The Big Impact of Small Business

Entrepreneurship and small business creation are integral to the U.S. economy and, indeed, are embedded in the national character. The economic slowdown, however, has posed stiff challenges to this employment segment. How will small businesses confront today’s environment?

The ode to the yeoman small businessperson has become an American mantra. “Small business accounts for the majority of all new jobs in America.” “Small business is the backbone of the U.S. economy.”

There’s considerable truth in those statements. About half of all Americans work at small businesses, and small firms account for about 60 percent of gross job creation, according to Federal Reserve Chairman Ben Bernanke. But like any label, “small business” contains nuances. For starters, analyzing small business as a monolithic economic component is difficult because of the diversity of that class of firms. That variety also makes it challenging to assemble definitive data about smaller companies as a group.

Moreover, recent research by John Haltiwanger, an economist at the University of Maryland, indicates that young firms, which tend to be small, are a major source of job creation. Bernanke noted in a July speech that over the past 20 years, start-up companies less than two years old generated about one-quarter of gross job creation even though they employed less than 10 percent of the nation’s workforce.

It follows, then, that young, mostly small, enterprises will play a vital role in an economic recovery. “Our findings highlight the important role of business start-ups and young businesses in U.S. job creation,” according to research Haltiwanger, Ron Jarmin, and Javier Miranda published in August. “Business start-ups contribute substantially to both gross and net job creation.”

That typically smaller size of new firms, however, has a direct bearing on their ability to generate jobs. “Size matters mainly because, conditional on survival, young firms grow faster than older firms and tend to be small,” Atlanta Fed vice president and senior economist John Robertson said.

Squeezed by the downturn
Like the rest of the economy, small companies have felt the sting of the recession and financial crisis. In most cases, smaller businesses lack the financial cushion or global expansion opportunities of large corporations. Resulting caution and limited growth mean the job-generating energy of small business, which could help propel economic recovery, has stalled.

“If small and, importantly, young firms are a significant jobs engine and they are not growing, then it means a slower recovery,” said Paula Tkac, assistant vice president and senior economist at the Atlanta Fed.

The observation that a severe recession would result in fewer new companies might appear obvious. In fact, the financial crisis and ensuing recession have had mixed effects...
on business formations, according to research presented at an Atlanta Fed small business conference in October. As might be expected, the number of new companies formally incorporated fell, especially in wealthy nations and those nations that felt the financial crisis more acutely.

"I was surprised at how quickly and sharply the number of new firms dropped," said Leora Klapper, a senior economist at the World Bank, who presented a paper at the conference titled “The Impact of the Financial Crisis on New Firm Creation.”

However, the study by Klapper and fellow World Bank senior economist Inessa Love did not take into account more informal, one-person businesses. In fact, the number of people going into business for themselves after losing a job during the recession has increased, according to "The Great Recession and Entrepreneurship," a paper by Robert W. Fairlie, an economist at the University of California, Santa Cruz. These so-called "entrepreneurs of necessity" tend to start operations—such as babysitting or lawn care services—that might not be formally incorporated and are unlikely to employ many, if any, other people. The incidence of necessity entrepreneurship, Fairlie points out, is greatest in metropolitan areas with higher unemployment.

"Individuals who have fewer labor market opportunities are responding to that [level of unemployment] by starting businesses," Fairlie said.

Regardless of size or complexity, small-business operators have been beset by challenges, some obvious and some not. Underpinning any set of business challenges is the nation’s biggest cyclical dip in employment in more than 60 years. The United States has lost more than 8 million jobs since December 2007. Amid a slow economy, consumers and businesses have generally cut spending, reducing demand in general for the goods and services of small and large companies alike.

**Banks tighten standards, purse strings**

Meanwhile, during 2009 and early 2010, many banks tightened lending standards for smaller firms, making it more difficult for
as consumers showed their reluctance to borrow, relying more on cash and debit cards for spending.

Southeast bank failures led the pack in 2010
The Southeast led the nation in bank failures as Florida and Georgia this year, with a combined total of 46 failures from January through November, were home to almost one-third of the failures that occurred nationally during the year. From January through November, 49 banks failed in the Southeast, surpassing the 42 failures the region experienced in 2009 (see the table). Unlike last year, when failures were mostly younger banks located in metro Atlanta and the southern coastal areas of Florida, failures in 2010 were more geographically dispersed throughout Florida and north Georgia and struck banks young and old.

Bank charter expansion ground to a halt in 2010—only one true de novo bank was opened in the Southeast through October. Other recently chartered banks were used as vehicles to acquire the assets of failing institutions. Georgia, with 48 bank failures since the beginning of 2008, is home to the most failures in the United States since the banking crisis began.

