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Down-Sizing the “Little Guy” Myth in Legal Definitions

Mirit Eyal-Cohen*

ABSTRACT: What is a “small business” in the eyes of the law? There is not one standard definition. Current legal definitions of a firm’s size are inconsistent and overinclusive. They vary from one area of the law to another and within various sections of the same law. They create a skewed picture and result in data distortion that reinforces favoritism toward small entities, as studies on the contribution of small businesses to the economy are greatly dependent on these studies’ delineation of the term “small.” In this time of huge deficits and rise in economic inequality, a lot of money is being spent based on the entrenched belief that small firms are the essence of our economy, which is not necessarily true. Therefore, this Article argues that the current focus on size in many legal definitions is a waste of both time and money.

This Article provides a comprehensive survey of legal definitions of small entities and the policy considerations that underlie these delineations. This Article concludes that the historical emphasis on magnitude no longer functions effectively. Current legal demarcations concentrated on “smallness” generate undesirable distributional effects, produce inefficient allocation of government resources, and defeat policy considerations of promoting entrepreneurship and economic growth. The recent proposal to integrate the Small Business Administration with other federal commerce and trade agencies into one super pro-business agency is yet one more step toward this proposed shift from a size-centered to a goal-driven approach.

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* Assistant Professor of Law, University of Pittsburgh School of Law. I thank Steven Bank, Ilan Benshalom, Pat Chew, David Herring, Bernard Hibbitts, Eric Jensen, Anthony Infanti, Assaf Likhovski, Jules Lobel, Orly Lobel, Michael Madison, Lu-In Wang, Rhonda Wasserman, as well as participants from the Case Western Reserve University School of Law faculty workshop and the University of Pittsburgh Junior Faculty workshop. A special thanks to Peter Oh for his valuable advice through the process of writing this Article. I also thank Associate Director of Public Services at Barco Law Library Marc Silverman and research assistants Jeremy Rivet and Tara Tighe for their research support. Finally, this Article would not have been possible without the encouragement of my loving husband, Tamir, to whom this Article is dedicated.

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I. INTRODUCTION

Small business represents the essence of the free-enterprise system and the American dream.¹ In recent years, there has been a growing interest in examining the degree to which small businesses contribute to economic growth.² Small entities are regarded as the job engine of the U.S. economy and are viewed as the source of entrepreneurship and innovation.³ In his 2012 State of the Union Address, President Obama stated:

[W]e should support everyone who’s willing to work, and every risk-taker and entrepreneur who aspires to become the next Steve Jobs.

After all, innovation is what America has always been about. Most new jobs are created in start-ups and small businesses. So let’s pass an agenda that helps them succeed. Tear down regulations that prevent aspiring entrepreneurs from getting the financing to grow.⁴

But just what is a “small” business? Depending on where one looks in U.S. laws, the definitions vary, and they differ from one section to another.⁵ During the nineteenth century, a personal relationship between the owners of a firm and their employees was one of the main characteristics that courts looked for when identifying an entity as a small business.⁶ Without a clear definition, other courts resorted to the “I will know it when I see it”

1. See generally Mirit Eyal-Cohen, *Why Is Small Business the Chief Business of Congress?*, 43 RUTGERS L.J. 1 (2012) (reviewing at length these justifications and their effect as positive feedback that reinforce the path dependence of small-business preferences, and concluding that these justifications reflect today’s small-business culture of continuously reinforcing glorification of these entities and the expansion of their preferential legal treatment).

2. In this Article the term “small business” is used in its singular form to denote the concept and values attributed to this term, whereas the plural “small businesses” is used when describing routine actions of small firms.

3. See *infra* Part II.B.

4. President Barack Obama, State of the Union Address (Jan. 24, 2012), available at <http://www.whitehouse.gov/the-press-office/2012/01/24/remarks-president-state-union-address>.

5. See MATTHEW KNITTEL ET AL., U.S. DEP’T OF THE TREASURY, METHODOLOGY TO IDENTIFY SMALL BUSINESSES AND THEIR OWNERS 2 (2011), available at <http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2011-04-Small-Business-Methodology-Aug-8-2011.pdf> (“[A] consensus does not exist regarding the specific attributes that distinguish small businesses from other firms.”); Martin A. Sullivan, *The Myth of Mom-and-Pop Businesses*, TAX ANALYSTS (Sept. 12, 2011, 9:42 AM), <http://www.taxanalysts.com/taxcom/taxblog.nsf/Permalink/UBEN-8LMHY5?OpenDocument> (“What exactly is a small business? There is no one answer.”); *infra* Part III.

6. See, e.g., *Andrews Bros. Co. v. Youngstown Coke Co.*, 86 F. 585, 591 (6th Cir. 1898) (“[For] small business corporations, . . . the personnel of the members is a matter of some importance, and is the only feature which particularly distinguishes these associations from ordinary corporations.”).

approach.⁷ The first legislative attempt to define a small-business enterprise was in 1947, by a proposed amendment to the Clayton Act, according to the entity's share of total national sales.⁸ This description did not persist, however, and soon other delineations of small firms appeared.

Historically, there have been at least three main defining characteristics of a "small" entity. First are the criteria involving an entity's total of revenue, sales, receipts, or profits.⁹ Second are criteria based on number of employees, a distinction that stems from the historical image of "mom and pop" shops that represents a romantic notion of small-business operations as friendly, personalized local dealers.¹⁰ Third, some legislation uses a measure of total assets to separate "small" businesses from midsize and large ones.¹¹ Today, a firm's number of employees is the main standard the Small Business Administration ("SBA") uses to define a small business; it considers most firms with 500 employees or fewer to be "small."¹² This size benchmark is, in effect, a historical remnant of a standard set by the Smaller War Plants Corporation created during World War II in order to urge federal agencies

7. See *O'Harra v. Littlejohn*, 69 F. Supp. 274, 276-77 (D.D.C. 1946) (stating that the legislature never defined a small business and left it up to administrators of different agencies to define it but concluding that "[i]t is clear that plaintiff dominates bus transportation in Alaska, and that, for Alaska, his enterprise is a large business").

8. Clayton Act, Pub. L. No. 63-212, 38 Stat. 730 (1914) (codified as amended at 15 U.S.C. §§ 12-27 and 29 U.S.C. §§ 52-53 (2006)); see *Amending Sections 7 and 11 of the Clayton Act, Hearings Before Subcomm. No. 2 of the H. Comm. on the Judiciary*, 80th Cong. 151-52 (1947) [hereinafter *Hearings on the Clayton Act*] ("[S]mall business corporations [are those] whose sales before and after acquisition would not represent 5 percent of the total in their respective lines of trade, either locally or on a national scale.").

9. See, e.g., 21 U.S.C. § 343(q)(5)(D) (2006) (providing that firms with annual gross total sales to consumers of not more than \$500,000 are exempt from the Food and Drug Administration Modernization Act); 29 U.S.C. § 203(s)(1)(A) (2006) (stating that a firm with annual gross sales under \$500,000 is exempt from the Fair Labor Standards Act).

10. See, e.g., David W. Boyd, *From "Mom and Pop" to Wal-Mart: The Impact of the Consumer Goods Pricing Act of 1975 on the Retail Sector in the United States*, 31 J. ECON. ISSUES 223, 223-24 (1997) (arguing that the Consumer Goods Pricing Act of 1975 had a crucial effect on higher-service, generally smaller, local retail proprietorships); Russell S. Sobel & Andrea M. Dean, *Has Wal-Mart Buried Mom and Pop?: The Impact of Wal-Mart on Self-Employment and Small Establishments in the United States*, 46 ECON. INQUIRY 676 (2008).

11. For example, the capital-gains tax preference introduced in the Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 416 (codified as amended in scattered sections of 19, 26 U.S.C. (2006)), is limited to firms with fifty million dollars or less in assets. See *infra* Part III.F.

12. Currently, the SBA generally defines an industrial small business as an enterprise with 500 to 1500 employees and a small retailer as an enterprise with annual receipts of \$7 million to \$35.5 million. U.S. SMALL BUS. ADMIN., TABLE OF SMALL BUSINESS SIZE STANDARDS MATCHED TO NORTH AMERICAN INDUSTRY CLASSIFICATION SYSTEM CODES 7-20, 23-26 (2012), available at [http://www.sba.gov/sites/default/files/files/Size_Standards_Table\(1\).pdf](http://www.sba.gov/sites/default/files/files/Size_Standards_Table(1).pdf). Furthermore, the SBA size standard found in 13 C.F.R. § 121.201 (2012) contains a list itemizing small-business size standards according to the North American Industry Classification System. See *id.* at 1.

and big businesses to increase the participation of small businesses in procurement contracts.¹³

What these typical criteria fail to actually assess, however, are the policy considerations, legislative intent, and prerequisites for defining a small-business enterprise. The U.S. government has been cultivating the notion that the key to a prosperous economy resides with entrepreneurial businesses.¹⁴ Consequently, Congress set out to encourage firms that have the ability to stimulate economic growth to do so.¹⁵ Nevertheless, is supporting "smallness" the best means to this end? Do small businesses today, by virtue of their size, stimulate the economy? It seems that, amid the discussion about how to reward "smallness," the primary goals of preserving a free-enterprise system, encouraging entrepreneurship, and incentivizing job creation—all of which sparked this discussion—have been essentially pushed aside in the race to win voters' hearts.¹⁶ Instead, the law's small-business favoritism continues to be expanded without accounting for the merits that these small entities are said to provide. Consequently, there is currently a vast disconnect between the government's perception of small business and the public's view of who those entities really are.¹⁷

Scholars have paid limited attention to the contextual conditions that moderate the efficiency of small entities. This Article scrutinizes the circumstantial delineations of small firms, which directly affect our ability to answer the question of whether they are indeed effective in stimulating the economy and creating a healthier job market. The Article argues that

13. Eyal-Cohen, *supra* note 1, at 32.

14. See Lawrence H. Summers, Remarks at the Presidential Summit on Entrepreneurship: Entrepreneurship and the Global Economy (Apr. 27, 2010), available at <http://www.whitehouse.gov/administration/eop/nec/speeches/entrepreneurship-global-economy> (suggesting that entrepreneurship drives economic growth in three critical ways: fostering competition, facilitating new technologies, and providing opportunities); see also 155 CONG. REC. 13,102 (2009) (statement of Rep. Etheridge) ("The American spirit of entrepreneurship is one of the key values that have made our nation great."); 144 CONG. REC. 1254 (1998) (statement of Rep. Waters) ("As we reflect on our history, I am more convinced now than ever that economic development through black entrepreneurship is a key to creating jobs, wealth and opportunities in our communities."); cf. JEANNE HOLDEN, *Entrepreneurship Aids the Economy*, in PRINCIPLES OF ENTREPRENEURSHIP (2007), available at <http://www.america.gov/publications/books/principles-of-entrepreneurship.html> ("[E]ntrepreneurship is essential to the vitality of any economy, developed or developing.").

15. See, e.g., 139 CONG. REC. 2723 (1993) ("These are high risk seed capital investments. There is no more important capital formation in the life of a business and these are the investments we most need to encourage with a new capital formation incentive. . . . This is what has made America so prosperous and free. This is the world of direct venture and seed capital investments.").

16. See *infra* notes 125, 130, 280.

17. See Bernard Featherman, *Small Business Administrator on Cabinet Is Good First Step*, J. TRIB. (Jan. 26, 2012), <http://www.journaltribune.com/articles/2012/01/26/columnist/doc4f216bea62300887094896.txt> ("While these numbers may sound like large companies, most small businesses really are small.").

current legal definitions of small entities suffer from several problems. First, they are inconsistent and vary from one area of the law to another and within each section. While variability appears desirable in some instances in the law, here it does not serve the entities it seeks to benefit. Instead, the different characteristics used to define “smallness” capture the absolute majority of all firms and result in undesirable distributional effects. Second, current legal definitions focused on magnitude are ineffective in allocating government resources, and instead of simplifying life for business owners, the definitions create unnecessary litigation and increased compliance costs.¹⁸ These overly broad legal definitions create a skewed picture when used in studies measuring the contribution of small business to economic growth. Lastly, economic stimulus, job creation, and the promotion of entrepreneurship will not be accomplished by focusing merely on size, but by crafting purposive definitions that will target and reward entities according to the activities the government seeks to encourage. *De facto*, current firms’ size classifications do not identify correctly those entities that indeed stimulate the economy because not every plumber, contractor, electrician, or lawyer creates jobs and represents the heart of free enterprise.¹⁹

Part II begins by outlining the policy considerations behind a firm’s size classification and the congressional intent underlying regulatory relief to small business. It reveals that economic growth through entrepreneurship, free enterprise, and job creation is the main justification for the preferential treatment accorded to small businesses. Yet, the picture portrayed demonstrates that we have not necessarily managed to achieve these goals. Part III presents the myriad of small-business definitions in various areas of the law, the number of businesses currently encompassed by each definition, and the legislative intent behind the definitions. It demonstrates that while small-business definitions are warranted by seemingly sound economic policy considerations, there is doubt as to whether *de facto* they accord to these policies. Part IV identifies and analyzes three main critiques of the focus on size in legal definitions: current size standards defeat legislative intent, are overinclusive, and result in an ineffective allocation of government resources. Part V concludes that the historical focus on size is flawed. Therefore, other criteria should be considered to achieve Congress’s goals. A proposed model that replaces the legal emphasis on size is further

18. See Lloyd Dixon et al., *The Impact of Regulation and Litigation on Small Businesses and Entrepreneurship: An Overview*, in *IN THE NAME OF ENTREPRENEURSHIP?: THE LOGIC AND EFFECTS OF SPECIAL REGULATORY TREATMENT FOR SMALL BUSINESS* 17, 17–68 (Susan M. Gates & Kristin J. Leuschner eds., 2007).

19. See Jason Keith, *State of the Union Furthers Small Business Misperception*, BOSTON.COM (Jan. 26, 2012, 8:28 AM), http://www.boston.com/business/specials/small_business_blog/2012/01/state_of_the_union_furthers_small_business.html.

explored in a forthcoming article, which introduces a graduated scale of a firm's entrepreneurial character.²⁰

II. POLICY CONSIDERATIONS

Why is our legislation overflowing with so many conflicting notions of size? What accounts for these disparate definitions of small business? To answer these questions, we must first look at the policy considerations behind the regulatory treatment of small business. Doing so, we find that the main goal that legislators articulate for introducing small-business preferences is to achieve economic development.²¹

The interaction of many variables determines the performance of an economy.²² Exploring the history of small-business preferences reveals three reasons why small businesses are believed to spur economic development. Small businesses are viewed as the source of entrepreneurship by creating new products that incorporate new ideas; they are considered the source of job creation; and they are viewed as the essence of the free-enterprise system and the guardians of market competition.²³ This Part will examine these rationales for viewing small business as the engine of economic development.

A. FREE ENTERPRISE

In 1953, small businesses across the nation experienced a milestone moment with the enactment of the Small Business Act.²⁴ The Act marked the first of many attempts to define the term "small business."²⁵ This

20. Mirit Eyal-Cohen, *Entrepreneurship, Intrapreneurship, and the Law* (unpublished manuscript) (on file with author).

21. See, e.g., 139 CONG. REC. 14,137 (1993) (statement of Sen. Feinstein) ("I am concerned that this legislation does not include a targeted capital-gains exclusion for small businesses. . . . The development of patient capital to aid in the start-up and expansion of small and mid-size businesses is vital to job creation.").

22. See, e.g., JAMES GWARTNEY ET AL., *ECONOMIC FREEDOM OF THE WORLD: 2001 ANNUAL REPORT* 5-31 (2001) (providing for an economic freedom index, which correlates positively with economic growth); Daniel Felsenstein & Joseph Persky, *When Is a Cost Really a Benefit? Local Welfare Effects and Employment Creation in the Evaluation of Economic Development Programs*, 13 *ECON. DEV. Q.* 46, 46 (1999) ("[L]ocal welfare effects of employment generation are often treated inadequately in the evaluation of economic development programs."); Sander Wennekers & Roy Thurik, *Linking Entrepreneurship and Economic Growth*, 13 *SMALL BUS. ECON.* 27, 27 (1999).

23. Martin A. Sullivan, *When Should Small Businesses Get a Tax Break?*, *TAX ANALYSTS* (Jan. 17, 2012, 11:31 AM), <http://www.taxanalysts.com/taxcom/taxblog.nsf/Permalink/UBEN-8QLLPH> ("If you listen to the politicians, you might think all would be right with the world if we just had more small businesses. There would be more innovation. More jobs. More entrepreneurship. More growth.").

24. Small Business Act of 1953, Pub. L. No. 83-163, 67 Stat. 232 (current version at 15 U.S.C. §§ 631-657q (2006 & Supp. V 2011)).

25. Congress provided for some sort of preferential treatment to small entities even earlier. See Louis B. Schwartz, *"Justice" and Other Non-Economic Goals of Antitrust*, 127 U. PA. L.

legislation paved the way for many of today's small-business subsidies and preferences.²⁶ For the first time, the government explicitly declared a policy directed to advance small entities over other business concerns.²⁷ Congress established the SBA as the administrative body to execute this policy.²⁸ What policy has the government sought to promote through the Small Business Act?

At the onset, the Act stated that Congress's policy was to promote market diversity and entrepreneurship, declaring:

The essence of the American economic system of private enterprise is free competition. Only through full and free competition can free markets, free entry into business, and opportunities for the expression and growth of personal initiative and individual judgment be assured. The preservation and expansion of such competition is basic not only to the economic well-being but to the security of this Nation. . . . It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect insofar as is possible the interests of small-business concerns in order to preserve free competitive enterprise²⁹

Traditionally, "free enterprise" and the "free market" have been salient verses in American society.³⁰ These phrases have been grounded in two fundamental principles: market diversity is the "backbone of democratic capitalism," and the market "prosper best when business judgments are unfettered by government 'interference.'"³¹

REV. 1076, 1077 (1979) (reviewing a list of small-business preferences, such as the Reclamation Act of 1902, which "limited the sale of water from federal irrigation projects" to a single owner; the Public Utility Holding Company Act of 1935, which relaxed restrictions to large utility firms provided that local firms were left unharmed; the Small Business Act of 1942, which assured small businesses would receive a fair share of government procurement contracts; and the Surplus Property Act of 1944, which gave preference to small purchasers in federal war-production facilities).

26. Currently there are 194 documents with references in the U.S. Code to "Small Business Act" according to a WestlawNext terms & connectors search of the unannotated U.S. Code.

27. Small Business Act § 202 (current version at 15 U.S.C. § 631 (2006 & Supp. IV 2010)).

28. *Id.* § 204(a) (current version at 15 U.S.C. § 633(a) (2006)) ("In order to carry out the policies of this title there is hereby created an agency under the name 'Small Business Administration' . . .").

29. *Id.* § 202 (current version at 15 U.S.C. § 631(a) (2006)).

30. See, e.g., 124 CONG. REC. 35,214 (1978) (statement of Sen. Nelson) ("[T]he small business community has always been the cutting edge of the American free enterprise system."); *id.* at 35,216 ("[I]t is time that we paid some attention to those businesses who are at the competitive edge of the free enterprise capitalist system.").

31. Harry N. Rosenfield, *The Free Enterprise System*, 43 ANTIOCH REV. 352, 352 (1985) (arguing that "free enterprise" is merely a talismanic phrase entrenched in political rhetoric,

Yet, "free enterprise" is a tricky term.³² Over time, the words "free enterprise" have signified different, contradictory ideas.³³ In the past, it meant an enterprise system free from monopolies.³⁴ Others view free enterprise as a system free of governmental interference.³⁵ Free enterprise today means supervised rivalry within antitrust rules.³⁶ It allows the government to "regulat[e] business under rules which give, as far as is feasible, reasonable opportunity for rival [business] groups to persist."³⁷

Small businesses have been viewed as both "victims" and "saviors" of the free-enterprise concept.³⁸ Politicians have glorified small businesses for being the essence of the free-enterprise system.³⁹ Small-business organizations promoted their members as adding to the diversity of the market.⁴⁰ Others have viewed small entities as maverick firms, which offer local low-cost alternatives to high-priced leading products produced by giant

but in reality government interference is inherent in the form of corporate welfare and government bailouts).

32. See A.D.H. Kaplan, *The Role of Small Business and Free Enterprise*, 22 PROC. ACAD. POL. SCI. 269, 269 (1947) ("A comforting quality of our understanding of the term free enterprise is the freedom that has been assumed in changing the definition of the term to suit the time and the particular interests that are involved.").

33. Frank T. Carlton, *What Is Free Enterprise?*, 3 AM. J. ECON. & SOC. 655, 655 (1944) (arguing that governmental interference with free enterprise is a primary post-war effect).

34. For example, in the 1940s the phrase reflected a desire for minimum government interference. *Id.* at 656 ("The words 'free enterprise' are used today by those who demand a hands off program on the part of government. . . . *Free* signifies no change or bounds; *enterprise* places before our eyes a picture of initiative, industry, and adventure. It is a phrase which nearly all Americans are inclined to favor.").

35. Merriam-Webster's Dictionary defines "free enterprise" as "freedom of private business to operate with little regulation by the government." MERRIAM-WEBSTER'S DICTIONARY & THESAURUS 325 (2007).

36. *United States v. Topco Assocs.*, 405 U.S. 596, 610 (1972) (describing antitrust laws as "the Magna Carta of free enterprise").

