

Report Documents 2004 as a Good Year for Small Business

American small business had a good year in 2004, according to a report issued at year's end by the Office of Advocacy. The annual report, *The Small Business Economy* (2005 edition) documents the state of small business and its contributions to the economy using the latest data for 2004.

"2004 was a good year for American small business," said Chad Moutray, chief economist for the Office of Advocacy. "The economic environment fostered entrepreneurial activity. The gross domestic product increased, the economy added jobs, and new employer firms and the number of self-employed increased."

The comprehensive report examines the role small business plays in the economy. Key segments focus on the economic environment, regulations, innovation, tax policy, minority

and veteran entrepreneurship, federal government procurement, and small business financing data.

This year's report includes a paper from William Baumol, a renowned economist specializing in entrepreneurship. Baumol's paper, "Small Firms: Why Market-Driven Innovation Can't Get Along Without Them," examines the reasons why small firms have contributed a critical share of radical innovative breakthroughs. (See story on page 8.)

The report also contains a paper authored by Advocacy economists Radwan Saade and Joe Johnson on the benefits of a more simple and predictable tax code.

The complete report is available online at www.sba.gov/advo/stats/sb_econ2005.pdf or in hard copy from the Office of Advocacy. To receive a copy, call (202) 205-6533.



Second-stage small businesses (firms that have survived the start-up phase and are seeking to grow) received close examination at a recent summit sponsored by the Office of Advocacy and the Edward Lowe Foundation. (See story on page 2.)

In This Issue

2005 Edition of Small Business Economy Released. 1

The David-Goliath Partnership 8

Message from the Chief Counsel

We Resolve in 2006 3

Economic News

Dynamic BLS Data Shed Light on Job Creation 2

Summit Examines Second-Stage Businesses 2

Regional Roundup

New Staff and Legislation Mark Productive Year 6

Legislative Update

House Subcommittee on Regulatory Affairs 7

Research Notes

New Advocacy Research 6

Regulatory News

Regulatory Roundup for 2005 . . . 4

EPA Actions Re Oil Spills, Toxic Chemicals, and Dry Cleaners . . . 5

Economic News

New Data Source Confirms Small Business Role as Major Job Creator

After much anticipation, the Bureau of Labor Statistics' Business Employment Dynamics (BED) program recently released a new series of job generation and destruction figures. The quarterly data cover a 13-year period, and they show that small firms (those with fewer than 500 employees) accounted for 65 percent of private-sector net employment growth. These findings are similar to those of the Statistics of U.S. Business (SUSB), which Advocacy cosponsors with the U.S. Bureau of the Census. Together, they make an even stronger case for small business's dynamic contribution to overall job creation. And there's more.

The BED data complement SUSB since BED comes out quarterly, with a 9-month delay. SUSB comes out annually with a two-year delay (and

contains a wealth of industry and geographic detail). The BED data are better for analysis of firm size dynamics around business cycles.

During the most recent recession (2001-2003), total employment declined for eight quarters (second quarter 2001 through the second quarter 2003). Firms with 500 or more employees accounted for 60 percent of the net job losses. The picture for very small firms was quite different. Those with 1-4 employees lost jobs in only two quarters, and those with 5-9 employees, in only four.

So the message that small firms are the major job creator has newfound support. And the BED data also show that employment among very small firms remains strong through downturns—at least in the most recent one.

Summit Examines Second-Stage Firms

Second-stage small firms—those that have survived the start-up phase and are seeking to grow—receive little attention. Although economic development specialists and researchers recognize their value, neither group has been able to focus on them. The Office of Advocacy and the Edward Lowe Foundation recently took some preliminary steps toward better understanding the value of second-stage small businesses to individual communities and the economy as a whole.

The November summit was hosted at the Lowe Foundation's Big Rock Valley campus in Cassopolis, Michigan. It was facilitated by the Sente Corporation and run by noted researchers David Audretsch and Zoltan Acs. The participants' diverse backgrounds—academia, government, and economic development—contributed to a broad, multifaceted view of the issues.

Chris Gibbons of Littleton, Colorado, started the event by discussing "economic gardening," that

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Why "Net" New Jobs?

