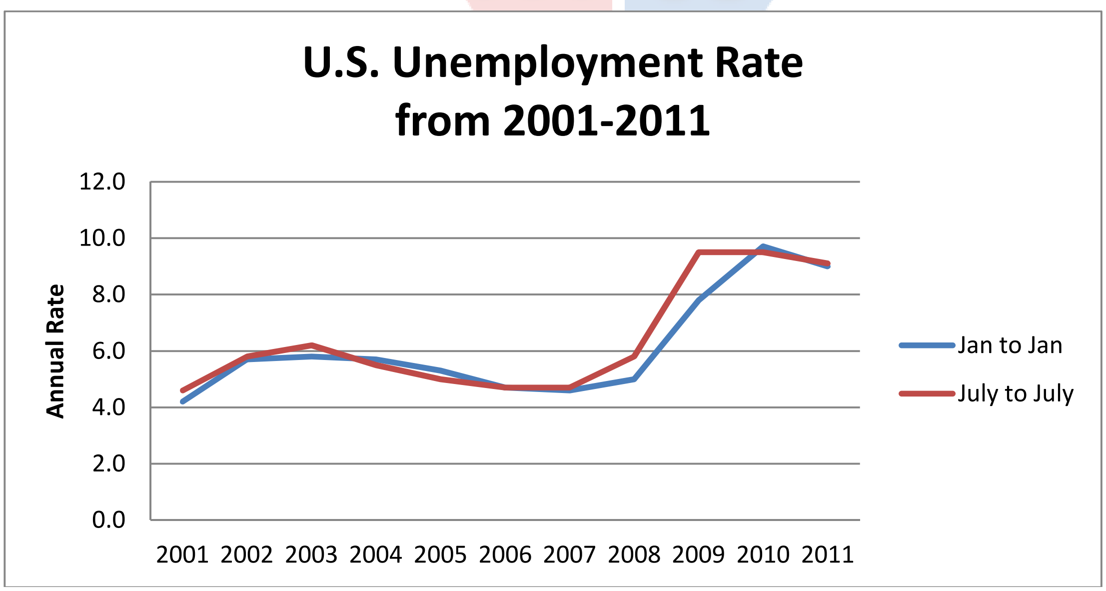


Figure 2:U.S. Unemployment rate last 10 years



Source: Adapted by R. M. Valadez (2011) from data from the Bureau of Labor Statistics, retrieved August 25, 2011 from http://data.bls.gov/timeseries/LNS14000000