37. Carlton, *supra* note 33, at 658.

38. On the importance of free enterprise to the economy see *Various Tax Proposals: Hearings Before the Subcomm. on Taxation & Debt Mgmt. Generally of the S. Comm. on Fin.*, 98th Cong. 277 (1980) [hereinafter *Hearings on Various Tax Proposals*] (report of the Joint Industry/Government Committee on Small Business Financing) ("No other nation in the world approaches the aggregate productive output of our economic system. This result is a direct consequence of our free enterprise system which allows every individual to maximize his potential and realize his goals through hard work, determination and the desire to succeed.").

39. See, e.g., 124 CONG. REC. 35,217 (1978) (statement of Sen. Nelson) ("That involves these 14 million businesses and small corporations, small businesses, which are the heart and soul of the competitive free enterprise system. We all want this system to flourish and grow. It must be nourished from the roots."); *Hearings on Various Tax Proposals*, *supra* note 38, at 277 ("Small business is traditionally the sector of the economy where expansion of industry and job development go hand-in-hand. Small business is the essence of our free enterprise system.' Those are the words of America's leading small businessman, President Jimmy Carter.").

40. See *Hearings on the Clayton Act*, *supra* note 8, at 29 (statement of Joseph D. Henderson, National Managing Director, American Association of Small Business).

corporations.⁴¹ The existence of substitute products in the market, created by smaller competitors, has been regarded as a key to preserving free competition. The existence of small business was said to be an essential element of a healthy competitive market.⁴²

Nonetheless, small businesses have also been regarded as victims of the free-enterprise concept; in this view, they struggle to stay afloat in a system dominated by large corporations and harsh competition.⁴³ Smaller firms lacking economies of scale have a greater economic incentive to deviate from other firms' price coordination, and must weather fierce competitive conditions. This harsh competition also places small-business concerns at an economic disadvantage.⁴⁴ As a result, many small entities default.⁴⁵ The massive failure of these entities weakens the competitive free-enterprise system and prevents the orderly development of the national economy.⁴⁶ Therefore, it has from time to time been essential for the government to interfere in the market, favoring smaller firms in order to preserve their existence.⁴⁷ It became congressional policy to assist small firms in order to

41. See, e.g., John L. Orcutt, *Improving the Efficiency of the Angel Finance Market: A Proposal To Expand the Intermediary Role of Finders in the Private Capital Raising Setting*, 37 ARIZ. ST. L.J. 861, 861–62 (2005) (distinguishing between small businesses that are “rapid-growth start-ups” and “liveliness businesses,” which start small and are likely to stay small).

42. 131 CONG. REC. 20,494 (1985) (statement of Rep. Kerry) (“[T]he entrance of a small business into a particular market makes that market more competitive.”).

43. See *Hearings on the Clayton Act*, *supra* note 8, at 29–30 (statement of Joseph D. Henderson, National Managing Director, American Association of Small Business).

44. See, e.g., U.S. SMALL BUS. ADMIN., *THE SMALL BUSINESS ECONOMY: A REPORT TO THE PRESIDENT* (2010), available at http://www.sba.gov/sites/default/files/sb_econ2010.pdf (detailing the difficult and challenging economic conditions small businesses faced in 2009).

45. For example, many small businesses defaulted for failing to raise outside capital, and the government response was to enact a bill to sponsor small-business debenture programs. 131 CONG. REC. 20,494 (1985) (statement of Rep. Kerry) (“It is no secret that small businesses . . . face an inherent disadvantage in private capital markets, which thwarts their growth, and which, I am sorry to say, seems to be growing worse.”).

46. Between 1990 and 1991, there were 540,900 firm births and 546,100 firm deaths, and between 2001 and 2002 there were 568,300 firm births and 586,500 firm deaths among firms with fewer than 500 employees. U.S. CENSUS BUREAU, *STATISTICAL ABSTRACT OF THE UNITED STATES: 2009*, at tbl.739 (2009), available at <http://www.census.gov/compendia/statab/2009/2009edition.html> (table is included in Section 15: Business Enterprise). Between 2006 and 2007, there were 668,177 employer-firm births for firms of fewer than 500 employees and 592,148 employer-firm deaths, resulting in a net increase of 76,029. U.S. SMALL BUS. ADMIN., *supra* note 44, at tbl.A.9.

47. Small Business Act, Pub. L. No. 85-536, § 2, 72 Stat. 384, 391 (1958) (current version at 15 U.S.C. § 631b(a) (2006)) (“The Administration shall from time to time make studies of matters materially affecting the competitive strength of small business, and of the effect on small business of Federal laws, programs and regulations, and shall make recommendations to the appropriate Federal agency or agencies for the adjustment of such programs and regulations to the needs of small business.”).

strengthen the nation's economy and maintain the competitive free-enterprise system.⁴⁸

Yet, in recent years, commentators have started to question the justifications for singling out small business for special treatment.⁴⁹ Some economists have noted that helping out the little guy may be good politics, but it isn't necessarily good economics.⁵⁰ They argue that small entities' positive spillovers, if any, are not independently a valid reason to favor them through the legal system.⁵¹ If those entities are productive, economists have observed, they should continue to produce positive externalities regardless of the state of market competition.⁵² Entrepreneurship is one such spillover commonly conflated with small business, but how closely are the two actually related?

B. ENTREPRENEURSHIP

Entrepreneurship has been commonly equated with small-business ownership, and it has been used to justify regulatory concessions.⁵³ Every so often, the small-business sector receives attention in the media, academia, and politics because of its arguable entrepreneurial character and significance to the economy.⁵⁴ Congress has also viewed small-business legislation as a means to assist entrepreneurs and innovators.⁵⁵

48. *Id.*

49. Alan Murray, *Packwood's Tax-Overhaul Plan Offers Small Firms More than They Sought*, WALL ST. J., Mar. 25, 1986, at 64. For the notion that "small business is not beautiful," see *infra* notes 110–12, 121, 286–92.

50. See, e.g., Hilary Stout, *A New Headache: In Health-Care Debate, Small Business Benefits at the Expense of Big: Large Corporations, Facing Higher Costs, Are Souring on Support for Reform; Little Firms, Mighty Lobbies*, WALL ST. J., July 21, 1994, at A1 (claiming that "economists don't see much justification in giving small business a break" other than, for example, to increase its lobbying power).

51. See *infra* notes 121, 254.

52. See George R. Davies, *Laissez Faire and Free Enterprise*, 7 AM. J. ECON. & SOC. 401, 409 (1948) ("In many fields of small business, however, competition is extreme and wasteful, and capital earnings are precarious. Particularly in retail stores and small shops, there is generally a wasteful surplus of establishments—duplicative investment as it is called—and profits may be abnormally low in accordance with the law of diminishing returns.").

53. 133 CONG. REC. 12,624 (1987) (statement of Sen. Karnes) ("The true entrepreneurial spirit thrives in small business throughout this country. . . . Much of the future of America's economy depends on the ideas of our entrepreneurs in small business.").

54. See Jeff Bailey, *Enterprise: Entrepreneurship, Too, Has Its Economic Limits—Encouraging Start-Ups with Legislation May Hold More Risk than Promise*, WALL ST. J., Oct. 1, 2002, at B4 ("Politicians, academics and many others have increasingly embraced small businesses and the entrepreneurs who start them as our economic saviors. Smaller companies create most of the new jobs, these boosters say.").

55. See, e.g., 137 CONG. REC. 19,637 (1991) (statement of Rep. Andrews) ("The Small Business Economic Opportunity Act will assist entrepreneurs who have promising plans for starting or maintaining successful businesses but who have particular difficulties in getting those plans off of the ground.").

Consequently, Congress has often allocated common resources to small business and entrepreneurship, viewing them as interrelated.⁵⁶ But a closer look at recent academic literature reveals that the two concepts are rather dissimilar. What stands behind the term “entrepreneurship”?

Entrepreneurship is a convoluted and obscure term, and defining it is surprisingly difficult.⁵⁷ Renowned Austrian economist Joseph Schumpeter saw entrepreneurs as individuals who possess the ability to drive economic development by innovating and combining resources in creative ways, while at the same time destructing previously existing economic orders.⁵⁸ Since then, economists have been arguing that entrepreneurship has been the key to economic growth and productivity.⁵⁹ It involves new independent business creation⁶⁰ and “taking judgmental decisions about the coordination of scarce resources.”⁶¹ Others have defined the entrepreneur as one who attempts to create value by recognizing a business opportunity, managing the risks inherent to that opportunity, and utilizing communication and management skills to bring the project to fruition.⁶² A survey on the meaning of entrepreneurship found that out of ninety potential attributes, most researchers and practitioners agreed that entrepreneurship consists of entity creation, acquisition, and integration of resources.⁶³

56. For example, in 1983, the U.S. Senate Committee on Small Business designated a Subcommittee on Entrepreneurship and Special Problems Facing Small Business. See *Special Problems Facing Small Business in the Midwest: Hearing Before the Subcomm. on Entrepreneurship & Special Problems Facing Small Bus. of the S. Comm. on Small Bus.*, 98th Cong. (1983).

57. See William J. Hausman, *Entrepreneurship in the United States: Defining the Field, Its History, and an Empirical Model of Long-Term Trends*, in COUNTRY STUDIES IN ENTREPRENEURSHIP: A HISTORICAL PERSPECTIVE 25, 26 (Youssef Cassis & Ioanna Pepelasis Minoglou eds., 2006) (“A number of scholars have stressed that entrepreneurship is difficult to define because the subject is so complex and elusive.”).

58. See Joseph A. Schumpeter, *Entrepreneurship as Innovation*, in ENTREPRENEURSHIP: A SOCIAL SCIENCE VIEW 51–75 (Richard Swedberg ed., 2000) [hereinafter Schumpeter, *Entrepreneurship*] (discussing the differences between entrepreneurship and innovation); see also JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM, AND DEMOCRACY 81–86 (3d ed. 1950) (describing technological breakthroughs that lead to destruction of old technologies, economic growth and further technological innovation).

59. See, e.g., ROBERT F. HÉBERT & ALBERT N. LINK, A HISTORY OF ENTREPRENEURSHIP 70–71 (2009); William J. Baumol, *Productivity Growth, Convergence, and Welfare: What the Long-Run Data Show*, 76 AM. ECON. REV. 1072, 1072 (1986) (comparing U.S. productivity, growth, entrepreneurship, and unemployment).

60. Albert Shapero & Lisa Sokol, *The Social Dimensions of Entrepreneurship*, in ENCYCLOPEDIA OF ENTREPRENEURSHIP 72 (Calvin A. Kent et al. eds., 1982).

61. MARK CASSON, THE ENTREPRENEUR: AN ECONOMIC THEORY 23 (1982) (emphasis omitted).

62. John J. Kao & Howard H. Stevenson, *Report of the Colloquium on Entrepreneurship*, in ENTREPRENEURSHIP: WHAT IT IS AND HOW TO TEACH IT 1, 3 (John J. Kao & Howard H. Stevenson eds., 1985).

63. William B. Gartner, *What Are We Talking About When We Talk About Entrepreneurship?*, 5 J. BUS. VENTURING 15, 21 (1990).

Legislatures sought to support entrepreneurship because entrepreneurial activity often generates important spillovers and positive outcomes to the economy.⁶⁴ Indeed, economic historians have identified individual entrepreneurs as a group that has often played an important role in past market-growth trends.⁶⁵ According to these scholars, while some entrepreneurial activities are unproductive (such as corporate takeovers, litigation, and tax evasion), there are many productive entrepreneurial activities that contribute directly to economic development by creating new value.⁶⁶

Researchers have identified four main types of entrepreneurship⁶⁷: (1) firms involved in entrepreneurial reproduction that create little new value and no innovation;⁶⁸ (2) firms that are entrepreneurial imitators that do not create new value, but reproduce an existing business activity by creating a new business form;⁶⁹ (3) valorizing entrepreneurial firms that innovate and produce significant new value; and (4) entrepreneurial ventures that lead to radical change, not only by generating new value, but also by creating whole new industries or sectors.⁷⁰

64. See Julie Berry Cullen & Roger H. Gordon, *Taxes and Entrepreneurial Risk-Taking: Theory and Evidence for the U.S.*, 91 J. PUB. ECON. 1479, 1479 (2007); cf. Michael Mundaca, *Startup America: How a Small Business Tax Cut Will Support Innovative, High-Growth Companies*, U.S. DEP'T TREASURY (Feb. 1, 2011), <http://www.treasury.gov/connect/blog/Pages/Startup-America-How-a-Small-Business-Tax-Cut-will-Support-Innovative,-High-Growth-Companies.aspx> ("[T]he President announced Startup America, a campaign to celebrate, inspire, and accelerate high-growth entrepreneurship throughout the country.").

65. William J. Baumol & Robert J. Strom, *Entrepreneurship and Economic Growth*, 1 STRATEGIC ENTREPRENEURSHIP J. 233, 233 (2007) ("These individuals recognize the commercial opportunities offered by innovations and transform these opportunities into new products that may improve the lives of all citizens and contribute to increased productivity throughout the economy."); see also Rajshree Agarwal et al., *The Process of Creative Construction: Knowledge Spillovers, Entrepreneurship, and Economic Growth*, 1 STRATEGIC ENTREPRENEURSHIP J. 221, 221 (2007) (discussing how entrepreneurial ideas and opportunities are generated and how knowledge spillovers create a process of creative construction).

66. See WILLIAM J. BAUMOL, *ENTREPRENEURSHIP, MANAGEMENT, AND THE STRUCTURE OF PAYOFFS* 141 (1993).

67. Christian Bruyat & Pierre-André Julien, *Defining the Field of Research in Entrepreneurship*, 16 J. BUS. VENTURING 165, 173-75 (2001).

68. See PAUL H. WILKEN, *ENTREPRENEURSHIP: A COMPARATIVE AND HISTORICAL STUDY* 70-73 (1979) (differentiating types of entrepreneurship by the degree of innovation and expansion).

69. *Id.*

70. *Id.* For instance, Henry Ford is well known as a nineteenth-century entrepreneur whose affordable Model T marked the opening of the mass production of automobiles and contributed to the growth of cities and suburbs and related industries. See generally CHARLES W. CAREY, JR., *AMERICAN INVENTORS, ENTREPRENEURS, AND BUSINESS VISIONARIES* 129-31 (2002). A more recent example is Stanford R. Ovshinsky, an American entrepreneur responsible for developing products such as an environmentally friendly nickel-metal hydride battery (widely used today in laptop computers, digital cameras, cell phones, electric and hybrid cars, flat-screen displays, and rewritable CD and DVD computer memories). See *The Edison of Our Age?*, ECONOMIST (Nov. 30, 2006), <http://www.economist.com/node/8312367>.

This taxonomy of entrepreneurship indicates that while most entrepreneurs may start small, not all small firms create new value.⁷¹ As opposed to traditional livelihood businesses that exist mainly in order to provide a means of support to the owner and his family, successful entrepreneurial entities take high risks by pursuing novel ideas, and when they are successful, they result in rapid and substantial wealth creation.⁷² The considerable wealth created by entrepreneurial ventures enhances the gross domestic product and contributes to the development of the nation's economy.⁷³

Nevertheless, legislative discourse uses small businessmen and entrepreneurs as synonyms without distinction.⁷⁴ In order to justify new regulatory concessions, small business has been constantly portrayed as the source of innovation and change—firms that by their mere existence generate new value and novel ideas.⁷⁵ Size has turned into a pivotal benchmark to indicate business novelty and positive contributions to the economy.⁷⁶

One illustration can be found in the late 1970s and early 1980s, during a severe economic recession that affected much of the developed world.⁷⁷ In light of this recession, described as “the worst since the Great Depression of

71. See Martin A. Sullivan, *New Research Weakens Case for Small Business Tax Relief*, TAX ANALYSTS (Jan. 4, 2012, 10:11 AM), <http://www.taxanalysts.com/taxcom/taxblog.nsf/Permalink/UBEN-8Q7JUU> (“Small businesses are mainly skilled craftspeople . . . [who] do little innovation. They provide relatively standardized goods and services for existing customer bases.”).

72. See PETER F. DRUCKER, *INNOVATION AND ENTREPRENEURSHIP: PRACTICE AND PRINCIPLES* 19–32 (Routledge 2011) (1985).

73. Zoltan J. Acs et al., *The Knowledge Spillover Theory of Entrepreneurship*, 32 SMALL BUS. ECON. 15, 16 (2009) (arguing that entrepreneurship creates technological change that is central in explaining economic growth).

74. See, e.g., *Impact of Tax Reform and Simplification Proposals on Small Business: Hearings Before the S. Comm. on Small Bus.*, 99th Cong. 299 (1985) (“I feel [recently enacted legislation] has been most helpful to the small business entrepreneur, such as the reforms of the subchapter S legislation . . .”); *Federal Tax Policy for Economic Growth and Stability: Hearings Before the Subcomm. on Tax Policy of the J. Comm. on the Econ. Rep.*, 84th Cong. 150 (1955) (statement of Rep. Mills) (“You say in the case of the entrepreneur, the small-business man, there is this deterrent.”); STAFF OF S. COMM. ON SMALL BUS., 99TH CONG., REP. ON IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS 3 (Comm. Print 1985) (“[T]hese Senators feel strongly that any current or future tax reform proposals considered by Congress must strive to preserve the incentives for small business entrepreneurship contained in the current tax code.”).

75. See 131 CONG. REC. 20,494 (1985) (statement of Rep. Kerry) (“I am cosponsoring this bill because it encourages such entrepreneurship and risk-taking and gives small business a chance to grow and compete in an economy that is sometimes unfairly stacked against them.”).

76. See 124 CONG. REC. 34,612 (statement of Sen. Hatch) (“Small business firms are flexible and innovative, producing over half of all the important industrial inventions and innovations in the United States.”); Zoltan J. Acs & David B. Audretsch, *Innovation in Large and Small Firms: An Empirical Analysis*, 78 AM. ECON. REV. 678, 678 (1988) (comparing innovative activity of large and small firms).

77. See MANSEL G. BLACKFORD, *A HISTORY OF SMALL BUSINESS IN AMERICA* 166 (2003).

the 1930s,"⁷⁸ the U.S. government made efforts to battle high inflation rates and encourage economic growth.⁷⁹ Among those efforts was the enactment of the Economic Recovery Tax Act of 1981.⁸⁰ The Act, also known as the "Kemp-Roth Tax Cut,"⁸¹ amended the Internal Revenue Code of 1954 by reducing individual income-tax rates, allowing expensing of depreciable property, and providing tax incentives for small businesses.⁸² Discussing the benefits of the Act in the Senate Finance Committee, representatives reinforced the axiom that small businesses are inherently innovative and entrepreneurial⁸³:

The importance of small business to the nation and the American people cannot be overstated. Through the drive, creativity and spirit of individual entrepreneurs, the economy of this great nation grew from its simple agrarian beginnings to the most dynamic and diverse economy in the world.

....

78. *Id.*

79. *See, e.g.*, Small Business and Federal Procurement Competition Enhancement Act of 1984, Pub. L. No. 98-577, 98 Stat. 3066 (current version in scattered sections of 41 U.S.C.); Competition in Contracting Act of 1984, Pub. L. No. 98-369, 98 Stat. 1175 (current version at 31 U.S.C. §§ 3551-3556 (2006 & Supp. V 2011)); Defense Procurement Reform Act of 1984, Pub. L. No. 98-252, 98 Stat. 2588 (codified as amended in scattered sections of 10 U.S.C.); Job Training Partnership Act, Pub. L. No. 97-300, 96 Stat. 1322 (1982) (amending scattered sections in 18, 29, and 42 U.S.C.); Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (codified as amended in scattered sections of 26, 28, and 42 U.S.C.); Omnibus Budget Reconciliation Act of 1981, Pub. L. No. 97-35, 95 Stat. 357 (codified as amended in scattered sections of U.S.C.); Small Business Economic Policy Act of 1980, Pub. L. No. 96-302, 94 Stat. 848 (codified as amended at 15 U.S.C. §§ 631a-631b (2006)) (providing that each year the President will submit to Congress a report on the role of small business and the state of competition to identify economic trends such as production, employment, investment, population, job creation and retention, annual business failures, and annual business startups).

80. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (codified as amended in scattered sections of I.R.C.).

81. The Act was named after its sponsors, Representative Jack Kemp (R-NY) and Senator William V. Roth, Jr. (R-DE).

82. The amendments included a reduction in corporate tax rate (section 231 of the Economic Recovery Tax Act of 1981), an increase in the minimum accumulated earnings credit (section 232), changes to Subchapter S corporations (sections 233-334), and changes to LIFO inventory and small-business accounting (sections 235-237). *See* STAFF OF J. COMM. ON TAXATION, 97TH CONG., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, at 143-50 (Comm. Print. 1981).

83. *See Hearings on Various Tax Proposals, supra* note 38, at 277 (report of the Joint Industry/Government Committee on Small Business Financing) ("According to a 1966 Commerce Department study, small business accounted for more than half of all scientific and technological developments since the beginning of this century. Also, a National Science Foundation study, which covered the period between 1953 and 1973, found that small firms produce about four times as many innovations per research and development dollar as medium-sized firms and about 24 times as many as the largest firms.").

This economic diversity is achieved to a great extent through the efforts of entrepreneurs whose small businesses encompass a substantial sector of the economy.⁸⁴

The observation that small businesses are entrepreneurial became repeated rhetoric on the congressional floor. For example, Representative Jack Buechner (R-MO), while supporting the enactment of a reduction in the capital-gains tax, noted:

Mr. Chairman, the essence of both a growing economy and a dynamic society has been known for almost 90 years, ever since the late Austrian economist, Joseph Schumpeter, identified innovation as the driving force behind economic growth, and the entrepreneur as the agent behind innovation. For it is the entrepreneur who moves resources from the old to the new, and from the obsolete to the productive.