Job creation is a moving target. As employment grows at some firms, it decreases at others. Economists use the measure of "net" new jobs to show actual increases in the number of jobs, after you subtract the number of jobs lost from the number of new jobs created. The result shows the overall increase, with the losses taken into account.

is, providing services directly to local growing businesses. Several themes emerged from the summit. Foremost among them was the need to find local champions to advance the cause of second-stage businesses. A better understanding of the relationship between location and business culture was also cited. Research is also needed to show the impact of local communities' strategies in the areas of economic "gardening, hunting, and seeding" (encouraging new ventures).

David Audretsch closed the conference by noting that the general state of the study of entrepreneurship—scattered among economics, finance, business management, and economic development—tends to inhibit research in this area.

Message from the Chief Counsel

We Resolve in 2006 . . .

by Thomas M. Sullivan, Chief Counsel for Advocacy

January is a time for reflection on the past and looking forward to the coming year. It gives a chance to take stock, check our progress, and set goals for the future. In that spirit, I thought it might be interesting to share some 2006 New Year's resolutions for the Office of Advocacy.

After talking with the directors of interagency affairs, economic research, regional affairs, and communications within the office, we came up with a series of resolutions for the coming year. I encourage you to read our resolutions carefully. See where you fit in. Think about how you can help us reach these goals and bring the voice of small business into the policymaking process in Washington, D.C., and state capitols across the country.

We resolve to continue our efforts to reduce the regulatory burden on small businesses throughout 2006. (No surprise there!) While strides are made every year, small businesses still face mounting costs from federal regulations. An important aspect of our job is to educate federal agency staff on their regulatory compliance requirements. By the end of 2006, we will ensure that more federal agencies have in-house expertise on how to comply with the Regulatory Flexibility Act (RFA).

Since we take our direction from small business, our office also resolves to hold more roundtables than last year in order to provide necessary feedback to regulatory agencies on their proposals. These roundtables, from one-time issue-oriented sessions to monthly discussion groups, allow us to focus our resources on key areas identified by the participants.

“We resolve to continue our efforts to reduce the regulatory burden on small businesses throughout 2006.”

While monitoring the federal Regulatory Flexibility Act is at the heart of what we do, we also work on the state level to educate policymakers about the importance of small business. Through the work of our regional advocates, we have been successful in bringing small business regulatory flexibility to states in all parts of the country.

In 2006, we resolve to continue this effort and work to have our model legislation considered in more states. It will be up to the state legislatures to pass the legislation, but we will provide them with the information they need to make sound decisions.

Sound policy decisions can only be made if they are based on sound science and research studies. That is why our economic research is so important to the public policy process. We resolve to release at least 25 economic studies in 2006 that are timely and relevant to academics and policymakers in the small business community.

Moreover, we will continue to distinguish ourselves through academic conferences focusing on small business issues. For example, in January Advocacy, the Ewing Marion Kauffman Foundation, and the World Bank will host a series of three sessions honoring Dr. William Baumol's contributions to entrepreneurship. In addition, in April we are organizing a conference focusing on the revitalization

of New Orleans and the Gulf Coast region through entrepreneurship.

Of course, all the academic studies in the world accomplish nothing if they gather dust on the shelf. That is why we believe it is so important to reach out to small business trade associations, and through them to their members and policymakers, letting them know the documented facts about the contributions of small business. To do this, we resolve to continue making contacts in the coming year.

These are ambitious resolutions and following through on them will definitely keep the Office of Advocacy busy in 2006. That is why we are here—to be the voice of small business in the federal government.

However, it is your issues, your concerns, your agenda that we make heard in the halls of Washington, D.C. So, we need to hear from you and we need your help to turn these resolutions into reality. And, if you make one resolution of your own this year, resolve to speak up and make your voice heard in the policymaking process.

Regulatory News

Regulatory Roundup for 2005

In 2005, the Office of Advocacy worked on numerous regulatory issues that would impose undue burdens on small businesses. For further information, visit Advocacy's webpage at www.sba.gov/advo/regulatory.html or email advocacy@sba.gov.

