

Microbusiness in West Virginia

Research jointly conducted by
the *Center for Economic Options*
and
*Marshall University's Center for
Business and Economic
Research*

Draft report
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Microbusinesses in West Virginia

Proposed continuing research and policy suggestions

Most West Virginians appear to value the role entrepreneurs and small businesses play as an important part of our economy. However, a value judgement, no matter how commonly shared, is an insufficient basis on which to set public policy. Policies that directly address the many difficult issues in the West Virginia economy should be based on rigorous analysis and hard evidence. This report will outline an ambitious area of research to be jointly conducted by the *Center for Economic Options* (the Center), a nonprofit organization working throughout West Virginia to promote microenterprise development and Marshall University's *Center for Business and Economic Research* (CBER). This research will focus on :

- Identifying the economic impact and characteristics of microbusinesses in Appalachia, with a special focus on West Virginia.
- Identifying strategies for universities and nonprofit organizations to enhance microbusiness and entrepreneurial education and programs.
- Identifying and recommending policy options to state and local government to enhance economic growth through improving micro and small business activity.

In order to establish the context and rationale for this research, this report reviews characteristics of microenterprises and small businesses that have already been identified through the efforts of CBER, the Center and others. This report also illustrates, through case studies of microbusiness owners, examples of the economic impacts we describe more formally in the text.

Microenterprise: An Overview

In 1999 over 73,000 West Virginians worked in firms that employed fewer than five people. Commonly called "microbusinesses," or "microenterprises," these firms employed roughly ten percent of the state's official labor force, but produced roughly 12.9 percent of the goods and services in the state. By comparison, in the adjoining nine state region, microbusinesses employed an equal percentage of workers, but produced only 8.5 percent of goods

Charlotte Chandler is a true entrepreneur. Originally from Alabama, Charlotte married and moved to rural Roane County, bringing her fledgling flower and herb business, "*Honey of an Herb Farm*" with her. The fact that she now lived on her husband's family farm in a rural, mountain community far from towns and commercial resources did not deter Charlotte. Her original intent was to keep her business strictly wholesale, and with just one small greenhouse, this seemed manageable. It was not long though, before she was adding value-added products to her line. Delectable bath oils and salts, fragrant potpourris and simmering mixes, and beautiful dried wreaths were as much a part of her business as her herbs, perennials and potted plants.

Charlotte has the true spirit of an entrepreneur – she does not let problems and challenges keep her from moving forward in a positive manner. For instance, in August 2000, lightning struck a tree, which then fell and burned the building where all of her value-added products were stored. "I think that since we are small, and not deeply in debt, we will be okay. If we had been a big company, you would probably see us applying for bankruptcy and leaving West Virginia." Instead, Chandler, and her husband Joe, who owns a small scale stone cutting and masonry business are seeing the silver lining in the otherwise black cloud.

With Joe's expertise in stone masonry and Charlotte's love for herbs and plants, they have been able to combine their work in order to provide landscaping services – one of their original business ideas. "Sometimes it takes a tragedy to make you do what you needed to do all along," stated Charlotte. Also, they recently expanded into the floral wedding arrangement market, and have done one wedding using entirely dried flowers and herbs. "We won't be able to have our Christmas open house this year, but we will have a bigger and better one next year, and one in the spring.

"I wouldn't consider not running my own business," stated Chandler. "To me, one of the largest benefits is that I can be with my family when I need to and I don't have to answer to anyone but myself."



and services. In West Virginia, *small* businesses (those employing fewer than 25 workers) employed 33 percent of workers and produced 38.8 percent of the state’s total goods and services. In the surrounding nine state region small businesses employed 29.9 percent of workers, but produced only 24.4 percent of goods and services. West Virginia has roughly the same proportion of microbusinesses and more small businesses than surrounding states, but they produce a higher proportion of the state’s goods and services. Microbusinesses are an important part of the state’s economy. If microbusiness were classified as a separate industry it would be a larger employer than the coal industry, the manufacturing industry, the financial sector, or public utilities.

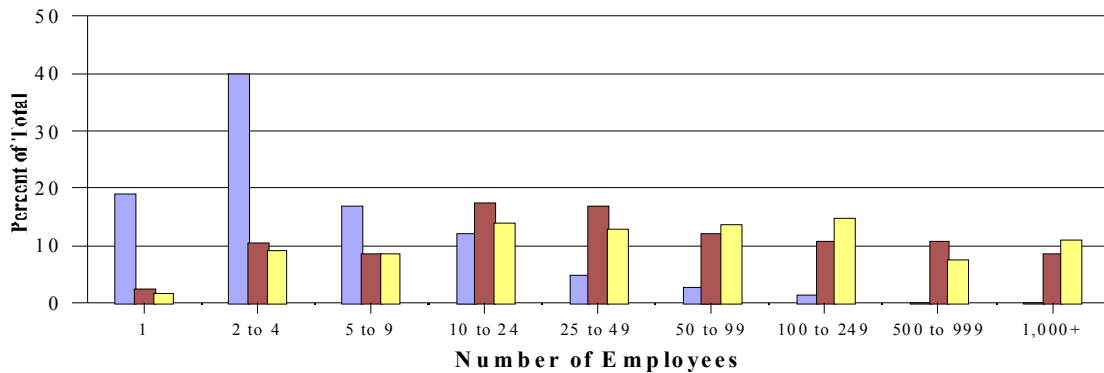


Figure 1, Distribution of Establishments, by Employment Size in West Virginia

West Virginians’ working in microbusinesses can be found in nearly all sectors of our economy. Many artisans, farmers and craftspersons operate microbusinesses, and preserve our past and cultural heritage through their work. Other microbusiness owners and workers manage bed and breakfast establishments, forge commemorative artwork in glass and steel, provide financial services, complete tax forms, offer hospice services, and provide engineering services to construction and coal mining firms. Microbusinesses also embrace the future economy and many of the fastest growing and best known high technology firms began as microenterprises. Many of these high-tech firms choose to remain small, however, capitalizing on the many benefits that small firms enjoy. Not surprisingly, some industries have a preponderance of small firms. Dental and medical offices, for example, are often employ just a few workers. Similarly, agriculture, the arts and many business services are heavily represented by microbusinesses. Other industries, such as chemical manufacturing and coal mining have firms with a higher-than-average number of workers. However, most industries have a range of firm sizes from the very small (under 5 employees) to large (more than 500).¹