But unfortunately, it is the entrepreneur and the small businessman who suffers the most from our adversely high taxes on capital gains.⁸⁵

Rhetoric aside, there is no direct correlation between the size of a business and its entrepreneurial character. New research shows that small businesses are mainly skilled craftspeople, professionals, shopkeepers, and restaurateurs that are responsible for little innovation or new value.⁸⁶ Once established, those small firms do not wish to grow or are not expected to grow.⁸⁷ Thus, it is clear that small businesses that happen to be entrepreneurial are not so solely by virtue of their size. Over the years, many federal and state economic-development plans have erroneously ignored the distinction between entrepreneurial and conventional small businesses.⁸⁸ That conflation of small businesses and entrepreneurs has hampered the precise goal of promoting entrepreneurship because the regulatory relief small-business owners receive does not necessarily match the support essential to entrepreneurial success.⁸⁹ The next Subpart will examine a similar flaw made in connection with another policy consideration for supporting small business—job growth.

84. *Id.*

85. 135 CONG. REC. 22,234 (1989) (statement of Rep. Buechner).

86. Sullivan, *supra* note 23.

87. *Id.* ("Once they are established, they do not grow. Moreover, they do not want to grow. One major reason for this is that many small-business owners are motivated by non-pecuniary benefits such as wanting a flexible schedule or to be their own boss.").

88. Eleena De Lisser, *States' Aid for Tech Start-Ups Is More Talk than Action*, WALL ST. J. (Jan. 4, 2000), <http://online.wsj.com/article/SB946940091317555945.html> ("The hot technology start-up with no profits but a bright future is lumped into the same small-business category as the family-owned grocery store.").

89. *See id.*

C. EMPLOYMENT EXPANSION

Another factor that promotes economic development is job growth.⁹⁰ Small businesses, particularly, have been depicted as job creators across industries and sectors more than any other type of business.⁹¹ This description derives from the fact that when a business is created, it engages the people employed in the entity, avails work to its owner, and provides capital and labor to its suppliers and surrounding entities.⁹² A European small-business scholar described the cause of the widespread belief in the job-creation potential of small businesses:

When a steelworks closes or—more topically—a large defence industry contractor shuts, it is the small firm sector which is seen as the source of new employment opportunities for the redundant workforce. Former unskilled employees become self-employed taxi drivers, window cleaners and small garage employees. Draftsmen, precision engineering fitters and computer specialists become self-employed in their own trades. Where major job shedding takes place, the small firm sector is seen to be the way in which the local economy can create its own employment by ‘pulling itself up by its own boot-straps’.⁹³

This depiction seems to confuse young firms with small ones. But the notion that small businesses are the creators of most net new jobs has been further cultivated by the SBA, which consistently reports that businesses with fewer than 500 employees generate half of the nation’s real gross domestic product and employ half of all private-sector workers.⁹⁴ Overall, according to

90. See Lynda Tran, *Unions and Employment Growth: Do Unions Increase Unemployment in Industrial and Developing Countries?*, 11 GEO. PUB. POL’Y REV. 17, 29 (2005) (“The underlying assumption of this paper is that increased employment aids economic growth in both industrial and developing countries.”); see also Obama, *supra* note 4 (“[W]e have to seize it. Tonight, my message to business leaders is simple: Ask yourselves what you can do to bring jobs back to your country, and your country will do everything we can to help you succeed.”).

91. See President George W. Bush, State of the Union Address (Feb. 2, 2005), available at <http://georgewbush-whitehouse.archives.gov/news/releases/2005/02/20050202-11.html> (“To make our economy stronger and more competitive, America must reward, not punish, the efforts and dreams of entrepreneurs. . . . [S]o we must free small businesses from needless regulation and protect honest job-creators from junk lawsuits.”); see also DONALD BRUCE ET AL., U.S. SMALL BUS. ADMIN., SMALL BUSINESS AND STATE GROWTH: AN ECONOMETRIC INVESTIGATION (2007), available at <http://archive.sba.gov/advo/research/rs292tot.pdf> (observing that small-firm establishments had a greater impact on state-level output, employment, and income than any other policy option); Featherman, *supra* note 17 (“While these are good ideas, we need immediate, positive actions to create jobs and improve the economy.”).

92. David L. Birch, *Who Creates Jobs?*, PUB. INT., Fall 1981, at 3, 7 (“Smaller businesses more than offset their higher failure rates with their capacity to start up and expand dramatically.”).

93. D.J. STOREY, UNDERSTANDING THE SMALL BUSINESS SECTOR 160 (1994).

94. U.S. SMALL BUS. ADMIN., THE SMALL BUSINESS ECONOMY: A REPORT TO THE PRESIDENT 7 (2009), available at http://www.sba.gov/sites/default/files/files/sb_econ2009.pdf.

these reports, between 1993 and 2008, small firms with fewer than 500 employees—which currently account for 99.9% of all firms⁹⁵—accounted for 65% of the net new jobs.⁹⁶

In recent years, the fervor to explore the sources of job growth has invited much attention to the role that small businesses play in generating employment.⁹⁷ Small-business lobby groups, such as the National Federation of Independent Business, have endorsed the notion that small business is tightly connected to job growth.⁹⁸ When advocating for tax breaks, the Chamber of Commerce voiced a similar opinion, stating that small businesses are the backbone of the nation's labor production and economy.⁹⁹ Lastly, some professionals have also affirmed the view that employment expansion is dependent upon the welfare of small businesses.¹⁰⁰

Following this general support, congressional representatives have repeated the mantra that small business is the nation's job creator.¹⁰¹ "Put

95. See *infra* note 211 and accompanying text.

96. BRIAN HEADD, U.S. SMALL BUS. ADMIN., AN ANALYSIS OF SMALL BUSINESSES AND JOBS 10 (2010), available at <http://archive.sba.gov/advo/research/rs359tot.pdf> ("The two principal official firm size employment creation/destruction data sources differ somewhat [S]mall businesses have accounted for about 65 percent of the private-sector net job creation according to BED figures [and] SUBS figures show small businesses accounting for about 90 percent").

97. David Neumark et al., *Do Small Businesses Create More Jobs? New Evidence for the United States from the National Establishment Time Series*, 93 REV. ECON. & STAT. 16, 27 (2011) (finding that small firms create more jobs, on net, although the difference is much smaller than other studies have suggested).

98. See *Retirement Income Policy Act: Hearing Before the Subcomm. on Savs., Pensions, & Inv. Policy of the S. Comm. on Fin.*, 99th Cong. 499 (1986) ("The major goal of our economy, given our trade and budget deficits, must be to increase the number of people working. To accomplish that, our employment policies must include encouraging and increasing the number of small businesses that employ people. If we eat the goose today, it is going to be terribly difficult to have omelettes for breakfast tomorrow. Small business economic growth is inextricably tied to labor costs.").

99. See, e.g., *Revenue Act of 1978: Hearing Before the S. Comm. on Fin.*, 95th Cong., pt. 2, at 233 (1978) (statement of Jack Carlson, Vice President and Chief Economist, Chamber of Commerce of the United States) ("[M]ore relief should be targeted toward business, especially small business, the backbone of our employment and output.").

100. See *Impact of Tax Reform and Simplification Proposals on Small Business: Hearings Before the S. Comm. on Small Bus.*, 99th Cong. 613 (1985) (statement of Thornton Stearns, President, Vacuum Barrier Corporation, Woburn, MA; and Director, Smaller Business Association of New England) ("There is a critical need for private capital for the formation and growth of small businesses. The growth of employment in our country is dependent on small business.").

101. *Comprehensive Tax Reform: Hearings Before the H. Comm. on Ways & Means*, 99th Cong., pt. 4, at 2738 (1985) [hereinafter *Hearings on Comprehensive Tax Reform*] (statement of Sen. Sasser) ("Perhaps the most startling proof of small business' job generating capacity was seen from 1980 to 1982. During that period, small business accounted for all the net new jobs in the United States. While small business generated 2.6 million jobs during this period, big business was losing 1.6 million employees."); see also *Hearings on Various Tax Proposals*, *supra* note 38, at 277 ("[T]he sum of the effect of small business on employment is almost 66 times the effect of

simply," one congressman noted, "small business is the engine which drives our economy."¹⁰² Because of these beliefs, politicians have endorsed various forms of regulatory relief for small business, proclaiming that this type of legislation will have a large effect on the labor market.¹⁰³ When opposing the Worker Adjustment and Retaining Act, Senator Orrin Hatch (R-UT) stated:

The bill raises the risk threshold for small business. . . . The growth in employment in the U.S. is occurring primarily in small to medium sized firms, legislation which affects the ability of small businesses to exit from the market, or cut their costs will have an adverse effect of future employment prospects.¹⁰⁴

Yet, new research demonstrates that it is young companies, not necessarily small businesses, that create most new jobs.¹⁰⁵ Some studies provide evidence that employment dynamics seem to be the same across firm size. They have indicated that while small firms and small establishments create more net jobs, the difference is much smaller than what has been suggested.¹⁰⁶ Others argue that the belief that small firms are

larger business. These figures help to highlight the importance of small business to the economic health of the country." (citing H.R. REP. NO. 95-1810, at 8 (1978))).

102. *Hearings on Comprehensive Tax Reform*, *supra* note 101, at 2742 (statement of Sen. Sasser).

103. See, e.g., Small Business Job Creation and Access to Capital Act of 2010, Pub. L. No. 111-240, 124 Stat. 2507 (codified at 12 U.S.C. § 4713a (2006) and amending scattered sections of U.S.C.); Small Business and Work Opportunity Act of 2007, Pub. L. No. 110-28, 121 Stat. 204 (amending scattered sections of U.S.C.); Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755 (codified as amended in scattered sections of 19, 26, and 42 U.S.C.); Small Business Economic Policy Act of 1980, Pub. L. No. 96-302, 94 Stat. 848 (codified as amended at 15 U.S.C. §§ 631a-631b (2006)).

104. S. REP. NO. 100-62, at 85 (1987) (emphasis omitted).

105. See Neumark et al., *supra* note 97, at 17; Mundaca, *supra* note 64 ("Recent research also shows that many startups have made outsized contributions to job growth, so enabling these entrepreneurs to succeed will create jobs."); Martin A. Sullivan, *Start-Ups, Not Small Businesses, Are Key to Job Creation*, TAX ANALYSTS (Jan. 10, 2012, 10:36 AM), <http://www.taxanalysts.com/taxcom/taxblog.nsf/Permalink/UBEN-8QCQT6> [hereinafter Sullivan, *Start-Ups*] ("[O]nly a subset of small firms—the start-ups—drive job creation. . . . [M]ost mature small businesses are not job creators but job losers.").

106. See Michael Rizzo (wintercow20), *Small Business and Job Creation*, UNBROKEN WINDOW (Feb. 15, 2010), <http://theunbrokenwindow.com/2010/02/15/small-businesses-and-job-creation/> ("What is this chart telling us? It is telling us that net employment dynamics seem to be the same across firm size. While conventional wisdom (indeed Presidential rhetoric) tells us that small businesses are the engines of job creation, a little more nuanced view of the world is perhaps in order."); see also Sullivan, *Start-Ups*, *supra* note 105 ("This problem, common in statistical analyses looking at data over time, results in an inverse relationship between size and growth (in this case, a relationship in which small firms grow faster than large firms) even when they are independent of each other. . . . When economists correct for this bias, they find the amount of small firm job creation is not as large as the unadjusted data suggest. And in some industries, small firms have no extra job growth at all." (citation omitted)).

major contributors of new jobs is largely based on methodological flaws.¹⁰⁷ While, in the past, startups, young firms, and mature firms were all lumped together, new data on job growth interrelated to firm age proves that “[y]outh, not smallness, is the key to job creation.”¹⁰⁸

Moreover, academics have also observed that employment in small firms is generally unstable and unskilled.¹⁰⁹ Most small businesses, scholars have contended, are “livelihood businesses,” such as the corner bakery or the local hair salon, which are not entrepreneurial in their character.¹¹⁰ Some data has even demonstrated that these livelihood businesses are the largest “destroyers” of jobs due to rapid job turnover, layoffs, and frequent bankruptcies; in fact, they are often described as “job churners.”¹¹¹ Likewise, some critics maintain that the quality of employment in those livelihood businesses is usually low-paying and lacks job security, benefits, and opportunities for advancement.¹¹² Therefore, it is clear that small entities do not promote job growth solely by virtue of their size. These entities may, however, promote other goals in our society.

D. OTHER CONSIDERATIONS

There are other social policies that policymakers seek to promote through the law. Fair labor practices, a safe and clean environment, public

107. Steven J. Davis et al., *Small Business and Job Creation: Dissecting the Myth and Reassessing the Facts*, 8 SMALL BUS. ECON. 297, 305–07 (1996) (arguing that temporary fluctuations in size systematically biases estimates in favor of small-firm job creation—the “regression fallacy”). But see Per Davidsson et al., *The Extent of Overestimation of Small Firm Job Creation—An Empirical Examination of the Regression Bias*, 11 SMALL BUS. ECON. 87, 87 (1998) (“There may be good reasons to question to what extent small firms can lead economic development, and whether it is good or bad if they do create most new jobs, but concern for the ‘regression fallacy’ does not seem to be an important issue in this context.”).

108. Sullivan, *Start-Ups*, *supra* note 105; see also John C. Haltiwanger et al., *Who Creates Jobs? Small vs. Large vs. Young* 28–31 (Nat’l Bureau of Econ. Research, Working Paper No. 16,300, 2010) (concluding that there is no systematic relationship between firm size and growth; it is the youth of small firms, not their size per se, that is creating jobs; and mature small firms have a negative effect on job creation).

109. See Sullivan, *supra* note 23 (arguing that large firms pay higher wages, provide better health and pension benefits, and have lower turnover than small firms).

110. See Orcutt, *supra* note 41, at 863 (“For example, owner-operated convenience stores, suburban construction companies, or hair salons would fall under the livelihood business classification. These livelihood businesses, which account for more than 90% of small businesses, are not the entrepreneurial force that drives the economy nor are they particularly strong job creators.” (footnote omitted)); Sullivan, *supra* note 23.

111. U.S. SMALL BUS. ADMIN., *supra* note 44, at 1–2 (“But just as small firms lead when the economy is gaining jobs, in some recessionary periods they experience greater job losses when the economy is shedding jobs. As the recession deepened in 2009, particularly in the first quarter, small firms accounted for almost 60 percent of the job losses. But the picture improved as the year progressed. By the third quarter, net job losses in small firms were down by two-thirds.”); Orcutt, *supra* note 41, at 863.

112. See Orcutt, *supra* note 41, at 863; Sullivan, *supra* note 23.

health, and reduced paperwork are just a few of those goals.¹¹³ In the past half-century, advancing racial justice and minority rights has been on the government's agenda as well.¹¹⁴ Various studies reveal that minorities find it harder to move up the social ladder and achieve economic independence.¹¹⁵ Minority groups are often refused work and have difficulties obtaining loans from traditional lenders because they are considered to have a greater risk of failure.¹¹⁶

An important mechanism the government utilizes to promote minority groups is small-business regulation.¹¹⁷ Boosting minority hiring within government agencies, investigating racial discrimination, and developing minority small-business programs are some of the paths Congress has taken to promote disadvantaged groups in society. In view of that policy, government agencies altered their approach to small businesses, shifting from a neutral stance to one that fosters minority business ownership.¹¹⁸ Small-business regulation became a government tool to improve minorities' economic participation in the community and to counter the effects of local efforts to establish race-neutral policies.¹¹⁹

113. See generally THEDA SKOCPOL, *SOCIAL POLICY IN THE UNITED STATES: FUTURE POSSIBILITIES IN HISTORICAL PERSPECTIVE* (1995).

114. On the evolution of minority rights in recent years, see generally SARAH A. BINDER, *MINORITY RIGHTS, MAJORITY RULE: PARTISANSHIP AND THE DEVELOPMENT OF CONGRESS 157-59* (1997) (examining changes in parliamentary rights allocated to minority parties in the House and Senate over a five-year period); JOHN D. SKRENTNY, *THE MINORITY RIGHTS REVOLUTION 143-64* (2002) (surveying the history of racial equality and the expansion of affirmative action programs).

115. See YING LOWREY, U.S. SMALL BUS. ADMIN., *RACE/ETHNICITY AND ESTABLISHMENT DYNAMICS, 2002-2006*, at 14 tbl.1 (2010), available at <http://archive.sba.gov/advo/research/rs369tot.pdf> (showing that in 2002, the unemployment rates was 10.2% for Blacks, 7.5% for Hispanics, 5.1% for Whites, and that the nation's total unemployment rate was 5.8%).

116. See ROBERT W. FAIRLIE & ALICIA M. ROBB, U.S. DEP'T OF COMMERCE, *DISPARITIES IN CAPITAL ACCESS BETWEEN MINORITY AND NON-MINORITY BUSINESSES: THE TROUBLING REALITY OF CAPITAL LIMITATIONS FACED BY MBES* (2010), available at <http://www.mbda.gov/sites/default/files/DisparitiesinCapitalAccessReport.pdf>; Veronica Byrd, *At Work: The Struggle for Minority Managers*, N.Y. TIMES (Mar. 7, 1993), <http://www.nytimes.com/1993/03/07/business/at-work-the-struggle-for-minority-managers.html?pagewanted=all&src=pm> ("As middle- and upper-level managers, African-Americans reaching for the next rung on the corporate ladder are often confronted with these day-to-day challenges. Most often, their colleagues—usually white and male—are oblivious to these problems. But they are all too real to black managers.").

117. See generally Parren J. Mitchell, *Federal Affirmative Action for MBE's: A Historical Analysis*, 11 NAT'L B. ASS'N L.J. 1 (1982) (outlining the history of minority business enterprises and special federal programs targeting these entities); Steven Pearlstein, *Small Business Gets Biggest Push: \$12.9 Billion Set-Aside Outpaces That for Minorities*, WASH. POST, Apr. 5, 1995, at A1.

118. For example, the Minority Business Development Agency is an institution created to help blacks, Mexican-Americans, Puerto Ricans, Native Americans and others become businesspersons, and it offers incentives for corporations to locate plants in run-down urban areas. See *Grants and Loans*, MINORITY BUS. DEV. AGENCY, <http://www.mbda.gov/main/find-grant-and-loan-info> (last visited Dec. 15, 2012).

119. In light of several court decisions, supporters of race-neutrality ideology in the U.S. succeeded in convincing several local and state governments to eliminate their affirmative

Yet, it is evident that not all small firms are engaged in minority advancement. In fact, studies have found that while “[w]omen were associated more often with smaller ventures, . . . there were no differences in the representation of minorities between the smaller and larger start-ups.”¹²⁰ Other studies showed that small firms tend to engage in much more discrimination than their larger counterparts.¹²¹ Consequently, the focus on business size as a means for promoting minority interests seems questionable. If the federal government wishes to encourage employment of minorities, a direct approach targeting these individual businesses could be a more efficient alternative.¹²²

One of the biggest concerns of small business is the heavy regulatory burden that results in high compliance costs, since these costs affect small entities disproportionately.¹²³ For example, tax complexity has been considered one of the highest compliance costs that small businesses face.¹²⁴ These elevated costs are inherent to small firms’ existence due to the factors of economies of scale and risk management, which work to the benefit of large entities.¹²⁵ Therefore, for administrative reasons, some regulatory relief

action programs. Increasing small-business regulation has become a federal way to deal with state initiatives to end policies that promote affirmative action. See Kenneth L. Marcus, *Diversity and Race-Neutrality*, 103 NW. U. L. REV. COLLOQUY 163, 170 (2008) (debating the effectiveness of alternatives to race-neutral programs); cf. Tanya E. Coke, Note, *Lady Justice May Be Blind, but Is She a Soul Sister? Race Neutrality and the Ideal of Representative Juries*, 69 N.Y.U. L. REV. 327, 348 (1994) (“The Court’s statements about the need for absolute race-neutrality in jury selection are worrisome for individual defendants and trial courts . . .”).

120. Arnold C. Cooper et al., *Entrepreneurship and the Initial Size of Firms*, 4 J. BUS. VENTURING 317, 317 (1989).

121. See Richard J. Pierce, Jr., *Small Is Not Beautiful: The Case Against Special Regulatory Treatment of Small Firms*, 50 ADMIN. L. REV. 537, 558–61 (1998) (reviewing the hiring preferences of small businesses and arguing against the special regulatory treatment for small business because they are responsible for social bads).

122. See *id.* at 562.

123. See, e.g., 124 CONG. REC. 34,614 (1978) (statement of Sen. Hatch) (“[S]mall business which pays the same tax rates, is subject to the same bureaucratic harassment and experiences the same cyclical economic changes that confront larger firms and is now forced to compete with them in the debt capital market.”).

124. See William M. Gentry & R. Glenn Hubbard, *Tax Policy and Entrepreneurial Entry*, 90 AM. ECON. REV. 283, 287 (2000) (analyzing how “the convexity of the tax system also affects behavior”); Sullivan, *supra* note 23 (“Small businesses bear disproportionate compliance burdens. According to the latest estimates, small businesses spent about 1.75 billion hours and \$15.5 billion on income tax compliance. Most of the time the burden was from record keeping. And most of the financial burden was in paying for professional help.”).