In February the Department of Labor's **Occupational Safety and Health Administration** (OSHA) held public hearings on a proposed rule to establish a new permissible exposure limit for occupational exposure to hexavalent chromium, and is expected to issue a final rule in January 2006.

In June **OSHA** accepted public comment on its lead in construction rule to determine whether the rule could be made less costly and burdensome for small business.

In June **OSHA** proposed a rule to revise the safety standards for electric power workers, and is expected to issue a final rule in 2006.

In June the Department of Labor's **Mine Safety and Health Administration** (MSHA) issued a final rule establishing new health standards for miners exposed to airborne particulates from diesel equipment. In September MSHA proposed a phased-in compliance schedule for the rule to help small mine operators.

The Department of Labor's **Employee Benefits Security Administration** issued a proposed rule that will require all employers that provide benefits and file Form 5500 to file the form electronically beginning for plan years starting after January 1, 2007.

In November the Office of Advocacy, the Office of Management and Budget, and the **Environmental Protection Agency** completed a review of the potential small business impact of an EPA

proposal to reduce the benzene content of gasoline, as well as to reduce benzene emissions from certain vehicles and from portable gasoline containers.

In March the **Federal Communications Commission** (FCC) issued a proposed rule asking for comment on intercarrier compensation. Intercarrier compensation is how telecom carriers reimburse each other for terminating telephone calls on each others' networks.

In April the **FCC** issued a public notice containing an initial regulatory flexibility analysis (IRFA) for an order which requires small rural telecommunications carriers to provide wireline-to-wireless telephone number portability. (Porting is the transfer of a telephone number from one carrier to another at a customer's request.) The FCC published the IRFA in response to a court order which held that the FCC had not complied with the Regulatory Flexibility Act and which directed the agency to conduct the analysis.

In July the Junk Fax Prevention Act of 2005 was signed into law. The law codified the "established business relationship exemption," allowing small businesses to fax their customers if they include an opt-out provision on the cover page.

In November the **Department of the Treasury** and the **Internal Revenue Service** issued proposed rules under section 199 related to the Income Attributable to Domestic Production Activities. This proposal implements a new deduction for manufacturing businesses. The deduction is worth 3 percent in 2005 (increasing to 9 percent in 2009) and is available to most non-retail businesses. However, calculation of the deduction is very complex, hence it is

not readily available to many small businesses.

In December 2004 the Department of Transportation's **Pipeline and Hazardous Materials Safety Administration** (PHMSA) published a proposed rule regulating external product piping (wetlines) on cargo tanks. Advocacy and the trucking industry are concerned the regulation will negatively impact small trucking companies. The agency is in the process of developing the final rule.

In February the Department of Transportation's **Federal Aviation Administration** proposed new regulations to require expanded use of cockpit voice and digital flight data recorders in passenger aircraft.

In April 2005 **PHMSA** published a final rule regulating the loading, unloading, and storage of hazardous materials in transportation. Despite concerns expressed by Advocacy and the industry, the agency published the rule with minimal changes.

In June **PHMSA** issued an IRFA for its 2002 proposed rule on Transportation of Lithium Batteries. The IRFA was issued in response to Advocacy's concerns about the proposed rule and because of a return letter issued by OIRA.

In August the Department of Transportation's **Federal Motor Carrier Safety Administration** issued a final regulation governing the number of consecutive hours commercial truck drivers may drive.

In May the Department of Agriculture's **Animal and Plant Health Inspection Service** (APHIS) published a notice of availability of the Draft Strategic Plan and Draft Program Standards documents for the National Animal Identification System (NAIS) in the *Federal Register*. The NAIS will be a

mechanism for tracking animals from birth to slaughter in order to enhance U.S. response to disease outbreaks across different animal species. Advocacy will continue to monitor this issue and work with the agency to address small entity impacts.

In August **APHIS** published a proposed rule governing the import of beef from Japan. The proposed rule would allow beef imports from Japan; these had been suspended in 2001 due to Mad Cow disease concerns. The rule was finalized in December.

