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Think small if you want to create more jobs

The creation of new jobs is critical in an election year. If Americans vote with their wallets, the employment issue will decide the outcome.

The jobless figures for April, which came out last week, showed that the US economy had generated 288,000 new jobs during the month. That beat forecasts, and will have given heart to the Republicans. But the economic upturn has not yet generated enough jobs to replace those lost during the slump. Neither the Republicans nor the Democrats yet have a sustainable and credible solution to the problem of job creation in this recovery.

Part of the reason is that the economy has changed. This is the second jobless recovery and the first time that productivity has increased in a downturn. Are employees being replaced by machines and technology? Or are we losing jobs to overseas competition?

Both are true. Technology is replacing people and US jobs are going overseas. Up to 25 per cent of traditional information technology jobs are expected to relocate to countries such as India, China and Russia by 2010.

The question is how to make sure that new jobs are created, and that the new jobs are better than the old ones. One way might be to look at smaller companies. Today, 50 per cent of all US workers are employed by companies with fewer than 500 employees. Between 60 and 80 per cent of all jobs created in the 1991-2001 period and three quarters of net new jobs in 1999-2000 were at small companies. By contrast, most of the jobs lost in the last 10 years were the result of large companies cutting back. The US is becoming a conglomerate of dynamic small companies that create new jobs for the knowledge economy. Why?

Research and development used to be dominated by large companies with large budgets. But in the creation of new products that drive the knowledge economy – from Linux operating systems to web telephone services – small companies now have an edge. They produce 13 to 14 times more patents per employee than large companies and their patents are twice as likely to be among the 1 per cent most cited in other patents.

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Will the US lose its historical advantage in mass production as a result? Not really. In the industrial age, companies needed to be big, because they had to build up large amounts of capital to fuel innovation and productivity. The networked economy makes it easier for smaller companies to pursue strategies that used to be available only to large groups. "Knowledge workers" change jobs frequently, ensuring that their skills and know-how are spread across the entire industry. It is the size of the industry not the size of the company that now matters. Smaller companies have the best of both worlds: increased economies of scale from the industry as a whole, and the benefits of competitive behaviour.

In fact, small companies are the closest thing the US has to a "job creation machine" and the government should clear the way for them by lowering or eliminating the barriers they face.

Small companies are viewed as risky, which deprives them of access to top talent and funding. In 2001, venture capital funding to small companies fell by 86 per cent. Many small companies closed down, or were unable to hire new staff.

Innovative financial policies can help manage the risks of smaller businesses. For example, credit enhancement instruments can ease smaller companies' access to capital and lower their costs. This approach is, however, limited because small companies rely mostly on equity capital, not loans.

It would be more effective to create financial instruments, "bundling" the equity of smaller companies into less risky investments. These bundles can be securitised and sold through financial institutions, giving smaller companies access to global capital markets. The result is to make a much larger pool of funds available to such companies, at better rates.

Freddie Mac and Fannie Mae have used diversification to lower risk in the home mortgage market, selling bonds backed by home equity. The assets backing "small company bundles" would be made up of equity in the companies themselves. Venture capital companies diversify their portfolios and benefit from the law of large numbers. This proposal would pass on such benefits to a much larger group of small companies.

The US economy stands to gain as much from providing financial support to smaller businesses as it has from supporting the smaller homeowner. By unleashing the market power of smaller companies, it can fuel the job creation machine.

The writer is professor of economics and statistics at Columbia University