Figure 3: Private Sector Jobs Gains and Losses from March 2000 to December 2010

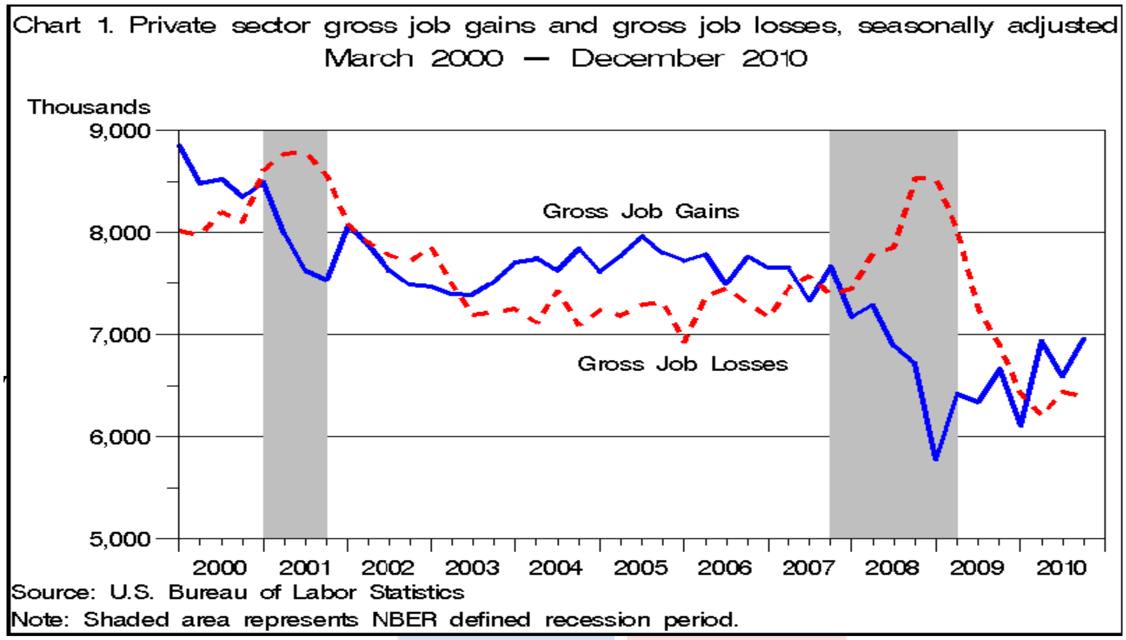
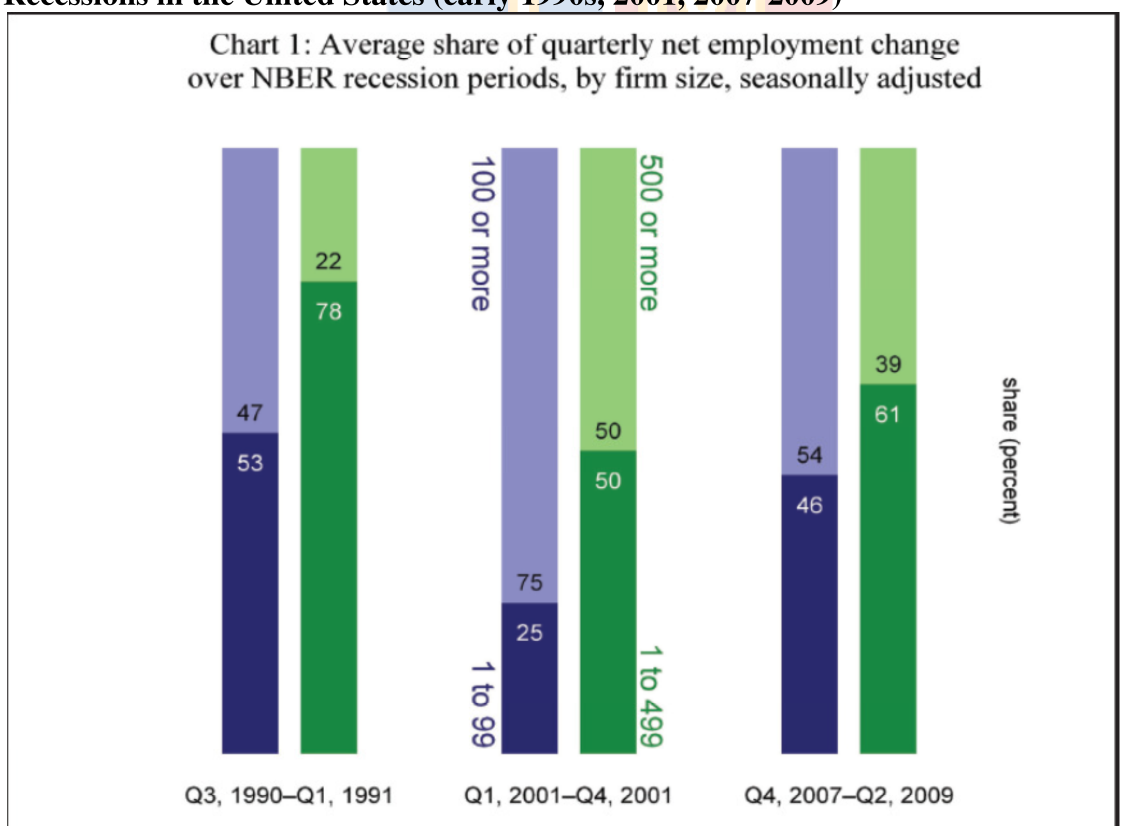


Figure 4. Average Share of Quarterly Net Employment Change During Last Three Recessions in the United States (early 1990s, 2001, 2007-2009)



Source: Konigsberg, S.L., Spletzer, J. R., & Talan, D. M. (2009) Retrieved August 23, 2011, from www.bls.gov: http://www.bls.gov/opub/mlr/2009/04/art2full.pdf