125. See, e.g., 124 CONG. REC. 35,214 (1978) (statement of Sen. Nelson) (“[D]uring the past quarter-century economic forces and public policy have created a hostile environment for small business: increasing barriers to capital formation, massive and unnecessary paperwork, proliferating regulation, the spread of anticompetitive practices, and unequal treatment under the many laws. These conditions threaten the future of small enterprise in this Nation.”).

is granted to firms according to their size.¹²⁶ An examination of this broad policy consideration in connection with "small business" would be an extensive project that has been discussed at length elsewhere.¹²⁷

Lastly, the small-business ethos is deeply rooted in the history of the American nation and its democratic tradition.¹²⁸ Thus, the importance of small business in our society has historical and public-choice angles.¹²⁹ Furthermore, there is a political and rhetorical value to invoking small-business arguments.¹³⁰ It may be that some of these stated goals are window dressing elected officials use to promote other political objectives. It is conceivable that politicians and policymakers promote small-business legislation and cite those entities as drivers of economic growth for its political value.¹³¹ Because small business has become, in essence, an embodiment of American ethos, politicians use small entities to elicit a positive image in the minds of voters.¹³² This theory may be beneficial in

126. For example, in bankruptcy law a "small business debtor" is defined as a person with debt that does not exceed \$2,343,300. 11 U.S.C. § 101(51D)(B) (2006) (dollar amount adjusted by the Judicial Conference of the United States pursuant to 11 U.S.C. § 104(a) (2006) after notice provided by 72 Fed. Reg. 7082 (Feb. 14, 2007) and 75 Fed. Reg. 8747 (Feb. 25, 2010)). This amount will be adjusted every three years to reflect changes in the Consumer Price Index. *Id.* § 104(a). An accelerated procedure sought to enable small-business debtors to maintain a higher proportion of their assets in addition to saving them administrative costs and compliance fees. The National Bankruptcy Committee declared that it considered debt level criteria appropriate to predict complexity of bankruptcy cases. It found that cases with lower debt levels usually had either no appointed creditors' committee or had an inactive creditors' committee. See NAT'L BANKR. REVIEW COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS 636 (1997), available at <http://govinfo.library.unt.edu/nbrcreportcont.html> (information in subsection "Small Business Proposals," in Chapter 2).

127. See Pierce, *supra* note 121, at 542-43.

128. See Lawrence M. Friedman, *Access to Justice: Some Comments*, 73 FORDHAM L. REV. 927, 930 (2004) (discussing the belief that "[p]eople are expected to 'make it' on their own").

129. But see Sullivan, *supra* note 5 ("[D]espite all you may have been hearing—there is nothing particularly wonderful about small business that it deserves special treatment from the federal government.").

130. See Jared Bernstein, Op-Ed., *Small Isn't Always Beautiful*, N.Y. TIMES (Oct. 24, 2011), <http://www.nytimes.com/2011/10/24/opinion/small-businesses-arent-key-to-the-economic-recovery.html> ("The next time a politician tells you how he or she is for small business (which will likely be the next time you hear a politician say anything), be mindful that to the extent that size matters at all for job growth, it's really about new companies that will start small and, if they survive, perhaps grow large. Everything else is largely noise—and too often, noise that has little to do with what this economy really needs.").

131. Sullivan, *supra* note 5 ("But politics has far more to do with emotion and perception than economic reality. Small companies are the darlings of the business world. They have semi-sacred status in the American political economy . . .").

132. For example, Samuel Joseph Wurzelbacher, a.k.a. "Joe the Plumber," gained national attention in the 2008 election when presidential candidates used him extensively to demark small-business policy perspectives. See Larry Rohter, *Plumber from Ohio Is Thrust into Spotlight*, N.Y. TIMES (Oct. 15, 2008), <http://www.nytimes.com/2008/10/16/us/politics/16plumber.html> (describing how Joe the Plumber became a symbol of small business for both candidates); Jodi Rudoren, *What About Joe?*, N.Y. TIMES (Nov. 12, 2008), <http://www.nytimes.com/2008/11/13/>

explaining why there are few incentives for congressional representatives to significantly curtail the definition of small entities and why politicians do not consider the current imprecision or overinclusiveness problematic.¹³³

Small business, in a way, has developed into the beast that feeds itself.¹³⁴ It has received a “semi-sacred status in the American political economy.”¹³⁵ Over the years, small-business owners have become “near and dear to the hearts of politicians in both parties.”¹³⁶ Jared Bernstein, a senior fellow at the Center on Budget and Policy Priorities, and former chief economist and economic adviser to Vice President Joseph R. Biden Jr., nicely summed up the small-business ethos in political discourse, noting, “I challenge you to find a stump speech by a politician running for any office from dog catcher to president that doesn’t invoke the importance of small businesses.”¹³⁷

Yet, this Article is about different things. In previous articles, this author scrutinized the persistence of small-business privileges using public-choice theory and the path-dependence paradigm.¹³⁸ Current legal paths of small-business preferences, it was argued, became dependent on or locked in an inefficient path due to a practice of “increasing returns” that occurred when supporting organizations lobbied and self-reinforced the spillovers created by small-business entities.¹³⁹ This atmosphere of vivacious “small business culture” that emphasized these entities’ positive contributions to economic development is one more explanation for why every politician, including

business/smallbusiness/13PLUMB.html (outlining a political debate with arguments by both candidates using Joe the Plumber); Op-Ed., *Socking It to Small Business*, WALL ST. J. (Oct. 21, 2008), <http://online.wsj.com/article/SB122455021772252457.html> (describing the debate over the effects of various political agendas on Joe the Plumber).

133. Sullivan, *Start-Ups*, *supra* note 105 (“[E]ven the Obama administration . . . will never attack the conventional wisdom about small businesses and job creation . . . because it does not want to offend the powerful small business community. . . . Better to upset a few economists than lose the support of the public, which has been taught to equate tax increases for the wealthy with tax increases for small business job creators.”).

134. *Id.* (“[N]o politician of any persuasion wants to do anything but praise small businesses.”).

135. Sullivan, *supra* note 5 (“Small companies are the darlings of the business world. They have semi-sacred status in the American political economy, like family farmers and homeowners. They are doers. They are entrepreneurs. Public sentiment for small business is far more favorable than for large business. When it’s David versus Goliath, human nature inevitably draws us to root for the little guy. It almost goes without saying that any public relations effort by business will place as much emphasis as possible on the smallness of it.”).

136. Sullivan, *supra* note 71 (“Next to support for the troops, nothing is more sacrosanct on Capitol Hill than support for small business.”).

137. Bernstein, *supra* note 130.

138. Mirit Eyal-Cohen, *When American Small Business Hit the Jackpot: Taxes, Politics and the History of Organizational Choice in the 1950s*, 6 PITT. TAX REV. 1 (2008) [hereinafter Eyal-Cohen, *Jackpot*]; Eyal-Cohen, *supra* note 1.

139. See generally Eyal-Cohen, *supra* note 1.

President Obama in his 2012 State of the Union Address, chooses to emphasize the significance of small entities to the economy.¹⁴⁰

In conclusion, this Part demonstrated that there is no direct correlation between a firm's size and its entrepreneurial character. In addition, *some*, but not *all*, small-business firms promote free enterprise and job growth—not because of their size, but due to their innovative character. Yet, even if one argues to the contrary, the next Part will demonstrate that current definitions of size should be curtailed because they are equally inconsistent and overinclusive. It will do so by first examining various firm-size delineations found in different legal definitions of small entities, then by examining their legislative intent, and finally by comparing the corresponding firms that are captured by those definitions.

III. CURRENT DEFINITIONS OF "SMALL"

Now that we have identified the goals behind special regulatory treatment of small business, we turn to our present legal system. How do we distinguish small firms from other entities? There is no one uniform definition of size used to determine when an organization is considered a small business.¹⁴¹ In each area of law, size classifications vary. This Part will review some of the most notable firm-size definitions and the corresponding population of firms they encompass. It will reveal that current size definitions are not only an inaccurate measure for promoting entrepreneurship, economic growth, and free enterprise, but they are also inconsistent and overinclusive.

An entity may be considered a small business in securities law but may not be treated as one when it comes to tax law or labor and employment law. In fact, only a small fraction of entities qualify as "small" across *all* definitions in *all* areas of the law. Many medium-sized firms are "free-riding," reaping the benefits intended for truly small entities. Therefore, the current legal definitions do not fulfill the policy considerations they aimed to promote in the first place. Put differently, even if small businesses are responsible for the positive spillovers some people attribute to them, they are not properly classified in current legal size definitions.

A. SECURITIES LAW

Securities laws govern business entities' abilities to access public capital markets. These laws treat small entities favorably by granting them more relaxed registration and reporting requirements.¹⁴² Small organizations under the Securities Act are defined according to their function in the

140. See Obama, *supra* note 4.

141. Even the SBA "uniform" size standards have been deemed too complex and unsatisfactory. See *infra* Part III.E.

142. See 17 C.F.R. § 230.157 (2012).

market, but they are generally described as entities engaged in small-business financing with total assets of \$5 million or less.¹⁴³ For example, the reporting obligations of small companies require simpler financial statements and do not need to be audited because the Exchange Act reporting obligations apply only to companies with more than \$10 million in total assets or 500 shareholders.¹⁴⁴ While 98% of all corporations have assets of \$10 million or less and can therefore potentially qualify as small under this exemption,¹⁴⁵ only 16.3% of all current public companies have total assets of \$10 million or less *and* 500 shareholders or less.¹⁴⁶

Recently, the Securities and Exchange Commission amended its disclosure and reporting requirements to allow more smaller companies scaled disclosure requirements under regulation S-K.¹⁴⁷ A new status was created—the “Smaller Reporting Company”—to denote companies with less than \$75 million in public equity float.¹⁴⁸ By expanding the concept of “smallness,” the regulations also expanded the number of companies that qualify for a scaled and simplified disclosure.¹⁴⁹ Prior to the amendment,

143. Moreover, in order to relieve the administrative burden in issuing securities, some securities laws utilize a definition based on the size of issue, not the size of the company. *See* Securities Act of 1933, Pub. L. No. 73-22, § 3(b), 48 Stat. 74, 76–77 (codified as amended at 15 U.S.C.A. § 77c(b)(1) (West 2012)); 17 C.F.R. § 230.251 (describing that a small-business offering is exempt from Regulation A filings registration if it does not exceed a dollar limitation prescribed by the Securities Act of 1933). Yet, these size definitions do not indicate the size of the offering firm. A company with trillions in assets may still have the ability to qualify under these exemptions if it has a small enough issuance, while a company with small or no total assets may fail to qualify for the exemptions if it is engaged in a large enough issuance.

144. 15 U.S.C.A. § 78l(g) (West 2012). Unlike Regulation A filings, Form S-1 requires audited financial statements. *See Small Business and the SEC*, U.S. SEC. & EXCHANGE COMM’N, <http://www.sec.gov/info/smallbus/qasbsec.htm> (last updated Dec. 21, 2012) (describing that the reporting obligations are suspended if a “company has fewer than 300 shareholders of record of the class of securities offered” or if a “company has fewer than 500 shareholders of record of the class of securities offered and less than \$10 million in total assets for each of its last three fiscal years”).

145. In 2008, out of a total of 5,847,221 firms, 5,749,768 had \$10 million in assets or less. *See* INTERNAL REVENUE SERV., U.S. DEP’T OF THE TREASURY, 2008 STATISTICS OF INCOME: CORPORATION INCOME TAX RETURNS 2 fig.A (2008) [hereinafter CORPORATION INCOME TAX RETURNS], available at <http://www.irs.gov/pub/irs-soi/08ccocr.pdf>.

146. As of December 20, 2012, out of 18,373 active and inactive public companies, 10,479 have 500 shareholders or fewer, 4918 have total assets of \$10 million or less, and applying both conditions results in 3001 public companies. *See Advanced Search*, MERGENT ONLINE, <http://mergentonline.com/advancedsearch.php> (last visited Dec. 20, 2012). Yet, this percentage could be even lower because small reporting companies cannot include a majority-owned subsidiary of a parent that is not a smaller reporting company. 17 C.F.R. § 229.10(f).

147. 17 C.F.R. §§ 229, 230, 239, 240, 249, 260, 269.

148. *Id.* § 229.10(f)(1)(i). The new Smaller Reporting Company Regulatory Relief and Simplification regulations replaced the definition of “small business issuer.” Instead, the new regulation added the term “smaller reporting companies.” *See id.* § 229.10(f).

149. Companies without a calculable public equity float will qualify if their revenues were below \$50 million in the previous year. *Id.* §§ 229.10(f)(1)(iii), 230.405, 239, 240.12b-2, 249, 260, 269.

29% of all reporting companies elected to take advantage of the small-business issuer status.¹⁵⁰ The Securities and Exchange Commission estimated that 42% will now be eligible to utilize the new scaled disclosure requirements.¹⁵¹ Therefore, we are left to wonder if there is a need for such a rule when almost half of the companies appear eligible for an exemption under the "small" status.

There are several rationales behind these small-business reporting exemptions, parallel to the policy considerations mentioned in Part II above.¹⁵² Granting small-business exemptions from certain disclosure requirements does not come without a price. Consumers and investors of small companies receive less information under the regulations and as a result bear a higher risk of default or fraud.¹⁵³ Nevertheless, Congress sought to balance protecting investors with benefiting small firms in the hope of increasing these entities' access to capital markets. The rationale is, once again, that small firms are viewed as the panacea for the nation's unemployment problem and as the gateway to economic growth.¹⁵⁴ In 1992, when debating small-business initiatives to create reduced small-business reporting requirements for the first time,¹⁵⁵ and during hearings to facilitate small-business capital formation and job creation, Senator Dodd reiterated these policy considerations:

I do not have to state for this audience the importance of small business, which has been the engine of economic growth and job creation in this country. We simply have got to look for ways to

150. Prior to the amendment, 3395 reporting companies elected to take advantage of the small-business issuer status out of a total of 11,898 reporting companies that filed annual reports in 2006. Smaller Reporting Company Regulatory Relief and Simplification, 73 Fed. Reg. 934, 935 (Jan. 4, 2008) (codified at 17 C.F.R. §§ 210, 228–230, 239–240, 249, 260, 269).

151. The Securities and Exchange Commission has estimated that a total of 4976 companies will be eligible to use the scaled-disclosure requirements under the new amendments, out of a total of 11,898 reporting companies that filed annual reports in 2006. *Id.*

152. See *supra* Part II.

153. *Legislative Proposals To Facilitate Small Business Capital Formation and Job Creation: Hearing Before the Subcomm. on Capital Mkts. & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 112th Cong. 61 (2011) [hereinafter *Hearings on Small Business Capital Formation*] (statement of Heath Abshire, Arkansas Security Comm'r) ("The challenge for Congress today is to find policies that achieve the right balance between the competing objectives of promoting investment in real and valid business opportunities and protecting citizens from inappropriate risk and fraudulent schemes.").

154. See, e.g., *The Future of Capital Formation: Hearing Before the H. Comm. on Oversight & Gov't Reform*, 112th Cong. 5 (2011) (statement of Mary Schapiro, Chairman, Security and Exchange Commission) (raising concerns regarding the ability of emerging small companies to grow and raise capital).

155. See Small Business Incentive Act of 1992, H.R. 4938, 102d Cong. (1992).

help these small firms, these incubator industries, to get the capital they need to grow and prosper.¹⁵⁶

The Senator marginalized other policy considerations such as reducing administrative and compliance costs on small business that were raised in support of the exemption, stating:

We had hoped that by increasing the lending power of small banks, we could begin to address the problems of small businesses gaining access to bank credit. . . .

So now we turn to yet another approach—giving small business better access to public capital markets and making it easier for mutual funds, venture capital firms, and other investors to channel money to small industries.

There are some who will support the legislation, I suspect, simply because it has been characterized as a deregulation effort.

Let me just say at the outset that I don't accept that argument as being the sole justification for this legislation. While it is true that regulations can be a burden, that in and of itself is not going to be a justification for passing this legislation.¹⁵⁷

Moreover, these rationales continue to feed into the discussion today on the expansion of disclosure preferences for small business. In recent hearings on legislative proposals to facilitate capital formation for small business, representatives maintained that a lasting solution to the nation's high unemployment rate includes measures to facilitate robust small business and entrepreneur access to capital: "By unshackling entrepreneurs and small businesses from excess Federal regulations, our economy job creation engine will once again put us on the path to prosperity."¹⁵⁸

B. HEALTHCARE

A key provision in the latest healthcare reform is the introduction of new benefits for small-business employers.¹⁵⁹ This portion of the reform sought to increase health-insurance affordability for small-business employers and therefore improve employee access to affordable

156. *The Small Business Incentive Act of 1992: Hearing Before the Subcomm. on Sec. of the S. Comm. on Banking, Hous., & Urban Affairs*, 102d Cong. 2 (1992) (statement of Sen. Dodd). Senator Donald W. Riegle, Jr. repeated this justification, noting that "[s]mall business is a powerful engine of employment growth." *Id.* at 5.

157. *Id.* at 3 (statement of Sen. Dodd).

158. *Hearings on Small Business Capital Formation*, *supra* note 153, at 7 (statement of Rep. McCarthy).

159. See generally Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010) (codified as amended in scattered sections of 21, 25, 26, 29, and 42 U.S.C.) [hereinafter Affordable Care Act]; Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (codified in scattered sections of 20, 26, and 42 U.S.C.).

healthcare.¹⁶⁰ The reform added a new term, "small employer," which is defined as an employer hiring up to 100 employees.¹⁶¹ Several other places in the Affordable Care Act apply this definition where the "small business employer" is mentioned.¹⁶² How many firms can utilize small-business benefits under this reform? Many. According to the U.S. Census Bureau, today about 98% of all employer firms have 100 employees or fewer.¹⁶³

The healthcare-reform law also introduced additional tax benefits that targeted small-business employers. For example, a new refundable tax credit sought to cover up to 35% of the employer's contribution (50% of the employer share by 2014).¹⁶⁴ However, to benefit from this tax credit, a small business must have ten or fewer full-time employees.¹⁶⁵ In corresponding numbers, about 79% of all employer firms have ten employees or fewer and therefore have the ability to take advantage of this tax subsidy.¹⁶⁶ The term "small" here includes, in fact, a vast number of firms.

160. See generally Edward Alan Miller, *Affordability of Health Insurance to Small Business: Implications of the Patient Protection and Affordable Care Act*, 36 J. HEALTH POL. POL'Y & L. 539 (2011).

161. See Affordable Care Act § 1304(b)(2) (codified at 42 U.S.C. § 18024(b)(2) (Supp. IV 2010)). Moreover, until 2016, states will be able to elect to limit that definition to fifty employees. *Id.* § 1304(b)(3) (codified at 42 U.S.C. § 18024(b)(3) (Supp. IV 2010)).

162. For example, each state has to establish an American Health Benefit Exchange with Small Business Health Options Programs ("SHOP") designed to assist small-business employers by enabling them to identify affordable health-insurance coverage options. See *id.* § 1311(b) (codified at 42 U.S.C. § 18031(b) (Supp. IV 2010)). The health reform also provided for grants and technical assistance to help states in establishing these Small Business Health Options Exchanges. See 2 TREATISE ON HEALTH CARE LAW § 11.24(1) (Alexander M. Capron & Irwin M. Birnbaum eds., LexisNexis 2012). The Affordable Care Act established special "cafeteria plans" for small businesses and announced that the government will provide grants targeting small firms to enable employees of such concerns to access workplace wellness programs. Affordable Care Act § 10408 (codified at 42 U.S.C. § 2801 and note (2006 & Supp. IV 2010)). But for that purpose, the Affordable Care Act stated that only employers with fewer than 100 employees who work twenty-five hours or more per week will be able to apply for those grants. *Id.*

163. In 2008, out of 5,930,132 employer firms (firms with payroll), 3,617,764 firms had one to four employees (61%), 1,044,065 firms had five to nine employees (17.6%), 633,141 firms had ten to nineteen employees (10.7%), 526,307 firms had twenty to ninety-nine employees (8.9%), and 90,386 had 100 to 499 employees (1.5%). See *Statistics About Business Size (Including Small Business) from the U.S. Census Bureau*, U.S. CENSUS BUREAU tbl.2a, <http://www.census.gov/econ/smallbus.html> (last visited Dec. 15, 2012) [hereinafter *Statistics About Business Size*].

164. See KOSALI SIMON, CTR. FOR AM. PROGRESS, IMPLICATIONS OF HEALTH CARE REFORM FOR EMPLOYERS: AN ANALYSIS OF THE PATIENT PROTECTION AND AFFORDABLE CARE ACT 9 (2010), available at http://www.americanprogress.org/issues/2010/05/pdf/health_employers.pdf.

165. Specifically, there must be ten or fewer full-time employees with average annual wages of up to \$25,000. See Affordable Care Act § 1421(a) (codified at I.R.C. § 45R(d) (2006 & Supp. IV 2010)).

166. See *Statistics About Business Size*, *supra* note 163.

The possible effect the new healthcare reform may have on small business has been a subject of much debate.¹⁶⁷ Yet, there has been remarkable bipartisan agreement on the importance of granting small-business tax credits in the Affordable Care Act. Small business has been cited by legislators as the wellspring of employment and economic development, and, as such, it should not be burdened by the added cost of providing health insurance to employees.¹⁶⁸ During debates on the healthcare reform, congressional representatives reiterated the importance of small business to the nation's employment-expansion and economic-growth policies. Here is a representative statement:

So underpinning, supporting the small business community, is important because, as we know, it is the driver; it is producing the great majority of new jobs in the private sector in America today. If we can take that outcome and enhance it by addressing an Affordable Care Act that impacts soundly and progressively and positively the small business community, then we are doing something to increase America's growth in jobs. . . .