Small businesses are not subject to some regulations larger businesses must adhere to. For instance, small businesses may be exempt from access regulations required by the *American’s With Disabilities Act*. However the *relative burden* of regulations are typically larger for small than large firms. This is true for compliance with *Occupational Safety and Health* regulations (e.g. preparation of *Material Safety Data Sheets*) as well as business licensing, etc. Since small firms have fewer workers to perform these tasks, the fixed costs of compliance are higher. This is a potential barrier to firms entering the marketplace. Indeed, in West Virginia, high fixed costs are most likely the single greatest reason some businesses operate in the *shadow economy* instead of becoming legitimate.

The Shadow Economy in West Virginia

That part of an economy which is unmeasured — the *shadow economy* — is a persistent part of all economies. Also known as the *informal sector* the *shadow economy* consists of legal activities such as home repair and child care as well as illegal activities such as the sale of illicit drugs. Some estimates of the size of the *shadow economy* also include non-market activities such as the value of a homemaker's care of children. This paper, however, is concerned with outlining the size of the *shadow economy* in which money is exchanged.

Measuring and understanding the size and impact of the shadow economy in West Virginia is important. First, it is important simply because measurement permits us to know where the state is in terms of economic activity. Also, mis-measurement and lack of understanding of the shadow economy inevitably leads to problematic public policy and dismissal of valuable economic activities. Also, since economic activity that takes place outside the eyes of the *Department of Tax and Revenue* is not considered legal, the benefit and experience of work performed in the shadow economy may be lost and never transferred to the formal sector of the economy. For example, a person providing child care in the *shadow economy* while attending college for an early childhood education degree is amassing important experience that will not likely *count* as experience when applying for a future job.²

Fortunately, West Virginia suffers few of the major problems of *shadow economies*. For example, the Ukraine and other parts of the former Soviet Union suffer tremendous fiscal drains from unreported activity. This weakens their government's ability to provide basic services. Also, activities that are purely illegal such as illicit drug sales, may impose tremendous costs on society in terms of health care, lost production and enforcement and incarceration costs. In West Virginia neither of these two problems appear to be great. It is unlikely that tax collections on all the *shadow economy* in the state would exceed enforcement costs. And, perhaps most significantly, the proportion of illegal activities (all of which occur in the *shadow economy*) appear to be relatively low in West Virginia. The best evidence of this is the very low crime rates enjoyed by the state.³

The *shadow economy* is difficult to measure. For this report we have estimated the size of West Virginia's shadow economy as a share of measured *Gross State Product*. The two most popular estimation techniques were employed, and their result averaged.⁴ Both methods yielded similar results, and when averaged provided estimates of the size of the *shadow economy* very consistent with other estimates in countries with economies similar to West Virginia. West Virginia's shadow economy ranges from 15 to 25 percent, while according to most recent studies, the U.S. as a whole has a shadow economy of roughly 10.5 percent.

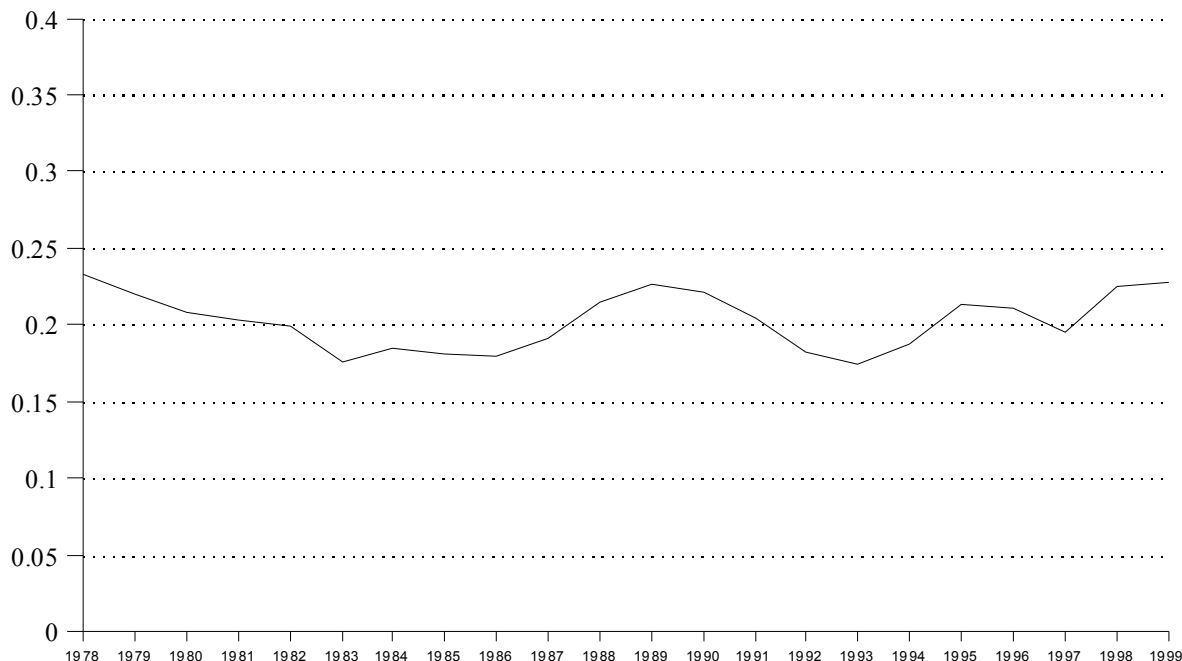


Figure 2, The Shadow Economy, as a Proportion of Gross State Product
(Average of Multiple Input-Multiple Cause Estimation and MV=PY Estimate)

The size of the *shadow economy* is important in comparing the level of the West Virginia's economy with the rest of the nation. West Virginia's measured per capita income is roughly 70 percent of that of the U.S. as a whole. When the size of West Virginia's *shadow economy* is included, though, the income gap between West Virginia and the rest of the nation closes by a third. This is good news because it suggests that workers in the state are materially better off than official statistics suggest. This information is especially useful for firms that make location decisions based on regional consumer demand. Due to the size of the unmeasured economy, West Virginians may possess as much as \$4,000 per capita in increased spending power than official statistics indicate.