The **Department of Defense** issued a proposed regulation in April to amend the Defense Federal Acquisition Regulation Supplement by adding a requirement that packages be marked with passive radio

frequency identification (RFID) tags. The change would require contractors to affix passive RFID tags at the case and palletized unit load levels when shipping packaged operational rations, clothing, individual equipment, and tools. The final rule was implemented in September.

In August the **National Archives and Records Administration** published a final regulation on Federal Record Centers. The final rule addresses records center industry concerns identified in OMB's 2003 *Report to Congress on Costs and Benefits of Federal Regulations*.

In December 2004 the **Small Business Administration** (SBA) issued an advance notice of proposed rulemaking (ANPRM) in the

Federal Register on Small Business Selected Size Standards Issues. This regulation sought comments on size standard issues not discussed in the March 2004 proposed restructuring of SBA's system of size standards. This ANPRM sought input on whether there should be an exclusion from the affiliation rule with venture capital companies and how to best simplify size standards.

In the spring and summer the Office of Advocacy joined with the **Department of Housing and Urban Development** to host small business roundtables around the country on the impact that HUD's efforts to reform the Real Estate Settlement Procedures Act may have on small entities.

EPA Actions Re Oil Spill Plans, Pollution Reports, and Dry Cleaners

Last year's regulatory activity included several breakthroughs on EPA issues. Two of the issues had been the subject of many years of study and negotiation.

Proposed SPCC (Oil Spill) Amendments. On December 12, the EPA proposed to amend the Spill Prevention, Control, and Countermeasure Plan requirements for certain facilities. (These plans outline the steps a facility would take to manage an oil spill.) EPA also proposed to extend the date by which facilities must come into compliance with the requirement to October 31, 2007. EPA and Advocacy have been working closely together on SPCC rule provisions since 2002. EPA's proposal allows most facilities that store less than 10,000 gallons of oil to self-certify their SPCC plans, in lieu of review and certification by a professional engineer. This proposal was based in large part on suggestions made by Advocacy, and reduces the cost burden on small businesses while protecting the environment.

TRI Paperwork Reduction. On October 4, EPA proposed streamlined reporting requirements on the use and management of certain toxic chemicals (the Toxic Release Inventory, or TRI). EPA is proposing that a simpler form (known as the Form A) be available for facilities that handle small amounts of chemicals. Under this approach, akin to the 1040-EZ short form for taxes, businesses will save some 165,000 hours. EPA's TRI paperwork relief does not compromise environmental safety or complicate community notification in the event of a dangerous release of toxic substances. Should a spill or accidental release occur, companies are required to notify the authorities under various laws that are in place to ensure the safety of first responders and surrounding communities.

Advocacy Assists Dry Cleaners with Proposed EPA Rule. On December 9, EPA proposed a rule that would impose new air pollution requirements on dry cleaners that use perchloroethylene (perc). The proposed rule affects about 28,000 dry cleaners, virtually all of them small. These dry cleaners will have to install detectors that can "sniff" for perc leaks, and about 200 will also have to replace their existing dry cleaning machines with new ultra-low emitting machines. EPA originally planned to phase out perc use in dry cleaners located in residential buildings. There are about 1,300 such businesses, mostly in New York and California. Small businesses were very concerned that a perc ban for residential dry cleaners would negatively affect the entire industry, and they asked Advocacy for help. Ultimately, EPA proposed an alternative that would allow the continued use of perc by residential dry cleaners, as long as measures were taken to adequately protect residents from perc exposure. This regulatory alternative was a result of small businesses' and Advocacy's involvement with EPA. It is an attempt at giving small businesses adequate consideration while working toward a cleaner environment.

Regional Roundup for the Year

New Staff and Legislation Mark Productive Year

2005 was a busy and productive year for the Office of Advocacy's regional team! The regional advocates connected with small business owners, notified universities of the office's research resources, and ensured that policymakers heard the concerns of small businesses at the state and federal level.

Every region was staffed in 2005. In June, Steve Adams came on board as the Region I Advocate (Northeast) and Eric Munson as Region VI Advocate (Southwest). Bob Judge came on as Region III Advocate (Mid-Atlantic) and Ray Marchiori joined Advocacy as the Region V Advocate (Midwest) in July. Sarah Wickham joined the headquarters staff as regulatory and legislative counsel for regional affairs. On a bittersweet note, Till Phillips, who served as Region VI Advocate, retired after 31 years with the SBA. Region II Advocate Alan Steinberg resigned in August

and was appointed by the President to serve as EPA Administrator for Region II.