We have seen what an economic engine the small business community is. Since time beginning for this Nation, the small business community has been that pulse of American enterprise. It has been that predictor of soundness, of job creation, and of economic recovery.¹⁶⁹

167. See, e.g., Reed Abelson, *Savings for Small Business in Health Plan*, N.Y. TIMES (June 10, 2009), <http://www.nytimes.com/2009/06/11/business/smallbusiness/11insure.html> (citing a study that concludes that the changes would be better for small employers); Editorial, *Health Reform and Small Business*, N.Y. TIMES (Aug. 12, 2009), <http://www.nytimes.com/2009/08/13/opinion/13thu1.html> ("The impact on small businesses has become a flashpoint in the increasingly raucous debate over health care reform."); Noam N. Levey, *Obama Healthcare Law Not Yet Resonating with Public*, L.A. TIMES (Mar. 20, 2012), <http://articles.latimes.com/2012/mar/20/nation/la-na-obama-healthcare-20120321> ("Just a tiny fraction of Americans has experienced a major benefit from the law."); Kathleen Sebelius, Op-Ed., *The Affordable Care Act Has Made the U.S. Health-Care System Stronger*, WASH. POST (July 9, 2012), http://articles.washingtonpost.com/2012-07-09/opinions/35487462_1_affordable-care-act-health-coverage-national-health-expenditures (arguing that the new health reform saves "hundreds of thousands of small companies thousands of dollars each on their insurance costs").

168. 158 CONG. REC. H5267 (daily ed. July 25, 2012) (statement of Rep. Richardson) ("I argue that the Affordable Care Act, when fully implemented, will promote job growth, support economic growth and spur deficit reduction in our economy in terms of the deficit that we currently are experiencing. . . . There is a common and persistent misconception that the Patient Protection and Affordable Care Act will pose an undue burden on small businesses and will limit job creation, but this is absolutely untrue.").

169. 158 CONG. REC. H4898 (daily ed. July 17, 2012) (statement of Rep. Tonko); see also 158 CONG. REC. S1959 (daily ed. Mar. 22, 2012) (statement of Sen. Whitehouse) ("These credits are a lifeline for small businesses that are struggling in today's difficult economy and for the people those small businesses employ."); 157 CONG. REC. H4201 (daily ed. June 15, 2011) (statement of Rep. Bucshon) ("Over and over, the small business leaders told me that government regulations and uncertainty are negatively affecting their ability to grow and create

Recently, the Supreme Court in a landmark decision delivered by Chief Justice Roberts upheld the constitutionality of the individual-mandate portion of the Affordable Care Act.¹⁷⁰ The individual mandate, the part in the Act that requires most Americans to maintain "minimum essential" health-insurance coverage and imposes penalties in the form of a tax on those who do not comply with the mandate,¹⁷¹ was held a constitutional exercise of Congress's taxing power. Yet, in light of the various tax benefits granted to small business under the Act, it was bewildering to some to discover that among the twenty-six states and several individuals that brought the suit challenging the Act's constitutionality was the National Federation of Independent Business ("NFIB"), a leading small-business association.¹⁷²

The key aspect of the health reform that inflamed small-business resistance was the tax penalties imposed under the Act.¹⁷³ In the suit, NFIB contended that the limited benefits provided by the tax credits do not offset the additional costs the Act imposes.¹⁷⁴ Moreover, these taxes were said to restrict the freedom of small business to self-insure instead of participate in state-regulated market exchanges.¹⁷⁵ Others argued that if more small businesses opt out of the Act and choose to self-insure, premiums for

jobs."); 157 CONG. REC. S2429 (daily ed. Apr. 13, 2011) (statement of Sen. Vitter) ("When those interest rates eventually go up, it makes it harder for all of us and our families to buy cars and homes, to pay tuition, to create jobs if we are a small business.").

170. Nat'l Fed'n of Indep. Bus. v. Sebelius, 132 S. Ct. 2566, 2600, 2606–07 (2012) (upholding the constitutionality of the individual mandate but striking down the withdrawal of federal Medicaid funding from states that opted out of the Medicaid expansion).

171. I.R.C. § 5000A(a) (Supp. IV 2010).

172. The NFIB was part of the Small Business Coalition for Affordable Healthcare, which included business groups such as the U.S. Chamber of Commerce. The coalition argued that the new law introduces new taxes and perverse incentives that will harm the workplace and the relationship between employers and their employees. See Kent Hoover, *Year of Uncertainty Ahead for Health Care Reform*, BUS. JOURNALS (Jan. 31, 2011), <http://www.bizjournals.com/bizjournals/washingtonbureau/2011/01/31/bureau1.html>.

173. John George, *Supreme Court To Hear Business Group's Challenge to Health Reform*, PHILA. BUS. J. (Nov. 14, 2011), <http://www.bizjournals.com/philadelphia/news/2011/11/14/supreme-court-to-hear-business-groups.html> ("Small businesses have been deeply concerned by the health-care law ever since it was enacted because they can't predict their expenses." (quoting Kevin Shivers, the director of the NFIB's Pennsylvania chapter)).

174. Brief for Private Petitioners on Severability at 18, Nat'l Fed'n of Indep. Bus. v. Sebelius, 132 S. Ct. 2566 (2012) (Nos. 11-393, 11-398, and 11-400), 2012 WL 72440 ("For all of these reasons, private insurance customers will continue to bear the cost of millions of people failing to buy insurance after 2014.").

175. Timothy Stoltzfus Jost & Mark A. Hall, *Self Insurance for Small Employers Under the Affordable Care Act: Federal and State Regulatory Options* 18–20 (Wash. & Lee Pub. Legal Studies Research Paper Series, Paper No. 24, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2070883 (arguing that the federal government should take the lead in determining the proper confines of self-funding in the small-group employer market).

insured plans will rise and could seriously impair the regulated market.¹⁷⁶ Nonetheless, as the administration begins to corroborate the healthcare reform, whether these are indeed valid concerns remains to be seen.

C. LABOR AND EMPLOYMENT

The Civil Rights Act and the Age Discrimination in Employment Act prohibit certain employment practices.¹⁷⁷ Employers are not allowed to discriminate on the basis of race, color, religion, sex, or age in hiring, firing, compensating, or granting employment privileges.¹⁷⁸

Nevertheless, both Acts contain small-business exclusions from liability. The Age Discrimination in Employment Act exempts employers with fewer than twenty employees,¹⁷⁹ while the Civil Rights Act excludes employers with fewer than fifteen employees.¹⁸⁰ A similar exclusion can be found in the Americans with Disabilities Act. Here, too, the term "employer" is delineated to include "a person engaged in an industry affecting commerce who has 15 or more employees for each working day"¹⁸¹ Correspondingly, about 84% of small-business owners and their employees are not held liable for violations of these Acts.¹⁸² One is left to wonder, then, what is the point of promulgating a rule from which more than half of the existing entities it targets are exempted?¹⁸³

176. *Id.* at 10 ("The possibility for adverse selection against the exchanges and insured markets and serious destabilization of the small group market is substantial.").

177. Age Discrimination in Employment Act 1967, 29 U.S.C. § 623 (2006 & Supp. IV 2010); Civil Rights Act of 1964, 42 U.S.C. § 2000e-2 (2006).

178. 29 U.S.C. § 623 (age); 42 U.S.C. § 2000e-2 (race, color, religion, and sex). The Acts also provide that it is unlawful for employers to advertise for employment by indicating a preference for certain employees or to retaliate against employees or candidates who expressed their dislike of such unlawful behavior. 42 U.S.C. § 2000e-3(a)-(b); 29 U.S.C. § 623(d)-(e).

179. The term "employer" is delineated in this Act as "a person engaged in an industry affecting commerce who has twenty or more employees for each working day in each of twenty or more calendar weeks in the current or preceding calendar year. . . . [P]rior to June 30, 1968, employers having fewer than fifty employees shall not be considered employers." 29 U.S.C. § 630(b).

180. 42 U.S.C. § 2000e(b).

181. Americans with Disabilities Act of 1990, 42 U.S.C. § 12111(5) (2006). A similar exclusion exists in the Consolidated Omnibus Budget Reconciliation Act, which ensures that individuals have continued access to their health insurance in spite of certain events that otherwise would lead to termination of coverage. This Act exempts any group health plan of an employer employing fewer than twenty employees during 50% of the preceding calendar year. 29 U.S.C. § 1161(b) (2006).

182. This is an estimate because there is no data available for firms of ten to fifteen employees. See *Statistics About Business Size*, *supra* note 163.

183. See, e.g., *Pacourek v. Inland Steel Co.*, 858 F. Supp. 1393, 1406 (N.D. Ill. 1994) ("Given the exclusion of small employers from liability under all three statutes, 'in light of Congress' intent to restrict the liability of small entities with limited resources, it is doubtful that Congress intended to impose [civil] liability upon individual employees.'" (quoting *Carlson v. Nw. Univ.*, No. 93 C 5879, 1994 WL 130763, at *3 (N.D. Ill. Apr. 14, 1994))). The courts in *Martinez v. Labelmaster, American Labelmark Co.*, No. 96 C 4189, 1998 WL 786391, at *8 n.9 (N.D.

Other labor and employment acts define small business differently. The Occupational Safety and Health Act protects employees' working conditions.¹⁸⁴ Therefore, the Act encourages employers and their employees to institute programs that provide a safer and healthier work environment.¹⁸⁵ The threshold for an exemption from record keeping under this Act is eleven employees or fewer,¹⁸⁶ which constitutes a little more than 79% of firms today.¹⁸⁷ This is not a negligible amount.

A parallel exclusion for small business appears in related labor acts: the Family and Medical Leave Act, which excludes an employer with fewer than fifty employees;¹⁸⁸ and the Worker Adjustment and Retraining Notification Act, which exempts firms with fewer than 100 employees from notifying their employees in a case of mass layoffs.¹⁸⁹ In numbers, these Acts exempt between approximately 92% and 98% of all firms from complying with the rules set forth in these Acts.¹⁹⁰

Lastly, in 1989, President Bush introduced a small-business exclusion to the Fair Labor Standards Act.¹⁹¹ Accordingly, employees of businesses with annual sales of up to \$500,000 are often unable to sue for unpaid overtime, minimum wage violations, or child labor violations, since their employers do not meet the requirements.¹⁹² According to the SBA, 61% of all firms report

Ill. Nov. 6, 1998), and in *Laporta v. Wal-Mart Stores, Inc.*, 163 F. Supp. 2d 758, 770 (W.D. Mich. 2001), criticized *Pacourk*.

184. See Occupational Safety and Health Act of 1970, 29 U.S.C. § 651 (2006).

185. *Id.* §§ 651, 654-655.

186. 29 C.F.R. § 1904.1 (2012).

187. See *Statistics About Business Size*, *supra* note 163. The exact number for employers with fewer than eleven employees is not known due to data availability. See *id.*

188. Family and Medical Leave Act of 1993, 29 U.S.C.A. § 2611(2)(B)(ii) (2006). An employer not covered under the Act is one that employs fewer than fifty employees "if the total number of employees employed by that employer within 75 miles of that worksite is less than 50." *Id.*

189. Worker Adjustment and Retraining Notification Act, 29 U.S.C. § 2101(a)(1) (2006).

190. See *Statistics About Business Size*, *supra* note 163. The exact number for employees with fewer than fifty employees is not known due to data availability. See *id.*

191. The term "Enterprise engaged in commerce or in the production of goods for commerce" was delineated in the Act to exclude only an enterprise whose "annual gross volume of sales made or business done was . . . less than \$500,000." Fair Labor Standards Amendments of 1989, Pub. L. No. 101-157, § 3(a), 103 Stat. 938 (codified as amended at 29 U.S.C. § 203(s)(1)(A)(i)-(ii) (2006)). This amount is "exclusive of excise taxes at the retail level that are separately stated." 29 U.S.C. § 203(s)(1)(A)(ii). For the legislative history of this Act as it concerns small business, see generally Marc Linder, *The Small-Business Exemption Under the Fair Labor Standards Act: The "Original" Accumulation of Capital and the Inversion of Industrial Policy*, 6 J.L. & POL'Y 403 (1998).

192. See, e.g., *Zarate v. Jamie Underground, Inc.*, 629 F. Supp. 2d 1328, 1333-36 (S.D. Fla. 2009) (granting summary judgment in favor of employer who did not reach the gross sales requirement of \$500,000). But see *Keystone Floor Refinishing Co.*, Admin. Rev. Bd. Case Nos. 03-056 & 03-067, at 5 (Dep't of Labor 2004), 2004 WL 2205230 (holding that Congress did not intend, through 1989 amendments to 29 U.S.C.A. § 203(s), to deny protections to employees of small businesses but "to set an annual \$500,000.00 floor for covered businesses").

receipts of \$500,000 or less and therefore are exempted from the requirements of the Fair Labor Standards Act.¹⁹³ Naturally, these exemptions receive much criticism on the grounds that they ignore the rights of millions of workers employed by small businesses and thus create a double standard.¹⁹⁴

Nonetheless, legislative and judicial histories of these laws teach us that Congress was ready to put these values aside and overrule these concerns when it came to small businesses.¹⁹⁵ Congressional debates and court opinions reveal concerns about the severe effect the control on employment will have on small businesses, which often maintain personal employment relationships.¹⁹⁶ Protecting small business from the burdens of compliance and the costs of litigation associated with labor and employment suits were other considerations for exempting small business.¹⁹⁷ Yet, preserving free

193. In 2007, 3,699,401 out of 6,049,655 firms reported receipts of \$499,999 or less. See U.S. SMALL BUS. ADMIN., EMPLOYER FIRMS, ESTABLISHMENTS, EMPLOYMENT, ANNUAL PAYROLL, AND RECEIPTS BY RECEIPTS SIZE OF FIRM AND MAJOR INDUSTRY, 2007 (2007), available at http://archive.sba.gov/advo/research/us_rec_mi.pdf.

194. See, e.g., Ruben H. Arredondo, Comment, *Different Strokes for Different Folks: Balancing the Treatment of Employers and Employees in Employment Discrimination Cases in Courts Within the Tenth Circuit Court of Appeals*, 16 BYU J. PUB. L. 261, 285 (2002) (criticizing small employer exemptions in anti-discrimination legislation); Kathleen M. Nichols, Comment, *Labor and Employment Law—Determining Employee Status for Evolving Business Associations Under the Americans with Disabilities Act—Clackamas Gastroenterology Associates, P.C. v. Wells*, 538 U.S. 440 (2003), 38 SUFFOLK U. L. REV. 239, 241 (2004) (“Congress determined these smaller entities would be unable to carry the burden of defending lawsuits when compared to their larger competitors. Several other federal anti-discrimination statutes also contain this exemption. As a result, the ADA does not cover over twenty million employees due to the size of the business.” (footnotes omitted)).

195. For example, during floor debates in 1964 on the small-business exclusion in Title VII, there was a bipartisan agreement on the need for such exclusions due to the costs associated with complying and defending against discrimination claims. See 110 CONG. REC. 13,091–92 (1964) (statement of Sen. Cotton); *id.* at 13,088 (statement of Sen. Humphrey); *id.* at 13,092–93 (statement of Sen. Morse). The dissent to the Act supported the exclusions, stressing the personal relations existing in small businesses and the potential effects on competition and the economy. See, e.g., *id.* at 7088 (statement of Sen. Stennis); *id.* at 7207–17 (statement of Sen. Clark). For a general overview of the legislative history of small-business preferences in labor and employment law, see Jacqueline Louise Williams, Note, *The Flimsy Yardstick: How Many Employees Does It Take To Defeat a Title VII Discrimination Claim?*, 18 CARDOZO L. REV. 221, 258 (1996) (“Congress and the courts have created a new minority—one that has no protection at all from the gritty wind of discrimination.”).

196. See, e.g., *Palmer v. Ark. Council on Econ. Educ.*, 154 F.3d 892, 897 (8th Cir. 1998) (“Congress based its twenty-employee minimum on ‘the practical consideration that a larger employer with more varied jobs could more constructively utilize an older worker’s skills.’” (quoting *Kelly v. Wauconda Park Dist.*, 801 F.2d 269, 272 n.3 (7th Cir. 1986))); 110 CONG. REC. 13,085 (1964) (statement of Sen. Cotton) (“But when a small businessman who employs 30 or 25 or 26 persons selects an employee, he comes very close to selecting a partner; and when a businessman selects a partner, he comes dangerously close to the situation he faces when he selects a wife.”).

197. See 110 CONG. REC. 13,092 (1964) (statement of Sen. Cotton) (“Title VII is the most dangerous part of it, because it would lead the Federal Government with all of its power . . . into

enterprise and healthy employment sources were the main policy considerations utilized to justify the special treatment granted to small businesses in labor and employment laws¹⁹⁸:

[I]t seems to me—forgetting for the moment the question of liberty or freedom or right or wrong or free enterprise or the solidarity of business—this will be an impracticable and unenforcible [*sic*] provision if eventually the requirement is dropped to 25 employees.

....

... [T]he small businesses along the main streets or in the villages and towns and cities are the backbone of our country and of our free enterprise system.¹⁹⁹

Some legislators viewed small businesses as job creators, and therefore there existed a need to maintain their competitive position by relaxing their regulatory burden²⁰⁰:

[L]et us not wreck the small business of this country that gives employment to hundreds of thousands of men and women. Their competitive condition is difficult; their costs are high all the way along the line. . . .

....

... [L]et us be careful that we burden not too heavily certain other segments of the economy.²⁰¹

the way of dealing with a small businessman who can ill afford to protect himself, and in many cases his actions will be judged by the facts of the race or color involved and not by the facts of the case."); *see also* *Thurber v. Jack Reilly's, Inc.*, 717 F.2d 633, 634 (1st Cir. 1983) ("Congressional debate on enactment of Title VII revealed concern for the over-regulation of small family or neighborhood businesses . . ."); *Richardson v. Bedford Place Hous. Phase I Assocs.*, 855 F. Supp. 366, 371 (N.D. Ga. 1994) ("[T]he cost of success on a motion to dismiss or motion for summary judgment runs into the tens of thousands of dollars. For small economic enterprises, such outlays threaten financial viability.").

198. 99 CONG. REC. 2045-46 (1953) (statement of Sen. Kefauver) ("In offering this proposed legislation I am seeking no special favors for small business. I am merely urging that small business be given an equal opportunity with big business to compete on the basis of efficiency and service. I am confident that, given this opportunity, small business will prosper and the free competitive system will be immeasurably strengthened.").

199. 110 CONG. REC. 13,085 (1964) (statement of Sen. Cotton).

200. *See, e.g.*, 101 CONG. REC. 10,960 (1955) (statement of Rep. Coon) ("However the economy in my district is the economy in the rest of the Nation, and if we drive small businessmen out of business . . . the repercussion is bound to hit my area sooner or later."); 92 CONG. REC. 2559 (1946) (statement of Sen. Willis) ("There is nothing in our free economy which denies a man the right, when he can see an opportunity to start a small business[,] . . . and there is nothing in our free economy or philosophy which should place that man under jeopardy of the law for so doing.").

201. 101 CONG. REC. 11,071 (1955) (statement of Rep. Halleck).

D. PATENT LAW

One of the primary goals of patent law is to support research and development. Its policy is also to incentivize investment in innovation and invention by encouraging small businesses and non-profit institutions to develop, collaborate, and secure patents:

It is the policy and objective of the Congress to use the patent system to promote the utilization of inventions arising from federally supported research or development; to encourage maximum participation of small business firms in federally supported research and development efforts; to promote collaboration between commercial concerns and nonprofit organizations, including universities; to ensure that inventions made by nonprofit organizations and small business firms are used in a manner to promote free competition and enterprise without unduly encumbering future research and discovery²⁰²

In the 1980s, the Bayh–Dole Act and its subsequent amendments provided that certain research-and-development institutions that patent inventions, such as universities, must give licensing preference to small businesses.²⁰³ Regulations soon followed to establish the right to innovations made through these collaborations.²⁰⁴ The term “small business” was defined, with reference to the Small Business Act, as an entity that “is independently owned and operated and which is not dominant in its field of operation,” and is in accordance with the size standards published by the SBA.²⁰⁵

By the same token, a key part of the statutory patent fee structure is a two-tier fee system, which provides small entities with discounted rates for fees required for application, issuance, search, and maintenance of patents.²⁰⁶ Small-business concerns receive a fifty percent reduction in most patent fees, which increases to seventy-five percent if the patent is filed electronically.²⁰⁷ To receive this benefit, the business owner must file a

202. 35 U.S.C. § 200 (2006). *But see* Deborah Sweeney, *New Patent Law and Its Impact on Small Businesses*, BUS. INSIDER (Sept. 26, 2011), <http://www.businessinsider.com/new-patent-law-and-its-impact-on-small-businesses-2011-9> (criticizing the negative effect of the recent patent-law reform on small business).

203. *See* Act of Dec. 12, 1980, Pub. L. No. 96-517, § 6(a), 94 Stat. 3015, 3025 (current version at 35 U.S.C. § 209(c) (2006)). Matthew A. Williams & Emily C. Lamb, *Patent Reform and Its Effect on University Technology Transfer*, FED. LAW., Sept. 2008, at 1, 12.

204. 37 C.F.R. § 401.1–.17 (2012).

205. 35 U.S.C. § 201(h) (2006) (referencing 15 U.S.C. § 632(a)(1) (2006)).

206. 35 U.S.C.A. § 41(h)(1) (West 2012); *see also* 35 U.S.C. § 376 (2006); 37 C.F.R. §§ 1.16–.21, .445 (2012).