Most studies find that economic activities in the *shadow economy* are extensions of work performed in the formal sector. For example, a carpenter who works part time for a neighbor for cash is augmenting income earned in the formal sector. A recent survey of *shadow economy* activities in West Virginia reveals this pattern clearly. A high proportion of *shadow economy* activities are reported to be related to formal work patterns. It is also interesting to note that a relatively high proportion of West Virginia's economy is composed of activities that are easily transferred to the *shadow economy*. For example, West Virginia has high proportion of its labor force employed in construction and health care. Both of these industries are prominent among the types of activities undertaken in the shadow economy. Simply stated, a skilled cabinet maker working in the formal sector is more likely to make cabinets in the *shadow economy* than is an university economist.

Workers employed in seasonal jobs such as education, construction and tourism are also more likely to engage in informal activities in the off season. In many counties our schools are the biggest employer making the summer time ripe for growth in the *shadow economy*. Also, as the tourism industry grows in West Virginia, so too will the proportion of seasonal workers. This may lead to an expansion in the size of the *shadow economy* in the state.

Table 1, Types of Shadow Activities

Activity (for cash or exchange)	All Households	Participating in Shadow Economy
Household repair	9.7%	48.3%
Collect wood, coal , landscaping or yardwork	5.4%	26.7%
Hunt or fish	1.2%	4.8%
raise farm animals	2.3%	11.5%
grow non-farm animals	1.3%	6.5%
crafts	6.4%	30.5%
child care, nursing, housework	8.3%	18.2%
bookkeeping	3.4%	16.5%
percent of total households engaged in shadow economy		21.4% —

Source: Mencken, F. Carson and Sally Ward Maggard “Informal Economic Activity in West Virginia: A Descriptive And Multivariate Analysis”, in Inside West Virginia: Public Policy Perspectives for the 21st Century.

The economic impact of the *shadow economy* cannot be simply stated as a dollar value, or in terms of the income it generates. In addition to the costs of the *shadow economy*, such as potential lost taxes, it is also useful to note that the *shadow economy* may yield benefits, such as serving as a gateway to the formal sector. One goal of the *Center for Economic Options*, for example, is to create opportunities for participants in the *shadow economy* to transition into the formal sector if/when they choose to do so. Also, the *shadow economy* may be one of the few available sources of employment for some workers. Part of the labor force is simply not sufficiently productive to make their hiring in the formal sector profitable to firms. Understanding how the *shadow economy* reacts to the business cycle is also important for policymaking. The response of the shadow economy to a recession may either cushion or exaggerate the impact of an economic downturn.

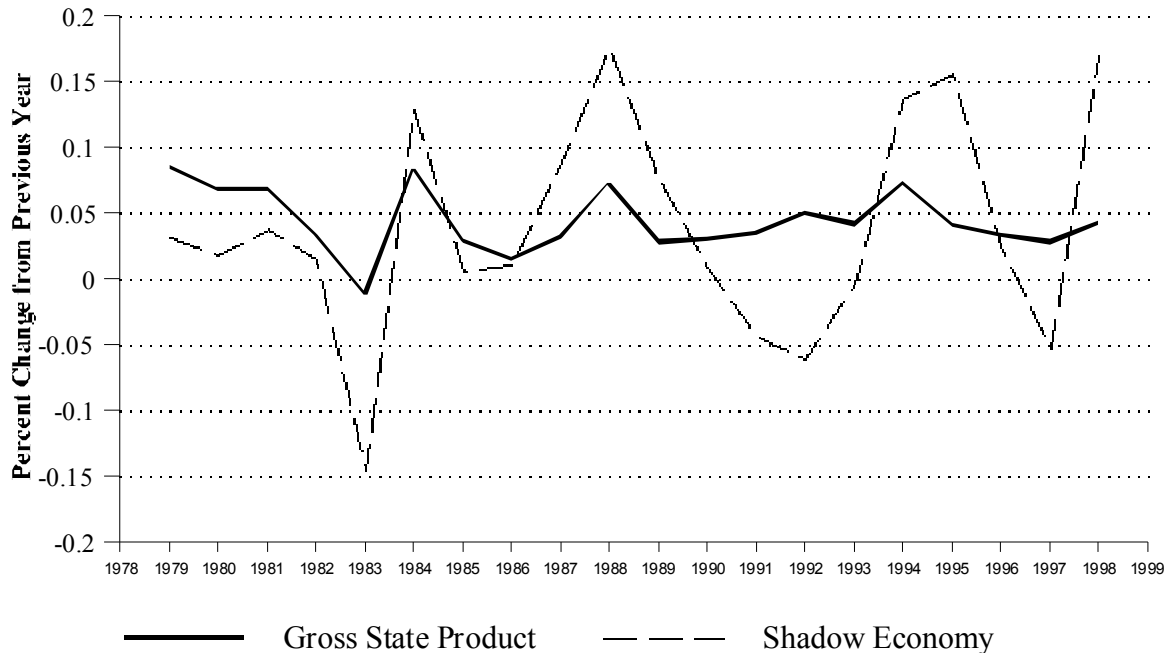


Figure 3, Percent Changes in the Formal and Shadow Economies in West Virginia

Finally, knowing the size and composition of the shadow economy is important in order to understand why it exists and how it affects West Virginia’s economy. Policies at the state and local level can address issues such as tax complexity, levels of taxation, education, access to capital and others factors that may influence the size and scope of the *shadow economy*.

