Watching and Waiting
Pinning Hopes on Small Businesses to Reignite Economy May Not Be the Best Idea

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Small business is actually quite big in America. In fact, according to the Small Business Administration’s (SBA) definition of small businesses — firms with fewer than 500 employees — they comprise 99.7 percent of all U.S. companies. They employ about half of the country’s private-sector workforce and are an important source of new job generation in the early phases of business-cycle expansions.

No wonder Americans are watching and waiting for the resurgence of small businesses to reignite the hiring process and get the economy back on track after the Great Recession.

But here are two things to consider about that premise. First, small businesses are not exactly the mass creators of jobs and wealth that they’re often cracked up to be.

Second, small businesses really took it on the chin during the recession. Between 2007 and 2009, self-employment fell, thousands of small firms vanished, and the pace of new business formation slowed. That’s a pretty significant blow to recover from, and it’s not clear how resilient today’s entrepreneurs will prove to be.

These two factors could potentially slow the pace of small business growth in the years ahead. That’s a problem because small businesses really do foster the sort of innovation the country desperately needs after the Great Recession. Nobody wants an environment where entrepreneurs are inhibited in their efforts to get started. Economic research, including studies by the Cleveland Fed, suggests that some government programs could be helpful in this regard.

Shocks Still Strong for Small Firms
As the recession deepened in 2009, especially in the first quarter, small firms accounted for almost 60 percent of job losses, according to the SBA. A mid-August 2011 survey by the National Federation of Independent Business reports that small-business owners are still stuck in recession-level growth trends, and the Bureau of Labor Statistics reports the growth in new business startups is the weakest it has been since the early 1990s, when the data were first tracked.
Also notable is research by the Ewing Marion Kauffman Foundation, which finds that today’s businesses start out smaller — and stay smaller — than their predecessors, rarely growing past their start-up employment levels. In fact, this research suggests that companies established in 2009 might now employ a million fewer people than the historic norm.

The Risks and Rewards of Launching a Business

Despite this evidence to the contrary, the myth of the entrepreneur endures. Small-business owners believe that running their own shop is best. High risk, high reward. Consider Mark Zuckerberg, co-founder of Facebook, billionaire, and entrepreneur: a resounding success story.

But Zuckerberg is far from the norm. Think of a plumber, for example, who leaves a larger company to run his own business. He struggles — getting clients, setting up a billing system, juggling the workload, deciding whether to hire others — and ultimately, he may not make any money.

“For every Mark Zuckerberg, there are a million guys like the struggling plumber,” says Scott Shane, visiting scholar at the Federal Reserve Bank of Cleveland and the A. Malachi Mixon III professor of entrepreneurial studies at the Weatherhead School of Management at Case Western Reserve University. “Americans pay more attention to the success stories, but it’s the statistics that don’t follow suit. And the media tend to overstate the probability of good outcomes.”

Truth is, the vast majority of people who start a business go back to wage employment or working for others. “If they spend four years getting a business off the ground, when they return to the workforce, it will take them longer to recoup the wages they were making four years prior. In addition, many of them have also pumped much of their savings into their business, and those funds are now gone,” Shane says.

Policy Challenges

But Facebook stories do exist. Most big businesses started small. Even though their contribution is sometimes oversold, small businesses are indeed integral to economic growth.
That’s why it’s important that they still have an environment in which they can flourish. Usually, innovation blooms anew after recessions, as laid-off workers start their own firms and work on ideas that were ignored by corporate bureaucracies. We should all be concerned about an economy in which people shy away—or are discouraged—from innovating.

As Shane puts it: “We don’t want to discourage innovation and the extreme high-growth companies.”

The challenge is to develop policies that address the specific needs of small businesses. For example, small firms spend more per employee than larger firms to comply with federal regulations such as healthcare, taxes, and environmental rules, and these costs may increase under new restrictions. “Even if the post-crisis regulations aren’t heavier, there is a perception that they are, and if small-business owners believe it’s going to be a burden to comply, then they’re going to hold back,” Shane says.

Access to credit is another sticking point. The decade leading up to 2007 was part of the housing boom. Small-business owners relied heavily on their personal property as collateral to obtain capital for their enterprises. In the wake of the recession, though, these owners are dealing with declining property values that limit their ability to obtain credit for financing their businesses.

Policymakers have intervened in the past, helping to buoy small-business owners. For example, the American Recovery and Reinvestment Act, enacted in February 2009, included several provisions targeted specifically at small businesses, such as tax incentives, reduced fees on certain SBA loans, and monetary support to help programs that promote economic development and entrepreneurship.

A working paper from the Cleveland Fed notes that “small businesses are likely to remain a sacred cow of public policy,” and will probably enjoy continued government support. There is evidence that some government interventions are effective. The researchers found that government interventions in small-enterprise credit markets, such as SBA loan guarantees, produce a positive impact on economic outcomes, especially when an intervention is designed to correct a market failure.

Because they serve as a substitute for collateral or relationships with loan officers, SBA loan guarantees are meant to increase the credit extended to small businesses. They allow lenders to charge a lower interest rate on the loan while mitigating their own risk on the longer-term loans that are the most useful for small businesses’ capital investment.

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But the plight of small businesses puts policymakers in a bind—there is no such thing as a “model” small business. “It’s not easy to design a policy for small businesses, because it’s also a policy for consumers,” says Shane, who points out that many small-business owners run their companies as extensions of their households, often mixing business and personal funds.

Also, small businesses are quite diverse; their issues differ widely, depending on whether the owner has five or 100 or 500 employees. As with so many other sectors, the future of small businesses remains uncertain in the wake of the Great Recession. Shane cautions, “I’m not sure we want policymakers to get us back to 2007. Many people believe we were experiencing a small-business bubble, driven by rising housing prices and the use of home equity to finance businesses. If we had a base point to compare to where we want to be, then we would be able to state if today’s levels are above or below where we should be.

“But,” he observes, “we don’t know what is normal.”

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