207. 35 U.S.C.A. § 41(h)(1)–(3). The reduced fees include the patent application filing fee, search fee, examination fee, application size fee, and excess claims fees, 37 C.F.R. § 1.16,

written assertion of small-entity status and explain why it qualifies for the status.²⁰⁸ Here, too, the small-entity category is defined with reference to the Small Business Act.²⁰⁹ To be eligible for reduced patent fees, a small business may not have more than 500 employees.²¹⁰ At present, the SBA Office of Advocacy estimates that 99.9% of firms (including nonemployer firms that have no payroll) have fewer than 500 employees,²¹¹ and over 99.7% of employer firms satisfy this requirement.²¹² Both figures demonstrate a preference granted to an overly broad segment of the market.

When discussing this "small inventor subsidy,"²¹³ testimony from "legislative debate[s] addressing the impact of proposed patent law reforms on independent inventors and small business" highlighted their importance to a healthy economy and a free-enterprise system.²¹⁴ During congressional debates, representatives were concerned about the negative effects that high litigation costs and patent filing fees have on small entities.²¹⁵ Congressmen raised policy concerns that these fees are obstacles to innovation and entrepreneurship by precluding small businesses from filing for U.S. patents.²¹⁶ In 1986, when discussing the small-business agenda for the 99th Congress, Representative John J. LaFalce (D-NY) raised the issue of high patent fees, stating:

Increased patent fees also continue to present a problem to small business and an obstacle to achieving the greatest amount of

extension of time, revival, and appeal fee, *id.* § 1.17, patent issue fees, *id.* § 1.18, statutory disclaimer fee, *id.* § 1.20(d), and maintenance fees on patents, *id.* § 1.20(f).

208. 37 C.F.R. § 1.27(c).

209. *Id.* § 1.27(a)(2)(ii).

210. *Id.* § 1.21.802.

211. *Frequently Asked Questions*, U.S. SMALL BUS. ADMIN., <http://web.sba.gov/faqs/faqindex.cfm?areaID=24> (last visited Dec. 15, 2012).

212. See *Statistics About Business Size*, *supra* note 163.

213. 131 CONG. REC. 36,933 (1985) (statement of Sen. Weicker).

214. Mark D. Janis, *Patent Abolitionism*, 17 BERKELEY TECH. L.J. 899, 920-21 (2002) ("Sympathy for the plight of the independent inventor also motivates proposals for second tier patent systems in various parts of the world."); see also 132 CONG. REC. 33,156 (1986) (statement of Rep. LaFalce) ("John F. Kennedy pledged to 'strengthen the cause of the small businessmen who are threatened to be crowded out from the American economic scene and who constitute an historic cornerstone of our free enterprise system.'").

215. 131 CONG. REC. 36,933 (1985) (statement of Sen. Weicker) ("[T]he record is clear that small innovative firms and independent inventors cannot afford to pay the full costs of patent user fees without this subsidized fee schedule.").

216. *E.g.*, 132 CONG. REC. 12,927 (1986) (statement of Sen. Mathias) ("H.R. 2434 . . . reduces patent fees for small business, independent inventors, and nonprofit organizations. . . . The vitality of the U.S. economy is increasingly dependent on protecting the tangible expressions of new and innovative ideas."); 126 CONG. REC. 29,900 (1980) (statement of Rep. Miller) ("I am concerned about independent inventors or small businessmen who will apply for patents in the future. If they cannot afford to pay the increase[d] fee, will we be preventing them from helping us to develop new technologies that will enable the United States to compete with other nations?").

technological innovation possible. Because of the burdens caused by the highest patent fees in history, many small businesses and independent inventors have had to abandon patents with clear commercial potential. The present 50-percent reduction in fees for small business should be made a permanent part of the patent statute, and consideration should be given to altering this new fee system to delay massive upfront charges until the commercial value potential of the patent can be assessed. Fees should be paid out of accruing profits rather than penalizing the inventor by taxing his or her creative efforts.²¹⁷

It is apparent that Congress has often reiterated either one or all of the policy considerations of free enterprise, entrepreneurship, and employment expansion anytime it discussed creation or expansion of favorable regulatory treatment to small business, regardless of whether these entities truly promote these policies.²¹⁸ This is especially true when discussing the longest entrenched small-business preference of all—government procurement contracts.

E. GOVERNMENT CONTRACTING LAW

The U.S. government has a long-established policy favoring small business by preferentially allocating government contracts to such entities. Currently, 23% of government-agency contracts must be assigned to small-business entities.²¹⁹ How does government contracting law define a small business? The Federal Acquisitions Regulations System (“FAR”)²²⁰ defines a small business as one that “is independently owned and operated, not dominant in its field of operation in which it is bidding,” and meets applicable size standards.²²¹ The SBA regulations determine the particular size standard in each industry.²²² Generally, size standards are measured by dollar volume of business or number of employees. For businesses in wholesale, retail, service, and distributive trades, a small business is one with no more than \$7 million in annual average receipts.²²³ For most

217. 132 CONG. REC. 33,156 (1986) (statement of Rep. LaFalce).

218. See John C. Stedman, *The U.S. Patent System and Its Current Problems*, 42 TEX. L. REV. 450, 496 (1964) (noting that it remains unclear to what extent these small-business arguments “are anecdotal rather than general, or based upon emotion rather than fact”).

219. *Small Business Goaling*, U.S. SMALL BUS. ADMIN., <http://www.sba.gov/content/small-business-goaling> (last visited Dec. 15, 2012).

220. 48 C.F.R. (2012). The small-business policy can be found in *id.* § 19.201.

221. *Id.* § 2.101.

222. *Id.* § 121.201. This is done according to the North American Industry Classification System. See SIZE STANDARDS DIV., U.S. SMALL BUS. ADMIN., SBA SIZE STANDARDS METHODOLOGY 10 (2009) [hereinafter SBA METHODOLOGY], available at http://www.sba.gov/sites/default/files/size_standards_methodology.pdf.

223. *Summary of Size Standards by Industry*, U.S. SMALL BUS. ADMIN., <http://www.sba.gov/content/summary-size-standards-industry> (last visited Dec. 15, 2012).

manufacturing and mining industries, small businesses are those employing fewer than 500 workers; the standard for wholesale trade industries is 100 employees.²²⁴ Currently, the SBA classifies about 97% of all employer firms as small.²²⁵ Here, it seems that almost all firms are "small."

The genealogy of the 500-employee size standard dates back to 1953, a defining moment for small business with the creation of its primary advocate—the SBA.²²⁶ Initially a temporary agency, the SBA was the successor of the Smaller War Plants Corporation, whose mandate was to mobilize the fair share of productive facilities to small businesses during wartime in light of their predicament during these times.²²⁷ During World War II, small business was depicted as "unable, without assistance, to meet the strains and stresses of the economic conditions that prevailed" and "unable to compete with big business," which obtained "all of the war contracts because small business did not have the capacity and the resources to carry out those contracts."²²⁸

Subsequently, when debating the establishment of preferences for small business in procurement contracts, legislators considered it a necessity to ensure that small businesses received a fair share of government contracts because they were viewed as a source of employment and part of the war effort in the country. Representatives from both parties restated free enterprise, entrepreneurship, and employment expansion as policy considerations justifying the introduction of this small-business subsidy:

[T]he Eisenhower administration is receiving much favorable comment on its favorable attitude toward small business. Small businesses in this country have a habit of growing into bigger

224. *Id.* In some industries such as manufacturing, small businesses are allowed to employ up to 1500 people. *Id.* In other industries, size is a function of the value of assets for financial institutions or mega-watt hours for electric service providers. SBA METHODOLOGY, *supra* note 222, at 37.

225. See ROBERT JAY DILGER, CONG. RESEARCH SERV., R40860, SMALL BUSINESS SIZE STANDARDS: A HISTORICAL ANALYSIS OF CONTEMPORARY ISSUES 1 (2012).

226. Small Business Act of 1953, Pub. L. No. 83-163, § 202, 67 Stat. 232, 232 (current version at 15 U.S.C. § 631(a) (2006)). The Act establishing the SBA stated:

It is the declared policy of Congress that the Government should aid, counsel, assist, and protect insofar as is possible the interests of small-business concerns in order to preserve free competitive enterprise, to insure that a fair proportion of the total purchases and contracts for supplies and services for the Government be placed with small-business enterprises, and to maintain and strengthen the overall economy of the Nation.

Id.

227. During the 1930s and 1940s, the Reconstruction Finance Corporation and the War Finance Corporation of World War I—the SBA's predecessors—supported state and local government loans to banks, railroads, and firms of all sizes. See ADDISON W. PARRIS, THE SMALL BUSINESS ADMINISTRATION 4-18 (1968).

228. 90 CONG. REC. 8694 (1944) (Statement of Rep. Spence).

businesses, of expanding their services to the public, and of increasing their employment and payrolls. By supporting small business, the administration helps the general economy of the Nation.²²⁹

Moreover, the benefits of administering procurement contracts to small business were emphasized by pairing the value of small business with supporting entrepreneurship.²³⁰ Small business, once more, was portrayed as the way to preserve a competitive society and the free-enterprise system:

The amendment simply provides for a distribution of purchases on the portion of procurement made in the United States and gives opportunity for small business to compete.²³¹

Another representative stated:

The sinews and the American way of life in competitive, free enterprise started in the places of small business in America and only by perpetuation of the intent and spirit of small business in America can our free, competitive enterprise be perpetuated in America.²³²

Nonetheless, the American economy has changed vastly since the SBA size baselines were first established in the 1950s.²³³ The 500-employee rule

229. 99 CONG. REC. A2711 (1953) (statement of Rep. Mack); *see also* 96 CONG. REC. 17,087 (1951) (statement of Sen. Fulbright) ("It is self-evident that independent small-business enterprises are indispensable to the free-enterprise system in the United States."); 90 CONG. REC. 8695 (1944) (statement of Rep. Spence) ("[S]mall business has always furnished more employment than those gigantic institutions. Seventy percent of the employment in America was in the small businesses. If we are striving for full production and full employment, we must preserve those institutions."); 88 CONG. REC. 4515 (1942) (statement of Rep. Lynch) ("[The bill's] importance lies . . . in that it will enable small business . . . to resume their normal activity and give employment at a time when employment will be badly needed.").

230. 96 CONG. REC. 17,087 (1951) (statement of Sen. Fulbright) ("The staff of the subcommittee [on Small Business of the Senate Committee on Banking and Currency] can often verify the needs of a small-business entrepreneur by acquainting himself more fully with his problem and advising him of the status of the law and governmental regulations.").

231. 95 CONG. REC. 4334 (1949) (statement of Rep. Burton).

232. *Id.* (statement of Rep. Doyle); *see also* 99 CONG. REC. 4902 (1953) (statement of Rep. Philbin) ("I hope that in due course [this bill] . . . may be adopted in the interest of our free enterprise system, our small-business men and their faithful employees who are so vital to the American economy."); 97 CONG. REC. 8584 (1951) (statement of Rep. Evins).

233. The Small Business Act of 1958 defined the term "small business" as follows:

For the purposes of this Act, a small-business concern shall be deemed to be one which is independently owned and operated and which is not dominant in its field of operation. In addition to the foregoing criteria, the Administration, in making a detailed definition, may use these criteria, among others: Number of employees and dollar volume of business.

Small Business Act, Pub. L. No. 85-536, § 2, 72 Stat. 384, 384 (1958) (current version at 15 U.S.C. § 632(a)(1) (2006)), *repealing and replacing* Small Business Act of 1953, Pub. L. No. 83-163, 67 Stat. 232.

was in many ways just a continuation of a standard used in World War II by the Reconstruction Finance Corporation and the earlier Small War Plants Corporation.²³⁴ Yet, the SBA size standards have remained largely unchanged, entrenched in past notions of magnitude detached from the public's current perception of such a facet.

F. INTERNAL REVENUE CODE

The government offers potentially significant tax benefits to people who operate small firms or own stock in them. Small entities are mentioned in numerous places in the Internal Revenue Code ("Tax Code"). While one might expect the Tax Code to have a consistent definition for small business, in fact the definition changes from one section to another. This inconsistency adds to the complexity of the Tax Code and the tax compliance costs endured by businesses.²³⁵

Section 1202 is one example of a preference that indirectly benefits small-business investors.²³⁶ This section, which originated in 1993, allows noncorporate taxpayers to exclude from taxation any gains from the sale or exchange of qualified small-business stocks.²³⁷ The Tax Code defines a qualified small-business stock as that of a C corporation with less than \$50 million in aggregate gross assets.²³⁸

234. For a review of these organizations and a historical account of the creation of the SBA, see generally Eyal-Cohen, *supra* note 1 (arguing that the small-business investment company is an example of a process of positive feedback and increasing returns of small-business preferences).

235. STAFF OF J. COMM. ON TAXATION, 95TH CONG., GENERAL EXPLANATION OF THE REVENUE ACT OF 1978, at 195 (Comm. Print 1979) (finding that many small businesses do not reap the full benefits they are entitled to—either because they are not familiar with the myriad aspects of the code or because they do not get adequate advice on how to meet the various definitions of a "small business").

236. I.R.C. § 1202 (2006 & Supp. IV 2010).

237. Individuals who own qualified small-business stock for at least five years under section 1202(a)(1) (2006), can exclude up to 50% of the capital gain on disposition, limited to the greater of either \$10 million reduced by any previously excluded gain attributable to such issuer or ten times the aggregate adjusted basis of the qualified small-business stock disposed of in the taxable year at issue. *Id.* § 1202(b)(1). See STAFF OF J. COMM. ON TAXATION, 103D CONG., OVERVIEW OF THE CONFERENCE AGREEMENT ON THE REVENUE PROVISIONS OF THE OMNIBUS BUDGET RECONCILIATION ACT OF 1993 (Comm. Print 1993); Joshua E. Husbands, Comment, *The Elusive Meaning of "Small Business,"* 2 J. SMALL & EMERGING BUS. L. 355, 368–69 (1998).

238. The C corporation has to be actively engaged in trade or business with less than \$50 million in aggregate total assets before and immediately following the issuance of the stock. I.R.C. § 1202(c)(1), (d)(1) (2006 & Supp. IV 2010). Prior to the Tax Reform Act of 1986, the Tax Code provided a reduced tax rate on long-term capital gains: "If for any taxable year a taxpayer other than a corporation has a net capital gain, 60 percent of the amount of the net capital gain shall be a deduction from gross income." I.R.C. § 1202(a) (1982), *repealed by* Tax Reform Act of 1986, Pub. L. No. 99-515, 100 Stat. 2085 (codified as amended in scattered sections of I.R.C.). Although this tax benefit was highly debated between 1969 and 1976, in 1978 a heavily lobbied statutory change put that tax benefit into place until the Tax Reform Act

A comparable tax benefit was later added in section 1045 of the Tax Code. This section permits taxpayers to defer taxes indefinitely by allowing them to roll over capital gains on the sale of small-business stock if the proceeds are reinvested in another qualifying small-business stock.²³⁹ This rollover provision was intended to push down the effective tax rate on small-business investment to zero if all proceeds are continuously reinvested in new small businesses.²⁴⁰ Qualified small-business stocks were defined with reference to section 1202 of the Tax Code. Currently, the Internal Revenue Service provides that 99% of all firms report \$50 million of assets or less—so potentially their investors are eligible for this exclusion as well!²⁴¹ Considering public companies, 19.7% potentially qualify for this favorable treatment.²⁴²

The legislative intent behind these tax benefits was to encourage people to invest in small businesses and to foster their growth by offering incentives for high-tech startup companies and stakeholders that invested in such companies.²⁴³ Policies of promoting entrepreneurship, innovation, and job creation were behind this incentive for entrepreneurial equity capital formation²⁴⁴:

The bill I am introducing today will ensure that these new capital-intensive small businesses will have the money they need to create innovative technologies and create jobs. By raising the Section 1202 definition of small business from \$50 million to \$300 million and raising the capital gains exclusion from 50% to 100% for both individuals and corporations, we can create a climate in

of 1986. See William C. Whitford, *Lowered Horizons: Implementation Research in a Post-CLS World*, 1986 WIS. L. REV. 755, 763–64.

239. I.R.C. § 1045 (2006).

240. Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-Ups*, 57 TAX L. REV. 137, 165–66 (2003) (arguing that the effect of qualified small-business stock subsidies in sections 1202 and 1045 is to cause venture capitalists to favor the C corporation form of incorporation). But see John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: "Hey the Stars Might Lie but the Numbers Never Do,"* 78 TEX. L. REV. 885, 920 (2000) ("[Section 1202] is unlikely to constitute a major factor in choice of tax entity due to the interplay of this preference with the Alternative Minimum Tax . . .").

241. In 2008, out of a total of 5,847,221 returns with or without net income, there were 5,812,477 returns filed by firms with assets totaling \$50 million or less of assets. See CORPORATION INCOME TAX RETURNS, *supra* note 145, at 2 fig.A.

242. As of December 20, 2012, out of 18,373 active and inactive public companies, 7800 companies have \$50 million or less of total assets and 8197 were incorporated/founded after 1993. Applying both conditions results in 3612 public companies. See MERGENT ONLINE, *supra* note 146.

243. See David O. Kahn, *A Qualified Small Business Stock Tax Primer*, L.A. LAW., Dec. 2000, at 17.

244. 146 CONG. REC. 19,031 (2000) (letter of Patrick Von Bargen, Executive Director, National Federation of Independent Businesses, submitted by Sen. Collins) ("[T]he tax incentives could well motivate many more investors to allocate more of their investment dollars to high-growth entrepreneurial companies.").

which individual investors are rewarded for their risky investment and entrepreneurs have the tools they need to succeed.

Capital gains taxes are one of this nation's primary obstacles to job creation and technological innovation. Anything to reduce the effective or actual rate on capital gains taxes will help put more money in the hands of our nation's most enterprising citizens and lift the standard of living for everyone.²⁴⁵

Similar to the favorable treatment of gains, losses incurred on small-business stocks also receive preferential treatment. Section 1244 of the Tax Code treats losses incurred by the sale of a small-business corporation's stock as ordinary losses and not as capital losses, resulting in a bigger write-off.²⁴⁶ Yet, here, a small entity is demarcated differently; it does not adhere to the definition in section 1202. In section 1244, a "small business corporation" is a corporation with an aggregate amount paid in surplus of \$1 million or less at the time of issuance.²⁴⁷ Today, about 32% of all public companies are likely to receive this benefit.²⁴⁸

Senator Bumpers, who authored these tax benefits, emphasized that his proposal maintains fairness by not merely providing tax benefits for the rich, but also by benefitting low and middle income taxpayers by encouraging free enterprise and employment expansion:

This legislation does confer advantages on wealthy taxpayers who act as outside investors and provide capital to entrepreneurs who need it. Any cut in capital gains taxes provides benefits to those who have capital to invest. But, the bill also provides tax benefits to individual entrepreneurs who found new businesses and build its value with their own savings and sweat equity.

The Progressive Policy Institute has found that a targeted capital gains tax reduction is fair to low and middle income taxpayers. The study is entitled "Tax Incentives for Investing in Emerging Firms: A Strategy for Enhancing U.S. Competitiveness" and its author is Robert Shapiro.²⁴⁹

Senator Bumpers went on to say:

This is the American capitalist spirit at work. This is free enterprise in its classic, risk-taking form. This is frontier risk-taking. This is long-term investing. This is the American entrepreneur.

245. 145 CONG. REC. E1369 (daily ed. June 23, 1999) (statement of Sen. Dunn).

246. I.R.C. § 1244(a) (2006).

247. *Id.* § 1244(c)(3). Other sections in the Tax Code refer to this definition of small business corporation. *See, e.g., id.* § 1274(c)(3)(A)(i)(II).

248. As of December 20, 2012, out of 18,373 active and inactive public companies, 5038 companies have \$1 million or less of stockholder equity. *See* MERGENT ONLINE, *supra* note 146.

249. 139 CONG. REC. 2721 (1993) (statement of Sen. Bumpers).

This is the Horatio Alger story in the real world. This is what has made America so prosperous and free. This is the world of direct venture and seed capital investments.²⁵⁰

In a later debate on these tax incentives, Senator Bumpers stressed the need to provide incentives for investments in entrepreneurial efforts and equated small businessmen to entrepreneurs, highlighting their importance to employment expansion and a healthy economy, stating:

Because small businesses are inherently riskier than large businesses, most investors are reluctant to invest in the smaller enterprises. This, obviously, tends to create a dearth of capital for entrepreneurs. But maintaining a healthy investment environment for small businesses is extremely important for the well-being of our economy. Most new jobs come from small businesses, not large ones. From 1991–95, businesses with fewer than 500 employees created 22 million new jobs, while businesses of greater than 500 employees cut 3 million jobs. And it was because of this dynamic small business impact on our economy that Congress passed section 1202 with great bipartisan support in both chambers: we wanted to create a capital formation incentive for small business.²⁵¹

Senator Bumpers concluded:

Mr. President, section 1202 is the major, if not the only, capital formation incentive for small business in the entire Tax Code. It would be a tragedy and a slap in the face of America's entrepreneurs if we fail to maintain this measure in viable form. The bill we are introducing today will do that, and I urge my colleagues to support it.²⁵²

A different example of Tax Code provisions that favor small business is Subchapter S.²⁵³ These provisions allow certain corporations to enjoy a flow-through tax treatment by taxing only their shareholders on corporate earnings.²⁵⁴ This preference, therefore, allows investors in a "small business corporation" (or "S corporation") to avoid the double taxation typically imposed on corporate earnings.²⁵⁵ To qualify as an S corporation, a small business must be a domestic corporation with no more than 100 shareholders and with only one class of stock.²⁵⁶ The Internal Revenue

250. *Id.* at 2723.

251. 143 CONG. REC. 8396 (1997) (statement of Sen. Bumpers).