Microbusiness By Choice

The Economic Impact of Microbusiness

By any measure, microbusiness represents an important part of our State’s economy. Simply the size of employment in small firms makes microbusiness an important force in the state; however, there are a great many other aspects that impact our economy. Many of the benefits of microbusiness are not obvious, yet may be much more critical to the maintenance of a robust economy than the direct impact of the firms themselves. This direct impact is easily defined. However, the more subtle, and perhaps more important contribution of microbusinesses is on their impact on labor markets, the business cycle and economic growth in the state. Also practical research strongly indicates that microbusinesses form mutually advantageous relationships with the communities in which they are located. Entrepreneurs often choose to be microbusiness owners because of their strong desire to stay in their communities and to improve the community through active civic involvement. Microbusiness owners are apt to spend their money locally, partner with other local microbusinesses for goods and services, and are less likely to leave an area during an economic downturn. Clearly, microbusinesses are often overlooked, but may turn out to be the economic engines in many communities -- especially in rural areas.

Economists often view firms as pure profit maximizers. There are many benefits of this approach, especially when evaluating the economy as a whole. It is also useful for describing the behavior of large businesses. However, this approach fails to explain a richness of firm behavior when there are aspects beyond pure profit maximization in the goals of the business. This is especially important in an examination of microbusiness.⁵ One recurring observation is that bigger firms can usually produce goods and services at lower per unit cost than smaller firms. These are known as *economies of scale*. High overhead costs are the primary cause of *economies of scale*. However, most microbusinesses (and many small businesses) produce goods and services at levels beneath the *economies of scale* range.



Five years ago, Mary Beth Furby and her partner Judy Huntz started a business called “Annie and Co.” to produce Raggedy Ann and Raggedy Andy dolls along with other crafts. Along the way, though, they have found another type of doll to produce that touches lives in many ways. Haunted by the memory of a young girl she met battling cancer and enduring chemotherapy, Mary Beth realized that a Raggedy Ann doll, before its hair is attached, resembled her young friend. Mary Beth and Judy began producing “Kemo Kids” – soft, eighteen inch dolls with big smiles, but no hair designed to brighten the lives of children fighting cancer. The dolls, Kemo Kody and Kemo Katy are dressed in colorful, removable clothing and are

produced in both light and dark skin tones. They also come with three colors of re-attachable hair that can be added when the child’s hair begins growing back.

Unlike a large toy manufacturer, Mary Beth and Judy have spent a lot of time finding ways to personalize their product and get them into the arms of children in need. They realized that parents whose children are undergoing chemotherapy may not be able to afford the dolls, and have worked to get businesses, churches, and organizations to buy and then donate the dolls to local hospitals in West Virginia. “We have to work for our market, but it is a labor of love,” Mary Beth said. Due to patient confidentiality, children’s names cannot be given out to hospitals and treatment centers. Mary Beth and Judy often work with life specialists or other hospital personnel to distribute Kemo Kids. Industries simply would not take the time to work like this; it would add too much overhead to the cost of the product. Mary Beth said, “I could send them overseas to be made cheaper, but I just don’t want to. Just to see the look on a child’s face when they receive a Kemo Kids doll is priceless.”

Why firms remain viable at production levels that do not result in the lowest per unit cost is a difficult question to answer. If these firms striving to grow, and will eventually achieve *economies of scale* then the existing theories explains their existence. However, many of these firms intentionally remain small. Analyzing this phenomenon is, in part, what this research agenda seeks to develop.

Two potential reasons for the contin-

ued presence of small firms have emerged. The first is that microbusinesses are not purely profit maximizing. In this explanation, small firms such as individual proprietorship and microbusinesses are interested in attributes other than profits. If not profit maximizing, factors such as location, working hours, etc. weigh heavily on the firms’ decision making. Of course, these factors are important to workers in large corporations as well, however individuals’ responses to these factors seldom influence firm size decisions. This does not suggest that larger firms are less sophisticated decision makers than smaller firms. Rather, it suggests that these factors do not influence a firm’s decision on size or production level. Large firms may accommodate a large, varied workforce by substituting higher wages, more benefits and incentives for the flexibility that smaller firms permit. Additionally, firms with only a handful of employees may seek to remain at their current size and forego more profitable levels of production to preserve aspects of the business that they appreciate more than additional monetary profit. These aspects may include a sense of artisanship, a close knit working relationship, flexible hours, reluctance to increase management responsibilities or the choice of location. Firms with workers that share these goals may choose appropriate production levels that jointly satisfy the goals, not one that simply maximizes monetary profits.

These issues are important because simple measures of wages does not capture the *flexibility* of microenterprises. And life-style flexibility may be more important to many individual workers than income. For example, the ability to assist in child care duties is clearly important to many workers, and

may be worth a direct income trade-off. This may be especially true since child care can be so costly for some workers that a lower paying or part time job with flexible hours *may actually yield a higher net income* than a fixed work week that pays a higher salary. This simple observation is absent from most policy discussions about wages and working conditions. As a result, a whole host of employment options are discouraged simply because they are not full time with extensive benefits. Policies that encourage only full-time jobs with benefits do not account for the value of life-style flexibility.

Market Flexibility and Microbusiness

Firms that operate beneath the *minimum efficient scale* and remain there would, under traditional explanations of industry dynamics, fail to survive. However, a large proportion of microbusinesses in West Virginia (perhaps more than 80 percent), remain modestly sized and flourish. The survival of these companies can be partially explained by their market flexibility. Anecdotally, in West Virginia many of the microbusinesses provide goods and services that are unavailable through larger enterprises. The state's microbusinesses are, in part, gap providers of specialty items. This is a flexibility that permits firms that can vary quality, quantity, service and location to flourish, even when they do not enjoy *economies of scale*.

The importance of flexibility in the production of goods and services cannot be overstated. A 1998 study found that the information flows between the largest and smallest firms in two very different industries led to dramatic delays in price changes. Indeed, in these markets the smallest firms were able to adjust prices to changes in demand over two months more quickly than the largest firms.⁶ These findings strongly reinforce the contentions that small firms may be able to survive simply through increased flexibility in business: pricing, quality, quantity, service and location. Two other researchers found that interfirm linkages, and small firm networks were able to replicate (or in some cases improve upon) the *economies of scale* inherent in larger firms.⁷ The flexibility of small firms permits them to survive and even flourish.