It was also an exciting year on the legislative front as many small business organizations and state legislators pushed to introduce regulatory flexibility legislation. In 2005, 18 states introduced and considered regulatory flexibility legislation; six states enacted regulatory flexibility legislation (Alaska, Indiana, Missouri, New Mexico, Oregon, and Virginia); and an executive order was signed in Arkansas. At year's end, legislation was still under consideration in New Jersey and Pennsylvania.

The regional advocates also continued to work closely with Advocacy's economists to spread the message about the small business data and research that Advocacy produces. They met with university professors, think tank staff, and public officials to provide

the most current small business data. Editorials by the regional team were published in many local newspapers; these opinion pieces highlighted and clarified issues of importance to small business. The regional advocates have also shared information about proposed regulations with small businesses and trade organizations, and they have brought small business commentary back to the chief counsel, keeping the Washington, D.C., office apprised of concerns "beyond the beltway."

In 2006, the regional team will continue representing the views and interests of small businesses across the country and making sure that officials in Washington, D.C., and in every state hear those concerns. Please contact the regional advocate for your region to find out more about their work in your state. To learn more, please visit Advocacy's website at www.sba.gov/advo/stateact.html.

Research Notes

New Advocacy Research for November and December

Small and Micro Business Lending for 2003-2004
by the Office of Advocacy
www.sba.gov/advo/research/2004.html

Advocacy's newest annual banking report documents increased access to capital in 2004. Small business loans outstanding by commercial banks increased by 5.5 percent between June 2003 and June 2004. The report includes rankings of the top state lenders for loans under \$1 million (small business) and under \$100,000 (micro business). Four sets of tables rank large bank holding companies (BHCs) and commercial banks nationally and by state. The study

is based on the two types of data that banks report to their regulating agencies—the Call Reports for June 2004 and the Community Reinvestment Act reports for 2003.

Broadband Use by Rural Small Businesses
by Telenomic Research
www.sba.gov/advo/research/rs269tot.pdf

Advocacy's latest telecommunications research gives evidence of the existence of an urban-rural digital divide. The report documents greater broadband use by small businesses in urban areas compared with small businesses in rural areas. The researchers reviewed a

number of reports showing links between information technology investment, broadband penetration, and economic growth. These results, combined with documented lower levels of rural small business broadband use, indicate that without increased broadband access rural economies could miss out on higher levels of growth and job creation.

The Effect of Changes in Monetary Policy on the Expectations, Spending, and Hiring Decisions of Small Business Owners
by William C. Dunkelberg and Jonathan A. Scott

Continued on page 7

Legislative Update

House Subcommittee on Regulatory Affairs—A Small Business Ally

In striving to be a strong and effective voice for small business within government, the Office of Advocacy welcomes partners wherever possible. The office's first and foremost partner is the small business community itself. Advocacy constantly holds roundtables, conferences, and one-on-one meetings with small business owners and their trade association representatives. These meetings are designed to make important information available to small businesses; but more importantly, they serve as a means of making Advocacy aware of the real priorities of small businesses and to direct the office's decisions of how best to use our resources.

Advocacy is also lucky to have a number of very important congressional partners as well. Both the House of Representatives and the Senate have Small Business Committees with important jurisdiction over SBA matters. The committees spotlight numerous small business concerns through hearings and other means.

But other committees and subcommittees are also effective fighters for small business. One of these is the Subcommittee on Regulatory Affairs of the House Committee on Government Reform. Although this subcommittee has been around in a slightly different form for some time, in this Congress it has been given a much sharper focus on regulatory issues—especially those that come down hardest on small business.

The subcommittee was created to identify areas where the U.S. government imposes an unduly heavy regulatory and reporting burden on American citizens and businesses. It sees its task as finding ways to minimize burdens and to reduce reporting requirements where feasible—clearly a task that goes hand-in-glove with the mission of the Office of Advocacy.