252. *Id.*

253. See I.R.C. §§ 1361–1379 (2006 & Supp. IV 2010).

254. See Eyal-Cohen, *Jackpot*, *supra* note 138, at 2.

255. *Id.* at 1–2.

256. I.R.C. § 1361(b)(1). For an elaborate history of Subchapter S and the birth of S corporations, see generally Eyal-Cohen, *Jackpot*, *supra* note 138.

Service reports that currently about 70% of all corporations elect to be taxed as S corporations, which remains a popular form of entity for businesspeople.²⁵⁷ Congressional leaders declared in 1958 that they intended this tax benefit to aid small businesses in order to support free competition and entrepreneurship²⁵⁸ in the American economy.²⁵⁹

Lastly, the research-and-development credit provides a credit equal to 20% of qualified research expenses in excess of a base amount.²⁶⁰ Yet, the benefit provides a 100% tax credit for amounts paid for certain qualified research in eligible small firms.²⁶¹ An eligible small business here is defined as a business in which the taxpayer does not own a fifty percent or greater interest and in which there are 500 or fewer employees.²⁶² As stated above, the SBA reported that over 99% of all firms employ 500 or fewer employees and therefore can qualify for that benefit.²⁶³ Once more, this small-business benefit was justified by considering small entities as productive job creators and continuous sources of innovation:

There are supply side tax incentives for capital investment and productivity. Approval of these priority measures by the Finance Committee enable one of the most productive sectors of the American economy to participate fully in our Nation's economic recovery program.

257. In 2008, from a total 5,847,221 entities that filed corporation returns, 4,049,944 filed S corporation returns. That year, the IRS received 31,607,710 total business returns, of which 3,146,006 were partnership tax returns (of which, 1,898,178 elected LLC status), and 22,614,483 were sole proprietorships. *SOI Tax Stats—Integrated Business Data*, INTERNAL REVENUE SERVICE, <http://www.irs.gov/uac/SOI-Tax-Stats—Integrated-Business-Data> (last updated Aug. 15, 2012) (click on "1980–2008" hyperlink under "Table 1").

258. 104 CONG. REC. 14,471 (1958) (statement of Rep. Mills) ("There is, I believe, a sound basis for emphasizing and perpetuating the importance of small business in our economy. Small businesses are the concrete expressions of the creativeness and the entrepreneur imagination which are basic resources for economic progress.").

259. See, e.g., *Tax Problems of Small Business: Hearings Before the S. Select Comm. on Small Bus.*, 85th Cong. 1111 (1958) (statement of B.I. Noble, a small businessman from Littleton, Colorado) ("[S]mall businesses . . . provide the heart and the life for these towns and cities, which combined together we call 'the free and the American way of life.'"); see also 115 CONG. REC. 17,848 (1969) (stating that the Senate Select Committee on Small Business declared that "there is no other tax so injurious to small business and so dangerous to our entire free-enterprise capitalism").

260. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755 (codified as amended in scattered sections of 19, 26, and 42 U.S.C.). "The base amount is determined by multiplying the 'fixed-base percentage' by the [taxpayer's] average annual gross receipts . . . for the four taxable years preceding the taxable year for which the credit is being determined." DAVID L. CAMERON & THOMAS KITTLE-KAMP, *FEDERAL INCOME TAXATION OF INTELLECTUAL PROPERTIES & INTANGIBLE ASSETS* ¶ 1.03(1)(b)(ii) (2012), available at 1998 WL 1038665, at *38.

261. CAMERON & KITTLE-KAMP, *supra* note 260, ¶ 1.03(1)(b)(ii), at *40.

262. I.R.C. § 41(b)(3)(D)(ii)–(iii) (2006).

263. See *supra* note 211 and accompanying text.

The record is clear that small business is really the essence of supply side economics. Small business accounts for 90 percent of the new private sectors jobs. Small business is responsible for 43 percent of the gross national product.

Small businesses, according to the National Science Foundation, produce four times more innovations than medium-sized companies and twenty-four times more innovations than large companies for every research and development dollar.²⁶⁴

To summarize this Part, each area of the law and each section within defines "small" differently. These delineations are clearly overinclusive. Accordingly, many larger and established firms that dominate their markets manage to meet some of the definitions of a small business. "Small" in the eyes of the law diverged from what is considered "small" in the eyes of the public.²⁶⁵ Legislative histories of these legal definitions demonstrate that each demarcation of small business was sought to achieve one or more of the policy considerations mentioned in Part II,²⁶⁶ namely preserving the free-enterprise system, promoting entrepreneurship, and stimulating employment expansion, while considering small business as undeniably providing these positive spillovers.²⁶⁷ A few commentators rejected this celebrated sentiment toward small business.²⁶⁸ The following Part will survey the criticism and disapproval of those size classifications that have been building in the public, media, and politics.

IV. DISAPPROVAL OF CURRENT SIZE CRITERIA

Even in 1953, when the Banking and Currency Committee first enacted the term in the Small Business Act of 1953, the committee recognized "the impossibility of attempting to write into law a rigid definition of small business."²⁶⁹ The Committee acknowledged that it is tricky to delineate

264. *Tax Reduction Proposals: Hearings Before the S. Comm. on Fin.*, 97th Cong., pt. 2, at 776 (statement of Sen. Weicker); see also *id.* at 945 (statement of Allen Neece, Counsel, Small Business United) ("Small R&D firms are particularly strapped for cash. The tax credit initiative not only affords them a smoother cash flow, but it also acts as an inducement to innovative thinkers in large corporations who are contemplating entering business for themselves.").

265. See *supra* text accompanying note 17.

266. See *supra* Part II.

267. For the history of the entrenched belief in small business promoting these policy considerations, see generally Eyal-Cohen, *supra* note 1.

268. See, e.g., *Tax Reduction Proposals: Hearings Before the S. Comm. on Fin.*, 97th Cong., pt. 1, at 231 (1981) (statement of Dr. Pechman) ("We have a lot of special provisions in the tax law for small business and they are still complaining. The same complaints I hear today were made 30 years ago when I was in the Treasury. What we have done is wasted an awful lot of revenue. So I would hope that you go easy on gimmicks for small business and use the tax resources that you have available to simply cut tax rates generally. You will do better in the long run."); Stedman, *supra* note 218; *supra* text accompanying note 218.

269. See H.R. REP. NO. 83-494, at 20 (1953) (statement of Reps. Patman & Multer).

entities strictly in terms of number of employees, amount of capitalization, or dollar volume of business.²⁷⁰

Over the years, much criticism has been aimed at legal definitions of size, specifically the SBA's size classifications. This Part will survey three main contentions. First, the current focus on size defeats the purpose of promoting entrepreneurship, free enterprise, and job creation. Second, today's size classifications are overinclusive and create undesirable distributional effects. Third, present firm-size delineations subsidize larger firms, thus resulting in data distortion and wasteful government expenditures.

A. THE FOCUS ON SIZE DEFEATS OUR POLICY CONSIDERATIONS

"[A]lthough there is an overlap between entrepreneurial firms and small-business firms, they are different entities."²⁷¹ Entrepreneurs are individuals who add value by creating new combinations of resources.²⁷² Clearly, not *all* small firms create that intended value.²⁷³ The focus on size is therefore flawed because it is not an accurate proxy for the beneficial qualities possessed by entrepreneurial firms.

In fact, entrepreneurial firms may be of any size.²⁷⁴ Studies observed that large firms have also been engaging in entrepreneurial-type behavior.²⁷⁵ "Intrapreneurship" denotes business units within large and established corporations that create breakthrough inventions that increase their entrepreneurial value.²⁷⁶ By emphasizing the importance of innovation, medium and large firms experiment with novel and emerging technologies and become pioneers of revolutionary developments.²⁷⁷ Consequently, studies have found that certain corporate managerial models promote

270. *Id.* at 20–21.

271. James W. Carland et al., *Differentiating Entrepreneurs from Small Business Owners: A Conceptualization*, 9 ACAD. MGMT. REV. 354, 354 (1984).

272. Schumpeter, *Entrepreneurship*, *supra* note 58, at 51–52.

273. For example, scholars found that family-business strategy focused on the needs of the family rather than the business and that its purpose is to provide outlets for family investment and careers for family members. LAWRENCE R. JAUCH & WILLIAM F. GLUECK, BUSINESS POLICY AND STRATEGIC MANAGEMENT 52–54 (1988).

274. See Cooper et al., *supra* note 120, at 318 ("[F]irms of different initial size tend to be associated with particular entrepreneurial characteristics . . .").

275. See Carland et al., *supra* note 271, at 355 ("Entrepreneurship has been found to extend beyond small businesses: some large corporations have been described as engaging in entrepreneurial activity.").

276. See Gautam Ahuja & Curba Morris Lampert, *Entrepreneurship in the Large Corporation: A Longitudinal Study of How Established Firms Create Breakthrough Inventions*, 22 STRATEGIC MGMT. J. 521, 521 (2001) (using the chemicals industry to argue that experimenting with novel, emerging, and pioneering technologies helps established firms overcome certain traps and create breakthrough inventions).

277. See *id.* at 539–41.

entrepreneurial initiatives in established and large firms through internal corporate venturing.²⁷⁸

A similar case can be made for the mistaken notion that small firms are the source of employment growth. The current debate in academic literature on whether small businesses indeed account for most of the job growth illustrates the flawed focus on magnitude.²⁷⁹ Labor statistics are inconclusive as to the question of whether small businesses always create positive net job change.²⁸⁰ Current statistics on employment expansion reveal that within each category of size in the last twenty years, there has not been much change in net job gains and losses as a percentage of employment.²⁸¹ Nevertheless, new data has revealed that firm age, and not its size, is the main fuel for job creation.²⁸²

Therefore, size does not seem to be directly correlated to growth in employment.²⁸³ As an alternative, if the government seeks to encourage employment, it could directly reward high-growth businesses for each employee they hire.²⁸⁴ Instead, the government chooses to indirectly encourage hiring by subsidizing certain businesses.²⁸⁵ By doing so, the

278. See, e.g., Robert A. Burgelman, *Designs for Corporate Entrepreneurship in Established Firms*, CAL. MGMT. REV., Spring 1984, at 154, 155 (presenting a model of strategic behavior in established firms for identifying entrepreneurial activity and for improving its capacity to deal with entrepreneurial initiatives); Shaker A. Zahra et al., *Entrepreneurship in Medium-Size Companies: Exploring the Effects of Ownership and Governance Systems*, 26 J. MGMT. 947, 947 (2000) ("Data from 231 medium-size manufacturing companies show that commitment to [entrepreneurship] is high when: (1) executives own stock in their company; (2) the board chair and the chief executive officer are different individuals; (3) the board is medium in size; and, (4) outside directors own stock in the company.").

279. See *supra* text accompanying notes 105–08; *infra* text accompanying notes 280–84, 286.

280. See Bernstein, *supra* note 130 ("But don't small businesses at least fuel job growth? Sort of. It's not small businesses that matter, but new businesses, which by definition create new jobs. Real job creation, though, doesn't kick in until those small businesses survive and grow into larger operations.").

281. For example, firms with between five and nine employees generated a minor net job increase between 1992 and 1999, but jobs with such firms decreased between 2007 and 2011. See Table 3. *Private Sector Firm-Level Gross Job Gains and Losses, as a Percent of Employment*, BUREAU LAB. STAT., http://www.bls.gov/web/cewbd/f.o2.table3_d.txt (last visited Dec. 15, 2012).

282. See Sullivan, *supra* note 71 (citing Haltiwanger et al., *supra* note 108).

283. See Veronique de Rugy, *Are Small Businesses the Engine of Growth?* 18 (Am. Enter. Inst., Working Paper No. 123, 2005), available at http://www.aei.org/files/2005/12/08/20051208_WP123.pdf ("[T]he conventional claim about small businesses' job creating rests mainly on statistical fallacies and misunderstanding of the data. . . . [T]he claim that small businesses are the fountainhead of job creation does not hold water.").

284. See David Smallbone et al., *The Characteristics and Strategies of High Growth SMEs*, INT'L J. ENTREPRENEURIAL BEHAV. & RES., Dec. 1995, at 44.

285. President Obama emphasized the need to remove tax benefits for firms that do not create employment. See Obama, *supra* note 4 ("So my message is simple. It is time to stop rewarding businesses that ship jobs overseas, and start rewarding companies that create jobs right here in America. Send me these tax reforms, and I will sign them right away.").

government ignores the important qualitative features of employment, such as job stability and security, wage level, benefits, and satisfaction. Size alone simply cannot purport to capture these elements.²⁸⁶

Lastly, assisting firms according to their size does not seem to promote "free enterprise" either. A person who owns an enterprise does not necessarily contribute to the free-enterprise system. Usually, small-business owners are individuals who establish and manage businesses for the principal purpose of furthering personal goals.²⁸⁷ The business is these individuals' primary source of income and consumes the majority of their time and resources. These individuals perceive the business as an extension of their personality and an outlet to satisfy their family needs and desires.²⁸⁸ Business motives are frequently repressed when confronted with personal circumstances.²⁸⁹ Those livelihood businesses are not driven mainly by economic motives and therefore cannot be relied upon to maintain a free-enterprise system.²⁹⁰

If free enterprise today means a system free of government intervention or concentrated economic power, small-business regulations do not contribute to this aim either.²⁹¹ By regulating business size, the government interferes with market forces and benefits firms without regard for their actual market value. Some of those businesses may not be effective anymore.²⁹² Therefore, granting them regulatory preferences disrupts the natural cycle of the firm's life.²⁹³ An alternative to this focus on size is a qualitative analysis of certain firms that benefit the market, such as maverick

286. For example, small firms fail at a rate far higher than that of large firms, contributing to the unstable nature of employment. See DUN & BRADSTREET, *THE STATE OF SMALL BUSINESSES POST GREAT RECESSION: AN ANALYSIS OF SMALL BUSINESSES BETWEEN 2007 AND 2011*, at 1 (2011), available at <http://www.dnb.com/asset/document/dnb-pdfs/15607032.pdf> ("[S]mall business failure rates have increased by 40% from 2007 to 2010."); Pierce, *supra* note 121, at 555.

287. Patricia D. Olson et al., *The Impact of the Family and the Business on Family Business Sustainability*, 18 J. BUS. VENTURING 639, 640 (2003).

288. Carland et al., *supra* note 271, at 358.

289. *Id.* (defining a small-business owner as "an individual who establishes and manages a business for the principal purpose of furthering personal goals").

290. *See id.*

291. *See id.*

292. *See, e.g.,* LuAnn Ricketts Gaskill et al., *A Factor Analytic Study of the Perceived Causes of Small Business Failure*, J. SMALL BUS. MGMT., Oct. 1993, at 18, 24 (reporting lack of management expertise and financial-related factors to be a consistent theme explaining small-business failures).

293. *See* JOSEPH A. SCHUMPETER, *Business Cycles (1939): The Theory of Innovation*, in *THE ENTREPRENEUR: CLASSIC TEXTS BY JOSEPH A. SCHUMPETER* 286, 293 (Markus C. Becker et al. eds., 2011) ("[F]irms do not exist forever. Many of them are, of course, failures from the start. Like human beings, firms are constantly being born that cannot live. Others may meet what is akin, in the case of men, to death from accident or illness. Still others die a 'natural' death, as men die of old age." (footnote omitted)).

firms.²⁹⁴ In other words, the government may interfere in order to protect particular firms for which there is direct evidence of the positive spillovers they offer to the free-enterprise system.²⁹⁵

In conclusion, policies designed to promote economic growth do not always have their intended effect. The features of entrepreneurial and high-growth firms are not correlated to the size of these firms. It seems that small entities may or may not be entrepreneurial, may or may not create jobs, and may or may not promote free enterprise. Firms that do promote these policy goals do so because of their inventive character and not their size. This being the case, the per se preferential treatment granted to small entities through the law does not unequivocally achieve its goals.

B. CURRENT EMPHASIS ON SIZE GENERATES UNDESIRABLE DISTRIBUTIONAL EFFECTS

Even if we accept the current demarcations of firms by size, they are far too broad and result in distributional imbalances. There is something fundamentally flawed in a legal system that considers over 97% of all firms “small” and therefore provides them regulatory preference.²⁹⁶ This broad definition of “small” today means that the exception has become the rule.

Commentators have long opined against the distributional effects caused by the various size definitions. Scholars long contended that many legal preferences designed to target small business are used mainly by large and established corporations.²⁹⁷ Politicians expressed their concerns that current small-business definitions are too broad and do not fulfill their stated purpose. In hearings around the country on reshaping current size standards, businesspeople came together to express their dissatisfaction:

In developing this package the President had an excellent opportunity to aid small business particularly in regard to capital formation. Unfortunately, most of the benefits are skewed to the large corporate end of the scale. The National Federation of Independent Business estimates that only \$400 million out of \$8.4 billion in revenue loss attributed to the business segment of the tax proposals goes to small firms.²⁹⁸

294. See *supra* note 41 and accompanying text.

295. This practice is already implemented in antitrust legislation and litigation. See, e.g., Jonathan B. Baker, *Mavericks, Mergers, and Exclusion: Proving Coordinated Competitive Effects Under the Antitrust Laws*, 77 N.Y.U. L. REV. 135, 136–37 (2002).

296. See *supra* note 225 and accompanying text.

297. See, e.g., Charles R. Babcock & Ellen McCarthy, *Companies Weigh In on Definition of “Small” Firm*, WASH. POST (June 18, 2005), <http://www.washingtonpost.com/wp-dyn/content/article/2005/06/16/AR2005061601491.html> (noting discontent regarding the number of employees being the chief size anchor).

298. *The President’s 1978 Tax Reduction and Reform Proposals: Hearings Before the H. Comm. on Ways & Means*, 95th Cong., pt. 4, at 2238 (1978) [hereinafter *Hearings on Tax Reduction*] (statement of Deane R. Steward, Chairman, National Oil Jobbers Council).

Businesspeople also noted:

The Senate Small Business Committee study reveals further that in terms of asset size, 69% of the benefits of the corporate tax reductions goes to companies with assets of over \$25 million. The 279,100 companies with assets under \$100,000 (and which also had 1974 taxable income) receive just over 1% of the benefits from the Carter proposal.²⁹⁹

One of the main urgings in these hearings was to change current size definitions to ensure that larger, more established firms do not unjustifiably utilize benefits designated for small business.³⁰⁰ Others suggested introducing a "micro" category for businesses to account for truly "small" businesses.³⁰¹

The media has often reported on the various injustices produced by current regulatory preferences granted according to firm size. The overinclusiveness of current size standards, reporters noted, precludes truly small entities access to federal grants, loans, and contracts designed for these same small entities.³⁰² Various newspapers reported that firm-size classifications became so liberal that they presently include medium and large firms.³⁰³ In a recent case, the media described a situation in which the government listed a contract with one of the largest debris-removal firms in the country (a billion-dollar corporation that boasts of having a former Vice President on its board of directors) as a small-business contract during the cleanup after Hurricane Katrina.³⁰⁴ Although the company is not "a small

299. *Id.* at 2234 (prepared statement of Deane R. Stewart, Chairman, National Oil Jobbers Council).

300. For example:

William C. Joern, vice president of the International Center for Language Studies Inc. in the District, said his company doesn't favor defining size by number of employees because the payroll fluctuates with the needs of government clients such as the Pentagon, State Department and FBI—hardly a guide to the long-term size and solidity of his company.

Babcock & McCarthy, *supra* note 297.

301. *Id.* One of the proposals was to create a category of firms with less than \$500,000 a year in revenue. *Id.* At the end of those hearings, then SBA's assistant administrator for size standards admitted it rather "difficult to 'draw the line' that defines 'small.'" *Id.*

302. *See id.*

303. Allan Sloan, *Small Business, Ill-Defined*, WASH. POST (Oct. 19, 2004), <http://www.washingtonpost.com/wp-dyn/articles/A43712-2004Oct18.html> ("But what exactly is a 'small business?' Given that I work full time at Newsweek, how did I become one of them? The answer is that the president's definition of 'small business' is somewhat liberal, to say the least.").

304. Griff Witte & Renae Merle, *Defining Small*, WASH. POST (Oct. 20, 2005), <http://www.washingtonpost.com/wp-dyn/content/article/2005/10/19/AR2005101902270.html> ("Department of Homeland Security spokesman Larry Orluskie said another reason why large companies occasionally end up listed as small is that a big firm can be considered small if it is doing work in a field where it is not a major player.").

business by any conventional standard,” the newspaper indicated that “because of a loophole in federal regulations, a company can be counted as one if it was once small even if it is not now.”³⁰⁵ This story is just one among many that have raised doubts about the validity of current legal size definitions and the allotment of government subsidies according to size.³⁰⁶

Over the years, much criticism has been directed specifically at the complexity and overinclusiveness of the SBA size definitions.³⁰⁷ As a usable set of size guidelines, the SBA size standards, some commentators argued, suffer from several deficiencies.³⁰⁸ They are lengthy and overdetailed, lacking the simplicity that business owners and corporate executives require.³⁰⁹ Others complained that the SBA size standard based on headcount has allowed businesses with few employees, but very high receipts, to qualify as small at the expense of other small businesses.³¹⁰

Scholars have long argued that relying on one benchmark of size to measure “smallness” is not enough to capture the complexities of all types of entrepreneurship.³¹¹ A single criterion for these definitions, they protested,

305. *Id.*

306. Another newspaper report found that more than \$5 billion of small-business contracts were awarded to businesses that were not really small. Those “small businesses” included global defense giants such as Lockheed Martin, General Dynamics, British Aerospace, Northrop Grumman, and Science Applications International Corp. and their subsidiaries. Carol D. Leonnig, *Agencies Counted Big Firms as Small*, WASH. POST (Oct. 22, 2008), <http://www.washingtonpost.com/wp-dyn/content/article/2008/10/21/AR2008102102989.html> (“[T]he U.S. government is just lazy and lax in making sure to use legitimate small businesses that can do the work and keep down the cost to the taxpayers.” (quoting Robert Taddeo, president of Pacifica Electronics) (internal quotation marks omitted)).