Labor Market and Microbusiness

The performance of labor markets is perhaps the most critical part of success in the overall economy. The flexibility of labor markets in the United States is credited with the unusually strong growth of the economy relative to that of other developed nations.

Sometimes, opportunity knocks loud enough for several people to hear. Recently, Kay Kingry, owner of Dark Hollow Foods opened the door of opportunity for herself and in



doing so, spread the opportunity to many others. Kay was presented with a chance to rent retail space at the Charleston Town Center Mall from October through December 2000. Unable to underwrite the space alone, she approached the Center for Economic Options, a non-profit organization that works with small-scale entrepreneurs, to see if a mutually beneficial arrangement could be reached. Diana Sowards, an entrepreneur with retail and merchandising experience collaborated with Kay, and signed a limited term agreement to open and manage "Showcase West Virginia" with the Center for Economic Options underwriting the space.

Housing over forty small-scale vendors, Showcase West Virginia is allowing many people to access a high-end retail market during the important holiday shopping season. "This is a good opportunity for small business people and something they could not afford to do individually for three months," said Kay. Diana added, "This venture ended up helping more than twice the original number of people we thought." Vendors contribute a small amount of their product to see if there is a market for it. Since products are sold on consignment, items that do not move readily are taken off the shelves through mutual agreement with Kay and Diana. However, if a product sells, the vendor is often able to double his or her wholesale price. Vendors are paid every two-weeks.

As a small business, Showcase West Virginia can be flexible and respond quickly to market demands and inquiries. The managers are able to work closely with the vendors to arrange product tastings, live demonstrations and special promotions. Showcase West Virginia has responded to market need, and has made selling at a retail outlet possible for many businesses.

Indeed, much effort in Europe is expended attempting to replicate, through policy, the flexibility of U.S. labor markets in order to capture the dynamic growth of the U.S. economy. A study undertaken by the *Corporation for Enterprise Development* outlined several social factors that are associated with entrepreneurship. These factors, when evaluated in the U.S. and Europe, illustrate a stark difference in the entrepreneurial climate of the two areas. Indeed, the greatest challenge facing European integration may well be the inflexibility of their labor markets. This problem threatens not only their economic growth but also the long term stability of the single European currency.

Labor market flexibility can be addressed through policy. Policies which support short duration employment, casual employment and part time employment allow workers to engage in these

type of activities. While it is a shared value that high wage, high productivity full time employment is a desirable component of labor markets, flexibility is equally important.

There is widespread evidence that smaller firms offer greater flexibility to workers than do larger firms. This flexibility takes two forms: easier entrance by workers into the labor market, and flexibility within the labor market. The first form of flexibility is critical to the performance of the economy in that it potentially shortens the duration of unemployment for individual workers. This is important as it reduces the duration of frictional unemployment and may reduce the length of cyclical unemployment. This leads directly to shorter recessions.

The second important contribution of small businesses is that they may serve as an important gateway to the formal labor market. Small businesses, as we have already mentioned, offer considerable flexibility in terms of pricing, quality, quantity and location. Though the evidence is not yet fully developed, there is some suggestion in labor market research of greater entrance and hourly flexibility in small business. Indeed, we suspect that much of the reason this issue has not received more formal research is that it appears as common sense that smaller firms will



Diana Sowards and her daughter Michelle Rainey love to take individual items and compile them into beautiful arrangements. So it seemed a natural step to create beautiful gift baskets designed and filled with primarily West Virginia-made products. Not long

after going into business, Diana and Michelle were approached by the Embassy Suites hotel in downtown Charleston to run their gift store. With no business experience, they ventured into the gift shop business. The hotel customers were not, however, the right market for their high-end gift baskets. Everything started going down hill at that point. Diana said, "We were basically [marketing] for companies without getting paid for it. It became harder and harder to do. People had a different perspective of what a hotel gift shop should be and not all the wonderful things we had." After two and a half years of struggle at Embassy Suites and eleven days before their contract was up, the hotel told them they had sold the retail space to someone else.

With this economic downturn, mother and daughter had to try another avenue to keep their business afloat. Since they are a very small business and therefore very flexible, they were able to change their business right away and find new markets for their baskets and are now selling baskets in a high-end retail shop in the Charleston Town Center Mall.

Michelle said, "Because we were a small company we could be more flexible. Where a larger company has a set way of doing things." Her experience has made them aware of several business realities such as managing debt and marketing. Michelle said, knowing what they know now, "If we had gone into the hotel, we would have done it only as a hotel gift shop. We thought we would be able to sell a lot of baskets through the hotel and that we could market our company in the Charleston area. We realized we could not be anything but a hotel gift shop."

Through determination and their willingness to succeed, not just for themselves, but their family, *Gifts of State* has survived this hard time and is still growing their business today. Although money was their largest obstacle because they didn't have the resources or clout that a bigger company would have, but because they were smaller they could investigate many more opportunities that larger business would not have had the flexibility to be able to explore. Many times they felt like quitting, but never did. They just regrouped their ideas and went on. If they had quit, they would have missed the great marketing opportunities they currently are working on now.

better be able to accommodate part time, special needs and nontraditional workers. Incidentally, it appears that larger firms are attempting to engage in more flexible hiring and employment practices, much like those already used by small firms.

The flexibility of labor markets also has a social value which is difficult to measure, but critical to West Virginia and Appalachia as a whole. The high levels of structural unemployment, low levels of labor force participation, and dense clusters of poverty make the presence of microbusiness important to the region's long term success. Simply, as West Virginia has experienced a long term decline in employment in large firms, and sectoral declines in employment in manufacturing and mining, there is an increasing need for labor market flexibility. Microbusinesses appear to provide this flexibility.