Figure 5. Two Data Sets in Calculating Net New Jobs by Firm Size

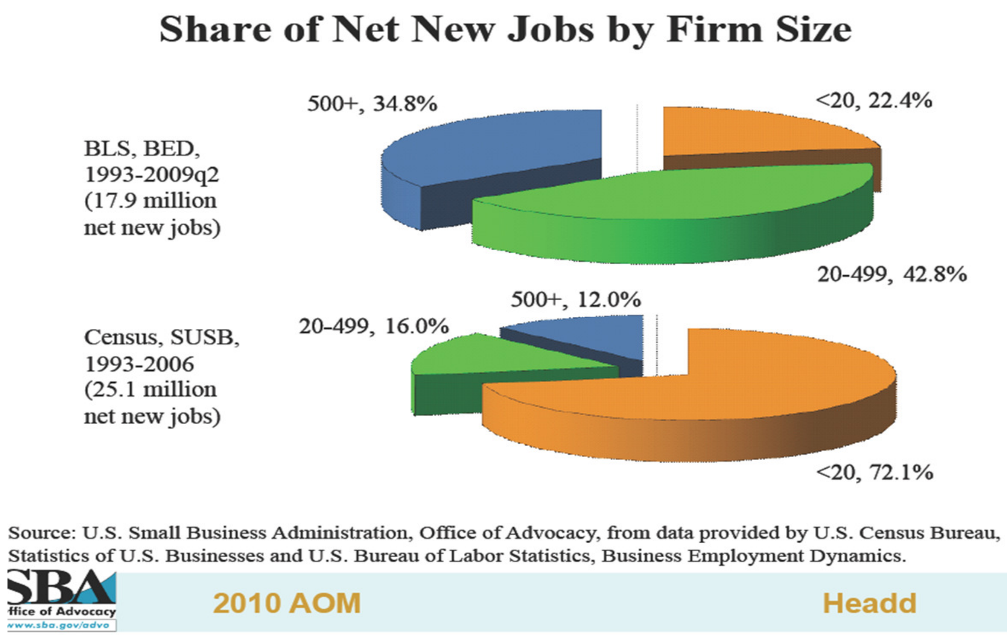


Table 1: Net Employment by Firm Size in U.S. (1993-2007)

	U.S. Net Job Creation (1993-2007) Number of Employees				
Period	**<20**	**20-499**	**<500**	**500+**	**Total**
2006-2007	986,619	-361,342	625,277	-88,075	537,202
2005-2006	1,589,546	936,064	2,525,610	1,072,710	3,598,320
2004-2005	1,026,394	-47,292	979,102	262,326	1,241,428
2003-2004	1,626,793	230,277	1,857,070	-181,122	1,675,948
2002-2003	1,573,462	416,864	1,990,326	-994,667	995,659
2001-2002	853,074	-1,282,606	-429,532	-2,231,026	-2,660,558
2000-2001	1,111,183	39,692	1,150,875	-150,905	999,970
1999-2000	1,593,466	912,246	2,505,712	853,707	3,359,419
1998-1999	1,363,258	379,769	1,743,027	844,711	2,587,738
1997-1998	1,386,293	348,283	1,734,576	1,078,601	2,813,177
1996-1997	1,557,696	796,506	2,354,202	750,081	3,104,283
1995-1996	1,435,453	24,059	1,459,512	407,733	1,867,245
1994-1995	1,677,783	935,522	2,613,305	978,262	3,591,567
1993-1994	1,311,540	281,810	1,593,350	351,110	1,944,460
Net New Jobs	**19,092,560**	**3,609,852**	**22,702,412**	**2,953,446**	**25,655,858**
Percent	**74.4%**	**14.1%**	**88.5%**	**11.5%**	**100.0%**

Source: Adapted by R. M. Valadez (2011) from data retrieved 5/15/2011 from http://www.sba.gov/sites/default/files/files/dyn_us_tot.pdf which was received by the Office of Advocacy, U.S. Small Business Administration, from data provided by the U.S. Bureau of the Census, Statistics of U.S. Business.

Notes: The data represent activity from March of the beginning year to March of the ending year-Excludes establishments with no employment in the first quarter of the beginning year. New firm births are classified by their first quarter employment size. Percent of size class is not calculated when size classes change in opposite directions. New firms represent new original establishments and deaths represent closed original establishments. Because of the methodology in determining new and closed original establishments, Census considers these figures to be estimates.