307. See, e.g., MIKE CARRIER ET AL., USING A TIERED SIZE STANDARD BASED ON THE NUMBER OF EMPLOYEES ONLY 1 (2011), available at <http://www.nafcausa.com/solutions/Tiered%20Approach.pdf> (“[C]urrent SBA methodology for size standard determinations is obsolete; it impairs the Agency’s ability to meet its charter and results in reckless waste of significant taxpayer funds without promoting the success of meaningful small business programs that stimulate the economy and mitigate inflation.”).

308. See Fred P. Hochberg, *Supporting America’s Engines of Growth*, in CHANGE FOR AMERICA: A PROGRESSIVE BLUEPRINT FOR THE 44TH PRESIDENT 7 (Mark Green & Michele Jolin eds., 2009), available at <http://www.americanprogressaction.org/wp-content/uploads/issues/2008/changeforamerica/pdf/sba.pdf> (chapter appearing only in online version of book).

309. *Id.* at 7 (“The problem is that current size standards are overly complex and out of step with a global economy. The complexity makes it difficult to determine whether a particular business qualifies as small . . .”).

310. See Sari Horwitz, *GSA Award Multiplies Math Box Profits*, WASH. POST, Dec. 30, 1985, at WB1. For instance, in 1985, the computer retailer MBI had \$89.5 million in sales (and \$2.6 million in net income), and was the “most profitable of the top eight publically held computer retailers.” *Id.* But it was still considered small according to the SBA size standards. *Id.* at WB3 (“We meet all the Small Business Administration definitions of a small business now even though we’re getting larger and larger. We have less than 500 employe[e]s.” (quoting Armen A. Manoogian, president of MBI) (internal quotation marks omitted))).

311. See, e.g., WILLIAM A. BROCK & DAVID S. EVANS, THE ECONOMICS OF SMALL BUSINESSES: THEIR ROLE AND REGULATION IN THE U.S. ECONOMY (1986); C. Steven Bradford, *Does Size Matter? An Economic Analysis of Small Business Exemptions from Regulation*, 8 J. SMALL & EMERGING

results in arbitrariness and unfairness.³¹² Others contended that it is problematic and controversial to use only one measure to determine a firm's eligibility to receive certain preferences.³¹³ By its own admission, the SBA conceded that its current size standards do not satisfy the public's notions of "smallness":

Should SBA consider lowering its size standards? SBA receives periodic comments from the public that its standards are too high in certain areas or for some types of Federal contracting opportunities. . . . This has always been a problem, one that SBA has had to deal with over the years. SBA's size standards appear large to the smallest of small businesses while larger small business often request even higher size standards. This problem is tied to Federal procurement practice because contracts get larger year after year, and they are often out of the reach of the "truly small business."³¹⁴

It is clear that "small," according to today's classifications, is not "small" in the eyes of the public anymore.³¹⁵ But this is no surprise. The legislative process is not free from political influence and lobbying efforts.³¹⁶ Medium- and large-business lobbyists advocate for the expansion of small-business

BUS. L. 1, 1 (2004) (arguing against granting special regulatory exemption for small business from regulations); Douglas Holtz-Eakin, *Should Small Businesses Be Tax-Favored?*, 48 NAT'L TAX J. 387, 387 (1995) ("[I]t is difficult to construct a case in favor of systematically favoring small businesses. Moreover, to the extent that one wishes to do so, the tax code does not appear to be a tool particularly well suited to the task."); David H. Safavian, *Indexing Tax Attributes for Inflation: Dispelling the Myths and Advocating Change*, 1995 DETROIT C. L. REV. 109, 111 n.11 ("Although § 1202 is sound as a form of tax relief for small investors, it will have a relatively minor effect on the capital markets, due to the qualifications necessary for stock to be eligible under § 1202(c)(1)."). See generally Pierce, *supra* note 121.

312. Husbands, *supra* note 237, at 373 ("The \$1 million cap on contributions to capital set by the definition of a 'small business corporation' addresses only one of the many pieces that make up a company and determine its size. A highly leveraged company conceivably could have millions of dollars in debt, make millions in profit, employ thousands of people, and still qualify as a 'small' business under section 1244." (footnotes omitted)).

313. See, e.g., MIKE CARRIER ET AL., *supra* note 307, at 1-2 ("[W]e find that the Agency is currently working against its own purpose, due to its insistence on using antiquated size standards and methodologies that fail to support small businesses that are not dominant in their field of operation.").

314. SBA METHODOLOGY, *supra* note 222, at 47-48.

315. See, e.g., Margaret Webb Pressler, *in Business: Making the Most of a Conference Call*, WASH. POST (Sept. 27, 1999), <http://www.washingtonpost.com/wp-srv/WPcap/1999-09/27/0671-092799-idx.html> ("Dynamic Concepts still meets the government's definition of a small business, but it is not small, in the traditional sense. To many, \$25 million in revenue and 400 employees is big business. But in the exploding arena of telecommunications[,] . . . [f]or most big contracts, the company is still too small to be in the prime time . . .").

316. For example, in 2005 "Sen. Christopher S. Bond (R-Mo.) reintroduced legislation that would repeal the restriction, imposed in 2003 after an SBA administrative judge decided that venture-owned firms did not qualify as small businesses." Babcock & McCarthy, *supra* note 297.

preferences and with it the firm-size criteria.³¹⁷ With the support of organizations such as the SBA and the Chamber of Commerce, there is a constant liberalization of the definition of "small business."³¹⁸ Therefore, more and more firms qualify for small-business status each year.³¹⁹ This overinclusiveness of current size standards denies truly small entities access to federal grants, loans, and contracts designed for these same small entities.³²⁰ The continuous increase in the firm-size limit over past years also results in more firms utilizing small-business preferences and attendant government resources.³²¹

Finally, present legal definitions of size cause other distributional distortions in our society. The focus on size is not only wasteful, but it also results in owners of medium and large firms benefiting more from preferences meant for the little guy than the little guy himself. In other words, high-income corporate shareholders are utilizing more preferences in an indirect way, hiding behind the fig leaf of small business. For instance, certain capital tax benefits aimed at incentivizing investments in small business are used primarily by high-income individuals who can afford to invest in riskier businesses.³²² Senator Dale Bumpers (D-AR), who initially proposed a capital-gains tax preference for new startup businesses, complained about the use of this preference by wealthy shareholders of large corporations: "I have never understood what economic benefit this

317. For instance, the president of Peoples Gas Co., which supplied "75 percent of the gas consumed in the Chicago metropolitan area," advocated for expanding tax preferences that would foster capital formation. *Hearings on Tax Reduction*, *supra* note 298, at 2228 (statement of Mark Salvino, President, Peoples Gas Company).

318. One of the Chamber of Commerce's arguments in advocating the expansion of small-business preferences is that not doing so would discriminate against many capital-intensive "small businesses" with more than \$1 million of depreciable assets. The SBA reiterated such recommendations when reporting on the state of small business. Professionals also supported liberalization of small-business stock rules. See *The President's 1978 Tax Reduction and Reform Proposals: Hearings Before the H. Comm. on Ways & Means*, 95th Cong., pt. 3, at 1401 (1978).

319. Essentially, the SBA uses government contracting information to support an increase to an industry's size standard where the small-business share that year is found to be low, but it does not alter the standard if it finds that the share of small businesses is high. As a result, every year, as part of its ongoing comprehensive review of all size standards, the SBA continues to increase its size standards. SBA METHODOLOGY, *supra* note 222, at 18-19; see also Small Business Size Standards: Professional, Scientific and Technical Services, 76 Fed. Reg. 14,323 (proposed Mar. 16, 2011).

320. Babcock & McCarthy, *supra* note 297.

321. See, e.g., *Hearings on Tax Reduction*, *supra* note 298, at 2392 (statement of Robert R. Statham, Chamber of Commerce) ("[T]he definition of a small business corporation under Section 1244 should be liberalized by increasing the equity capital limitation from \$1 million to \$2 million and increasing the permissible amount received by the corporation for its stock from \$500,000 to \$1 million."); 124 CONG. REC. 34,616 (1978) (proposing to increase the firm size from one million to two million.).

322. See, e.g., I.R.C. §§ 1045, 1202, 1244 (2006 & Supp. IV 2010); see also *supra* Part III.F.

country derives when somebody sells General Electric and uses the money and buys DuPont stock."³²³

C. *PRESENT FOCUS ON SIZE CREATES DATA DISTORTION AND INEFFECTIVE ALLOCATION OF RESOURCES*

Current size classifications add to the compliance and litigation costs of doing business. Many cases challenging small-business size classifications have been adjudicated in the federal court system. Courts have been called upon to rule on what is "small," especially in cases where small entities have become larger, but are still listed as small on government contracting records.³²⁴ Size appeals have been litigated not only in the federal arena, but also in state courts.³²⁵ In many cases, instead of simplifying life for business owners, current firm-size definitions have increased their compliance and litigation costs.³²⁶

That is not all, however. Studies on the contribution of small businesses to economic growth depend very much on how one defines a "small business." It is not surprising, then, to find small-business organizations, such as the National Federation of Independent Business, continuously emphasizing that small businesses have "[g]enerated 60% to 80% of net new jobs annually over the last decade" and "more than half of nonfarm private gross domestic product,"³²⁷ or the SBA reporting each year, in its

323. John W. Lee, *Critique of Current Congressional Capital Gains Contentions*, 15 VA. TAX REV. 1, 76 (1995) (quoting 141 CONG. REC. 10,762 (1995) (statement of Sen. Bumpers)) (internal quotation marks omitted).

324. See, e.g., *Diversified Maint. Sys., Inc. v. United States*, 93 Fed. Cl. 794, 801 (2010) (contesting alleged misrepresentations regarding HUBZone set-aside program eligibility); *Pac. Helicopter Tours, Inc. v. United States*, No. 06-613 C, 2007 WL 5171114, at *1 (Fed. Cl. Jan. 12, 2007) (contesting a post-award bid protest action); *Rotech Healthcare Inc. v. United States*, 71 Fed. Cl. 393, 406 (2006) (holding that a non-manufacturer rule of the SBA applies to supply contracts which also require provision of some services); *United Enter. & Assocs. v. United States*, 70 Fed. Cl. 1, 11-14 (2006) (holding that a certificate of competency review by the SBA is required in a sole source section 8(a) program procurement); *Stamford Wrecking Co. v. United Stone Am., Inc.*, 912 A.2d 1044, 1049 (Conn. App. Ct. 2007) (holding that evidence that the SBA treated a contract as a "special trade" contract was not admissible to vary terms of subcontract agreement).

325. See, e.g., Daniel B. Moskowitz, *Business Size Is Ruled To Be No Small Matter*, WASH. POST, Feb. 8, 1988, at BF36. A food-service contract was set aside by the Pentagon and upheld by the Size Appeals Board. *Id.* The losing bidder sued the low bidder for fraud and misrepresentation under state law, but the trial court dismissed the suit based on federal preemption. *See id.* However, the U.S. Court of Appeals for the Tenth Circuit reversed the trial-court judgment. *See id.* The judges explained that a potential liability suit aids small businesses by discouraging businesses that are too big from bidding on set-aside contracts. *Integrity Management International, Inc. v. Tombs & Sons, Inc.*, 836 F.2d 485 (10th Cir. 1987).

326. Moskowitz, *supra* note 325.

327. *Issues—The Economy*, NAT'L FED'N IND. BUS., <http://www.nfib.com/issues-elections/economy> (last visited Dec. 15, 2012).

economic report to the President, that small firms account for more than half of the net new jobs created in the last decade.³²⁸

These flawed reports on the small-business contribution to the economy are greatly affected by the way they define a “small business.”³²⁹ Simply, the inclusion of medium firms in the legal definitions of “small” results in the overinclusion of these firms in those studies.³³⁰ Consequently, these studies present a skewed picture that overrates the spillovers of “small” entities.³³¹ Accordingly, these regulatory preferences and subsidies become further entrenched in our legal system.³³² It seems that if we are to consolidate various firms together under the term “small,” we have to show a substantial identity shared among the entities to be consolidated.

Nonetheless, across the various firm-size definitions, there is only a diminutive group of firms included within all size delineations. These firms are the “truly” small firms. However, since only a minor group of small firms qualify as such in *all* legal size standards, the question that arises is: What about the rest of these firms, which qualify as “small” under one definition but not under another? The answer lies within the question. Since these firms are not uniformly “small” in the eyes of the legislature, they are, by default, medium or large firms. Thus, the present focus on size in legal definitions results in many designated small-business benefits being utilized by unintended entities. This inclusion of medium firms that qualify as “small” reveals a wasteful allocation of government resources.

Consequently, the current focus on size in legal definitions leads to misallocation of government resources away from the more productive firms to small and medium firms that receive those funds solely by virtue of their size—not according to their contribution to the economy.³³³ This flawed emphasis on size, therefore, is “distortionary by allocating more resources to

328. U.S. SMALL BUS. ADMIN., *supra* note 44, at 1.

329. Bernstein, *supra* note 130 (“Besides, don’t most people work for small businesses, and aren’t such businesses the engine of job growth? Actually, no. . . . In what may be the most misunderstood fact about the job market[,] . . . [y]ou can tweak the definitions, but even if you define “small” as fewer than 500 people (as the federal government does, basically), you still find that half the work force is employed by large businesses.”).

330. Sullivan, *Start-Ups*, *supra* note 105 (“[I]t is easy to say that any sector with net job creation was responsible for a large share of overall job creation. . . . [T]here are massive swings in gross job creation and gross job destruction by both large and small business. . . . The arithmetic may be correct, but net employment growth figures leave a false impression.”).

331. Kaplan, *supra* note 32, at 18 (“‘Small business’ is as elusive a term as ‘free enterprise’. Any line of demarcation drawn between small and big business will include some that are large enough to have big business characteristics, and it will exclude a number which, while physically large, have the problems of a small business in relation to the giants that surround them.”).

332. On the path dependence of small-business benefits, see generally Eyal-Cohen, *supra* note 1.

333. See Alan D. Viard & Amy Roden, *Big Business: The Other Engine of Economic Growth*, AM. ENTER. INST., June 2009, at 1, 4 (“Preferences for some firms over others interfere with the market’s allocation of resources and disrupt the efficient workings of the economy.”).

the small-business sector than would be otherwise optimal."³³⁴ At times of huge deficits and budget cuts, this waste comes at the expense of more useful government programs.³³⁵

V. CONCLUSION

The Gordian knot of current small-business definitions is rooted in our nation's history. In the early decades of the United States, the typical business enterprise was minor, local, and personal.³³⁶ Those in the days of small-scale production, skilled artisans, and sole proprietorships envisioned small businesses such as the mom-and-pop shops and local traders.³³⁷ With the onset of the era of industrialization and mass production, the size of businesses grew larger, the structure of ownership became more diverse, management developed into a profession distinct from ownership, and clusters of corporations—rather than individuals—became a significant element of the American economy.³³⁸

Today, legal delineations of size have three main drawbacks: They are inconsistent, overinclusive, and have strayed far from their legislative intent. With the advancement of modern society, free enterprise and entrepreneurship can transpire in various ways in *all* sizes of businesses; reducing unemployment is a policy concern that can be achieved by *various* types of businesses. To continue to measure the ability to contribute to these goals only by size is to defeat their purpose.³³⁹ Current legal definitions are no longer restricted by past perceptions of minor entities, and they produce undesirable distributional effects by including larger and established entities. Consequently, the present focus on size creates a severe data

334. Erik Hurst & Benjamin Wild Pugsley, *What Do Small Businesses Do?* 38 (Nat'l Bureau of Econ. Research, Working Paper No. 17041, 2011).

335. See Sullivan, *Start-Ups*, *supra* note 105 ("If government is kind to these likeable economic entities, is there really any harm? Well, yes. Economics is coldhearted. Subsidies should not be the prizes of popularity contests. Without sound justification (such as correcting a market externality), government interference with resource allocation will hurt rather than help growth.").

336. See Carlton, *supra* note 33, at 656.

337. Sullivan, *supra* note 5.

338. Qualifying as a small business in the United States brings considerable benefits. See *supra* Part III. Moreover, many states developed small-business environmental assistance programs to assist small businesses with environmental compliance. ENVIRONMENTAL LAW PRACTICE GUIDE § 9A.03 (Michael B. Gerrard ed., 2012). Another example can be found in the Regulatory Flexibility Act ("RFA"):

The RFA requires any agency conducting a notice and comment rulemaking to consider fully the rules' effect on 'small entities.' . . . In 1996, Congress further expanded these responsibilities by passing the Small Business Regulatory Enforcement Fairness Act. This Act gives the RFA sharper teeth by providing for judicial review of federal agencies' RFA analysis.

Husbands, *supra* note 237, at 359 (footnotes omitted).

339. Carland et al., *supra* note 271, at 354.

distortion in studies that rely on these definitions of size and results in ineffective allocation of government resources to a big group of firms that allegedly contribute more to the economy.

One normative conclusion could be to acknowledge our impulse to help “truly” small businesses for political, historical, moral, or other normative appeal. The welfare of small entities can be endorsed as a way to inspire market diversity in a world dominated by big brands and chain stores. Supporting certain small-business programs can also be seen as an affirmative-action mechanism and a distinct way of improving the economic situation of the minority population in our society.³⁴⁰ Nevertheless, a different and more valiant resolution could be to completely abandon our focus on size and look at other firm behaviors to better accomplish our goals. Either way, it is time we acknowledge that size is no longer an absolute corollary to positive economic impact.³⁴¹

The economic literature reinforces the notion that the way to achieve economic development is to support innovation and entrepreneurship.³⁴² A forthcoming paper will propose to replace some of the many references to size in our legal system with a flexible graduated scale of entrepreneurial viability as a function and indicator of firms’ potential ability to innovate in their marketplace.³⁴³ This coming paper will analyze the taxonomy of economic growth and posit that while most entrepreneurs may start small, not all small firms create new value.³⁴⁴ Successful entrepreneurial entities take high risks by pursuing novel ideas, and when they are successful, they result in rapid and substantial wealth creation.³⁴⁵ The progressive nature of the proposed schedule of entrepreneurship will maintain equality by extending greater incentives to more entrepreneurial ventures. Furthermore, as opposed to the current one-factor size standard, the deployment of a multi-tiered graduated scale will reduce the arbitrariness and uncertainty currently inherent in the size-focused approach.

Recently, President Obama asked Congress to grant him the power to consolidate the SBA with the U.S. Trade and Development Agency, Overseas Private Investment Corporation, Export-Import Bank, Office of the U.S. Trade Representative, and some U.S. Department of Commerce programs

340. See *supra* Part II.D.

341. See Cooper et al., *supra* note 120, at 318.

342. For the relationship between entrepreneurship and economic growth, see generally Martin A. Carree & A. Roy Thurik, *The Impact of Entrepreneurship on Economic Growth*, in HANDBOOK OF ENTREPRENEURSHIP RESEARCH 557 (Zoltan J. Acs & David B. Audretsch eds., 2d ed. 2010).

343. Eyal-Cohen, *supra* note 20.

344. *Id.*

345. See *supra* note 72 and accompanying text.

into one super pro-business agency.³⁴⁶ The purpose of this proposal was to maintain "one department where entrepreneurs can go from the day they come up with an idea and need a patent, to the day they start building a product and need financing for a warehouse, to the day they're ready to export and need help breaking into new markets overseas."³⁴⁷ President Obama added, "These changes would help small business owners like you. It would also help medium and large businesses."³⁴⁸ This integration is the first sign of the proposed shift from a size-centered to a goal-driven approach, and hopefully it will not be the last.³⁴⁹

346. President Barack Obama, Remarks on Government Reform (Jan. 13, 2012), *available at* <http://www.whitehouse.gov/photos-and-video/video/2012/01/13/president-obama-speaks-consolidating-government-departments-encour#transcript>.

347. *Id.*

348. *Id.*

349. Although, some commentators have already expressed their concern that small business will lose its status in the political agenda. *See, e.g.,* Rhonda Abrams, *Small Business Strategies: Obama's Proposal Could Hurt*, USA TODAY (Jan. 19, 2012), <http://usatoday30.usatoday.com/money/smallbusiness/columnist/abrams/story/2012-01-19/obama-small-business-plan/52685870/1> ("I'm also somewhat concerned about the president's use of the term 'entrepreneur.' . . . If the president's plan goes through as proposed, small businesses will lose their seat at the table. . . . Being part of a larger agency is almost certain to diminish what little voice it has now. . . . [W]hile it may be a great idea to bring all the animals under one roof, when you do, the smallest ones are most likely to get trampled."); *see also* Jose Pagliery, *Some Businesses Worry About Obama's SBA Move*, CNN MONEY (Jan. 13, 2012), http://money.cnn.com/2012/01/13/smallbusiness/obama_agencies/index.htm ("'Throwing a small business in the same pot with General Electric . . . or Microsoft . . . or eBay doesn't work very well,' said Dan Danner, president of the National Federation of Independent Business. . . . [C]onsolidating operations into one worries Lloyd Chapman, president of the American Small Business League. He said the existence of a larger department will eliminate transparency and ease the ability to cut staff that ensures small businesses receive the legally-mandated 23 percent of all federal contracts.").