Innovation and Growth

The higher growth rate attributable to the presence of smaller firms may be explained in a number of ways. First, the labor market flexibility discussed earlier is an important component to enhancing overall productivity in the economy. Second, the ability of smaller firms to develop quality, quantity and pricing niches that larger firms cannot is important.⁹ Third, smaller businesses tend to provide a seed bed for technological development and innovation. One recent study found that the ratio of Research and Development spending to actual innovation was much more favorable in small businesses.¹⁰ Fourth, it is possible that small businesses are more productive. This means that they simply produce more goods and services, per worker, than do larger business. Smaller businesses are more productive in West Virginia than their larger counterparts. This is true even when we account for the industry in which each operate. Figure 4 illustrates a sampling of the State's industries, by productivity and size. (Note: the downward regression line illustrated holds throughout the sample, though this graph illustrates only about 85 percent of the firms in the state. The sample was reduced only to make the graph readable.) This relationship is simple data, the cause and implications are not yet fully understood. This last hypothesis needs much further development. That is one of the many questions this research will seek to answer.

Figure 4, Productivity of West Virginia Workers, by Firm Size

FIGURE MISSING

Finally, the impact of microbusinesses on the macroeconomy and microeconomy in West Virginia is only partly known. The need for more research into microbusinesses and small to medium-sized enterprises is clear.

Microbusiness and the Macroeconomy

Strong performance of the

economy is an important goal of fiscal policy. Governments choose a set of taxation and expenditure goals that provide the mix of public services that individuals and businesses need. These include education, physical infrastructure and a healthy legal environment. The policies employed at the federal, state and local level play an important role on the overall economy and on individuals and firms directly. This research is directed at recommending an appropriate set of policies. In formulating these policies much attention has been paid to the immediate impact on firms. This is also the goal of most traditional economic development policies such as tax abatements and worker training programs.

Policies directed specifically at microbusinesses should be predicated on an understanding of the role of microbusiness in the overall performance of the economy. If, as much evidence suggests, microbusinesses play a key role in enhancing the performance of the economy, then policies directed at its growth are of potential benefit. If the impact of firms on the aggregate economy does not vary with firm size then fiscal and economic development policy should provide a neutral affect on firms with respect to size. Today, most economic development and fiscal policy is not size neutral. Indeed, despite much evidence that smaller firms play a greater role in the performance of the economy than do larger firms, most development and fiscal policy remains biased in favor of larger firms. While these issues need much greater exploration, here we will offer several brief explanations as to why microbusinesses are of greater relative importance to the overall economy than larger firms.

Microbusiness and Economic Growth

Growth in per capita income and production offer obvious benefits to society; such as more consumer goods, better housing and higher education. There are other more subtle benefits such as more leisure time, greater choice in living arrangements, greater options regarding location, and choice of career. Similarly, the range of choices offered to more affluent regions represent a more attractive set of options. While it is easy to become immersed in the current national debate regarding health care, the

When Todd Harrell was thirteen, he had his first business cards. “Harrell Cartoon Originals” was the name of his first business, and as a teenager living in Los Angeles, spent his spare time, and made spare money by hanging out at airports, drawing caricatures of people’s planes. When he moved to West Virginia, a few years later, he found fewer people with airplanes to draw, but discovered he could make a profit drawing people’s souped-up trucks and vans. While he attended Marshall University pursuing a Fine Arts Degree, Harrell painted signs for local businesses, designed logos and tee-shirts, and produced 3-D models and graphics for legal firms. “I’ve always done things to make money,” Harrell says, “the trick is finding a niche, and filling it.”

After college, Harrell moved to Lexington Kentucky and went to work for an ad agency. Around this time, he also started getting serious about his sport – skydiving. “Skydiving is not a cheap sport, and to get equipment, I started designing ads for equipment manufactures and trading them for what I needed,” stated Harrell.

Harrell quit his day job with the ad agency, and started working exclusively for the skydiving industry. Looking at the trends, he got in on the first floor of the digital revolution and equipped his studio with cutting edge computers. He supplied print advertising for dozens of companies that ran in magazines around the world. When Harrell moved back to West Virginia in 1996, he brought his business with him, and formalized “Techna Design Studio.” Techna provides high-end imaging to larger ad agencies and other larger companies that do not wish to invest in building their own digital imaging departments.

“I could not find a job doing what I do that would have paid a decent wage in Charleston, West Virginia,” he said. “Working for myself was my only option.”

environment and a social safety net, these are a *much preferable* set of problems to those faced in poor countries. Simply, all things being equal, high levels of per capita income and production are preferable.

Microbusinesses play an interesting role in supporting economic growth. For instance, a number of studies have indicated that economies with higher proportions of microenterprises grow faster than those with lower proportions. Also, research suggests that in terms of impact on the economy, education and training offers more benefits to long-term growth than does almost any other public investment (This is a recurring finding in economics, and one that will perhaps become popularized in policy circles with the 2000 award of the Nobel Prize in Economic Science to James Heckman, the leading researcher in the field). It is also commonly believed that on-the-job training is superior to off-site training. If this is the case, then microbusinesses, due to their labor market flexibility, may allow a significant number of people to gain direct experience through work, as well as allowing people to continue formal schooling due to their overall high tolerance for flexible scheduling. Therefore, microbusinesses may be contributing to economic growth several different ways.

Taxation and Microbusiness

A system of taxation also influences economic growth.

There is a strong consensus on a set of goods and services that should be produced by governments-- it is the quantity of these services that is typically at issue in the United States. The following are common goals of tax policy:

- Taxes should be collected to provide goods and services in ways that provide stable and buoyant revenue sources that do not overly fluctuate with the business cycles' series of recessions and booms.
- The tax system should be neutral and economically efficient. This means that the system should not modify behavior or reduce production in ways that are unintended. For example we may want to heavily tax cigarettes and alcohol in an effort to reduce their use, an unintended consequence of this would be extending the tax to medical-use alcohol employed in disease prevention. That would be a non-neutral and economically inefficient tax.
- Equity in a tax system is valued. This is a more difficult measure than the others, but

Rags to Rugs is a business run by the Shack Neighborhood Community Center, and is comprised of a network of weavers that turn recycled material into high-quality hand-loomed rugs, purses, and bags. The idea behind the business was to train people as weavers and then sell the merchandise at a profit sufficient to pay them. Project coordinator, Patty Davidson oversees the non-profit program for the community center, but hopes Rags to Rugs will be a stand-alone business within five years. "We would have to make between \$30,000 and \$50,000 per year to be sustainable," she said, "and we are a long way from that goal." The weavers are, however, in the process of increasing the amount of product and Patty recently found a new market she hopes will increase their sales.