In addition to its focus, the subcommittee also has new leadership. Congresswoman Candice Miller from Michigan's 10th congressional district has had a long career in public service—but it all began

with her experiences in her family's small business where she learned to meet a payroll and provide jobs. Her direct and immediate exposure to the costs and burdens of regulations helped prompt her to seek public office so that she could help make the whole regulatory process make sense. This practical knowledge of what it means to be a small business owner has been a valuable asset as she chairs the subcommittee.

During one five-month period this year, the subcommittee held nine hearings on the impact of regulations on various aspects of the economy and whether agencies are doing all they can to reduce regulatory burdens. The Departments of Labor and Transportation as well as the Environmental Protection Agency and the Internal Revenue Service have been called in to explain their burden reduction efforts.

The Office of Advocacy and small business are lucky to have partners like Congresswoman Miller and the Subcommittee on Regulatory Affairs.

New Research, from page 6

www.sba.gov/advo/research/rs267tot.pdf

This contract research report examines how small firms react to unexpected changes in monetary policy. The researchers analyzed monthly survey data from the National Federation of Independent Business to illustrate how owner expectations are affected by these changes, with corresponding adjustments to spending and hiring plans, and ultimately changes in actual spending and hiring. The results provide micro-level insight into how quickly changes in monetary policy work through the small

business sector and ultimately the aggregate real economy. The findings indicate that the small business sector responds immediately to announced changes in monetary policy and that these changes have a significant impact on employment and prices, the two major concerns of monetary policy.

Agency Costs and Ownership Structure: Evidence From the Small Business Finance Survey Data Base by Jacky Yuk-Chow So
www.sba.gov/advo/research/rs268tot.pdf

This Advocacy working paper examines issues that arise when small businesses employ a professional manager (or agent), separat-

ing business owner(s) from direct control of the business. When the size of the company increases, and when professional managers are recruited, delegation of authority becomes necessary. To reduce the associated agency costs, corporate control mechanisms involving family members and/or banking relationships should be established to monitor the behavior of the non-owner managers. Otherwise, the management scandals that have plagued Fortune 500 companies may become a reality for small firms, too.

The David-Goliath Partnership

Entrepreneurial small firms have created a critical share of the innovative breakthroughs of recent centuries (see partial list below). In the 2005 edition of *The Small Business Economy*, renowned economist William Baumol notes that the innovative process is a David-and-Goliath partnership: market forces divide the process between small and large firms, each specializing in different tasks.

Innovative breakthroughs may be more likely to come from small firms willing to accept a significant share of payment in psychic rewards. The enormous prestige and financial returns of breakthrough inventions, along with their rarity, transform the innovator's activities into something like a lottery—with just a few mega-prizes. Once this lottery has settled on a winner, large firms are in a better position to provide the research and development funding needed to develop the invention into a sophisticated consumer good.

For example, the personal computer was invented by a small business. But a large company, Intel Corporation, was responsible for the incremental changes that eventually revolutionized the computer chip. Over the 1968-2003 period, the number of transistors embedded in a single chip expanded more than *10 million percent*. The subsequent revolution in clock speed contributed far more computing capacity than was provided by the original revolutionary breakthrough of the invention of the electronic computer. Only through the combined work of small and large firms did the powerful and inexpensive apparatus we know today become reality.

Innovative entrepreneurship can also be a way to escape poverty, Baumol says. Why? Entrepreneurs need no employer consent and can be successful innovators starting with little in financial capital or education. Case in point: the Wright brothers never attended high school. Message to aspiring inventors: if

you're in school, don't drop out. But if you're on the brink of adversity—take heart and jump in!

Small Firm Inventions from A to Z

Airplane
Defibrillator
Electronic Spreadsheet
FM Radio
Heart Valve
Integrated Circuit
Kidney Stone Laser
Large Computer
Microprocessor
Outboard Engine
Personal Computer
Rotary Oil Drilling Bit
Soft Contact Lens
Two-Armed Mobile Robot
Vacuum Tube
Xerography
Zipper

For a longer list, see *The Small Business Economy 2005*, page 186.

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