All fabrics are donated, and most rugs are an average of 20x30 inches. Each rug is unique due to the type of materials available, and some of the more distinct rugs retain the character of the material of which it was made. Blue jeans for instance make a unique, durable rug, and rugs made from sweatshirts retain the softness and feel of the fabric. Each weaver is paid per inch and makes approximately \$6.00 per hour at the loom.

Rags to Rugs is more than a money-making venture, though. The Center runs the business as a way to teach low-skilled workers about business and life skills. As they work to fulfill orders, the weavers are also building their resumes. The weavers usually graduate out of the program, and Patty reports that after their experience with Rags to Rugs some have decided to pursue wage-based jobs— perhaps for the first time.



Patty says that Rags to Rugs has benefited from starting out as a very small company because they have not had to overstep their financial boundaries. The size, she believes, has led to greater stabilization. "I think part of the success of business is that the marketing plan and policies are very flexible," she says.

perhaps the best method of measuring equity is to evaluate whether like individuals pay similar amounts and whether benefits flowing to taxpayers proportionately represent their payment to the system.

■ Finally, a tax system can influence the economy through its method of administration and ease of compliance. A tax system which is difficult to administer is more costly, and one which is difficult to comply with will move more taxpayers out of the formal sector and discouraging entrepreneurial activity.

In the Spring of 2000 Governor Underwood unveiled the results of the two year bipartisan *Governor's Commission on Fair Taxation*. The *Commission* recommended a series of reforms that would dramatically correct most of the shortcomings in West Virginia's current tax system. Most importantly, the proposed comprehensive tax reform would eliminate the *Business Franchise Tax* on capital. The BFT tax directly levies taxes on the value of physical capital in businesses. This tax, designed in earlier times when the bulk of the state's businesses could not relocate regardless of tax pressures, acts as a tremendous disincentive to new investment in the state. West Virginia businesses that employ a great deal of physical capital in production are disincentivized to invest under the current system. This violation of one of the basic premises of a tax system severely weakens the state's economy because it lowers the productivity of the work force and reduces incomes. If the tax system is corrected, West Virginia may experience the expansion of business of all kinds, including microbusiness. Also, it is likely that part of the *shadow economy* will re-enter the formal economy as taxes on their productive capital are replaced with a more equitable and neutral system.

Economic Development Policy

West Virginia, like most other states, designates economic development policies to the administration of by the *West Virginia Development Office* and local development organizations. The state may recognize the role of Education and Tax and Revenue on economic growth, but the Development Office can adjust policies in a very short amount of time. Many of the policies take a short-term approach to correcting the basic flaws in the state's tax system, thus making West Virginia more attractive in terms of investment. However, most economic research questions the effectiveness of many of the policies evoked by states' development offices work. For example, many areas offer tax abatements and infrastructure incentives.

There are several issues with this approach: first, it is unlikely that state government can identify and offer incentives to only "good deals" in a dynamic economy. Second, even if a state can target industries with high probabilities of success, it must then either increase taxes on reduce services to existing businesses and consumers. By so doing the state is either increasing the cost of doing business or shrinking markets for the existing firms. And existing firms are responsible for creating the bulk of new jobs in the state. Essentially, for every 100 jobs created through the economic development policies there is the potential for destroying or preventing the creation of *more* than 100 jobs. Economic development incentive policies are constrained by the simple arithmetic of job creation and destruction. It is a virtual certainty that the host of economic development policies are not causing the economy to grow.

Indeed, data from the 1990's suggests that *existing firms in the economy account for 69 percent of net employment growth* over a three year period. Taxing these firms more heavily in order to encourage new firms to enter the market is likely to have slowed overall economic growth by inhibiting expansion in existing firms.

In addition to slowing economic development, many of these policies have traditionally not been equitable to small businesses. West Virginia's *Super Tax Credit* exemplifies the overemphasis on larger corporations in the state. Fortunately, in recent years an extension of the WVDO policies into the realm of smaller enterprises has occurred. The Governor's *Small Business Work Force Program* is an example of training support directed to small business. However, most policies focus on rewarding businesses based on traditional measures of "success" such as numbers of employees, amount of investment, and increasing profits. As discussed earlier, many microbusinesses may be in an extreme disadvantage in they may choose to remain small to take advantage of the benefits of flexibility, location, and desire for manageability.

Additional research is indicated to determine more appropriate measures of "success" for microbusinesses and develop policies to support this important sector of the economy. The Development Office may be better served to focus on providing data on markets, regulations and other key business information, rather than advancing policies and incentives which may actually contribute to economic decline.

If limited interventionist policies are to be recommended, what role then does microbusiness play in economic growth? In West Virginia the answer is easy. Microbusinesses are critical to economic growth. While one of the long term goals of the *Center for Economic Options* and the *Center for Business and Economic Research* is to

Floridian Teresa Fisher moved to West Virginia several years ago to be closer to her family. As a licensed massage therapist, she was able to bring her business with her. However, she found that massage therapy and other forms of "alternative medicine" were not as widely accepted in West Virginia as in her home state. For instance, massage therapist have only been licensed in West Virginia since July 1998, while in Florida, they are not only licensed, but in 1998 were placed under the same governing board as Doctors and nurses.

Regardless, she opened her business "Rehabilitative Massage Therapy" and found a location in which to set up shop. Her business was started with a small amount of her personal savings, and her largest expense was rent. Open for the past six months, Teresa found the first couple months to be very lucrative, but after this period business fell off drastically, "I think that after one treatment, a lot of my patients just got better, and didn't feel like they needed to come again," she said. "The area is just not ready for me. I started off with the bare minimum so I would be able to keep my prices affordable." She has had to lower her prices significantly compared to what she was charging in Florida.

Unfazed by the downturn in her business, Teresa reviewed her situation and made the decision to close her business' physical location and focus on serving her clients on-site at their homes or businesses. Almost half of her clientele were served on-site anyway, and by closing the physical location, Teresa removed her greatest overhead cost. "I needed to do something before going into debt and losing everything," she said. "I wanted to make a difference here and I think I did with the people I got to touch and get in contact with. I just have to take a different avenue, now." Yet, Teresa believes that if she had been a larger business, or had taken out loans to repay, she could not have made the necessary adjustments in her business plan. She has no regrets about opening her business, and has learned a lot from the experience. "It's not about the money to me. All I want to do is make enough money to keep going and pay my own domestic bills. I love what I do," she said.



quantify and trace the impact of microbusinesses on the economy, a few key issues are already known: first, the presence of microbusinesses (and small business in general) is strongly correlated with higher levels of economic growth. More clearly, the higher the proportion of smaller firms in an economy, the more diverse the economy, and the higher the overall growth rate.

The Future of Microbusiness Research

The *Center for Economic Options* and the *Center for Business and Economic Research* are embarking on an ambitious, multi-year examination of the role of microbusinesses on the state's economy. This work will consist of a partnership that seeks to link the academic research in economics and other social sciences with the experiences and practical research of community nonprofit development organizations. The result will be comprehensive findings and recommendations to be used to enhance the role of microbusinesses, where appropriate, in the state's economy. The questions we will ask include the following:

- How do microbusinesses enhance economic growth?
- How do microbusinesses support economic development, especially in rural areas?
- What specific characteristics of entrepreneurship can be taught in our schools and universities?
- What are the major inhibitors to microbusiness growth, and how can they be removed?
- What are the social benefits to microbusiness that cannot be easily measured?
- What role can the private sector, government, non-profits and universities play in microbusiness development?
- How can we further evaluate the role and complexity of the shadow economy?

Authors:

Michael Hicks is the Director of Research, *Center for Business and Economic Research* and assistant professor of finance and economics at Marshall University's *Lewis College of Business*. He is the author of studies on taxation, economic development, and firm behavior. He has also authored several economic forecasts for federal, state and local governments as well as private industry. He has a B.A. from Virginia Military Institute and an M.A. and Ph.D. from the University of Tennessee.

Marilyn Wrenn Harrell is the Manager of Research and Development at the Center for Economic Options. She has extensive experience in community and economic development and has worked with many rural communities to find strategies to sustainably grow economies. She has a B.S. and a M.A. in Communications from the University of Kentucky.

Ashley Summitt, is a graduate of Hollins College, and obtained her Masters degree from the London School of Economics. After ten years in community economic development field, she recently received her J.D. from the Northeastern University School of Law, where she was a *Peggy Browning Fellow*. She joined the Center for Economic Options in its work to promote economic development in West Virginia through the creation of microbusiness.

Amy Broughton is a graduate student in the *Lewis College of Business* and research assistant at the *Center for Economic Options* and the *Center for Business and Economic Research*. She is the author of economic development studies in Kentucky and West Virginia. She has a B.A. from Marshall University and is a native of Ashland, Kentucky.

End Notes:

¹Though part of the variation is due to data irregularities (such as firms that have actually closed down remaining as sole proprietors) this is a minor instance. The *West Virginia Bureau of Employment Programs* uses data on firm size for only those firms registering with them for unemployment insurance. This dramatically biases the sample so that these data do not capture actual distribution of firms by size.

²A recent book by Hernando de Soto, *The Mystery of Capital*, outlines a great deal of evidence that this has led to dramatically slower economic growth in parts of that country. While it is possible that physical capital is not easily transferred from the shadow to formal sectors of the economy, it is more likely that this is a problem for human capital.

³It is important to note though, that a recent study by Richard R. Clayton Marijuana in the “Third World” Appalachia, U.S.A., found that eastern Kentucky suffered from an unusually high level of marijuana growth. In Elliot County, for example, \$21M of production was estimated in a county where total personal income was only \$70 M per year. These numbers frankly seem a bit high for West Virginia. Notably, the high cyclical nature of the shadow economy suggests the bulk of its production is in legal areas, since illegal activities do not diminish in a recession. In any event the immediate damage to the economy related to illicit drugs is at their point of use, not their point of production.

⁴The two techniques are the Multiple Input - Multiple Cause method which uses a nested multiple regression model to estimate the annual change in the shadow economy which is then anchored using a money demand equation (Giles, 1999). This is a very technically challenging method. An alternative method is to compare the proportion of currency in circulation to that which should be used to support measured economic transactions in the State (this is also known as the *missing money* technique). Both methods yielded remarkably similar results.

⁵Among the earliest explanations for the formation of firms was that they exist to minimize the transactions costs of organizing production. This theory was developed by Ronald Coase in 1937, for which he received the 1991 Nobel Prize in Economics. This explains both the existences of firms and of coordination organizations (like the *Center for Economic Options*).

⁶Hicks, Michael J. Hierarchical Delays as a Source of Sticky Prices: Evidence From Two Workably Competitive Markets, Ph.D. Dissertation, University of Tennessee, 1998.

⁷Lazerson, M “Organizational Growth of Small Firms: An Outcome of Markets and Hierarchies?” *American Sociological Review*, 53(3), pp 330-342, 1998; Gomes-Cassey, B *The Alliance Revolution: The Shape of Business Rivalry*, Cambridge, Mass, Harvard University Press. 1998.

⁸It should be noted that the WVDO, like many other state and local economic development agencies employs data on new job announcements published by *Site Selection Handbook*. This data source counts only new jobs announced by firms (almost always those relocating to an area) even if they are expected to occur at some distant date.

⁹It is interesting to note that the dominant explanation for the cause of business cycles relies on the inability of firms to exploit changes in these attributes. These theories, often referred to as New-Keynesian economics employs rigidities in wages and prices to empirically model business cycle activities. So, though it has yet to be evaluated statistically, the presence of firms able to rapidly make price, quality and quantity adjustments may act to stabilize an economy.