Credit standards to remain high
The current banking landscape reveals that banks are no longer tightening credit but they are maintaining high credit standards. Indeed, most bankers expect their lending standards to remain high for the foreseeable future. A reduction in the number of problem banks and bank failures will most likely lag the economic recovery. Southeast bank performance remains weak but is improving as banks work to shore up their balance sheets weakened by loan losses from the housing market and pending foreclosures. The outlook for the banking industry remains cautious as reforms are implemented to address the issues that precipitated the banking crisis.

This sidebar was written by Pam Frisbee, an analyst in the Atlanta Fed’s research department.

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<th>FDIC-Insured Bank Failures in the Southeast</th>
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Note: 2010 data are through November 30.
Source: FDIC press releases

them to secure financing. Small business loans by commercial banks declined by more than $40 billion between the second quarter of 2008 and the second quarter of 2010, according to U.S. Bureau of Labor Statistics data cited by Federal Reserve Bank of Boston researchers. (It’s also worth noting that loan demand decreased with the decline in sales during the recession.)

With small business loans remaining near record lows, less than one-third of small businesses in the Southeast reported borrowing on a regular basis during the third quarter of 2010, “not surprising given the persistent emphasis on cost cutting and the curtailment in capital expenditures,” according to the Atlanta Fed’s September Small Business Trends report. “Borrowing that does occur tends to be for the purpose of smoothing cash flow rather than for funding expansion or hiring,” says the report.

Other difficulties facing entrepreneurs are less apparent: household wealth, for example. A large majority of new companies are financed by the business owners themselves, according to William Gartner, professor of entrepreneurial leadership at Clemson University, who presented a research paper at the Atlanta Fed small business conference. In 2005–06, some 82.5 percent of entrepreneurs, according to data Gartner cited, relied mainly on personal contributions to launch their businesses.

Between the end of 2007 and the second quarter of 2010, the total assets of U.S. households and nonprofits fell $11.2 trillion, or 14 percent, according to Federal Reserve data. Plunging home values explain much of that lost wealth. American home-owners’ equity in real estate in the second quarter of 2010 was $6.2 trillion, or 47 percent, lower than it was in 2005, even after rebounding from a trough in early 2009, according to the Fed’s Flow of Funds Accounts of the United States. That dip in home equity has sapped a key source of financing for entrepreneurs, Fairlie pointed out.

That decrease in household wealth has had another effect. Not only is personal wealth a direct source of new-business financing, it is also commonly used as collateral to obtain business loans, Fairlie said. Atlanta Fed surveys of small business
operators reinforce that point. For companies less than four years old, loss of the owner’s personal wealth, including home equity and other assets, was the primary obstacle to accessing credit, according to the Atlanta Fed’s second quarter small business survey.

**Glimmers of hope?**

Heading into 2011, even amid the significant gloom, signs of optimism for small firms have begun to appear. The second-quarter Atlanta Fed survey of 432 small business owners in the Southeast indicates that credit availability appears to be improving. In addition, more than half of the respondents said they expected their sales to increase in the next six months. Only 14 percent of respondents said they had been denied credit by a lender, down from a rate of 40 percent in a first-quarter 2010 survey.

On the other hand, many more offers of credit were refused by the borrower, suggesting more applications were being approved, just not at terms acceptable to the businesses. That dynamic—more small companies finding credit available, just not on conditions they like—appears to be continuing, according to preliminary findings from the Atlanta Fed’s third-quarter small business surveys. What is more, the Fed’s senior loan officer surveys show that in the third quarter of 2010, the percentage of financial institutions continuing to tighten lending standards was falling, compared with the proportion either loosening terms or leaving them unchanged.

These findings do not suggest that obtaining credit is easy, but that it is available for sound small businesses, Tkac noted. “I think the picture is getting somewhat better,” she said.

Nationally, small business optimism inched upward in September. The National Federation of Independent Business’s index of small business optimism was higher than its recent low during late 2009 but still well below levels before the financial crisis and recession. In another sliver of promise, small business employment in the Southeast climbed in October 2010. Florida and Georgia small business employment increased 0.3 percent and 0.2 percent, respectively, according to Intuit’s small business employment index.

A rapid resurgence of small and young firms does not appear likely, but this key engine of job creation could play a crucial role in bringing down the nation’s persistently high unemployment rate. For that reason, the Atlanta Fed has renewed its focus on small business research, both at the grassroots and scholarly levels, and has created the Small Business Focus website at frbatlanta.org/research/smallbusiness/. The Small Business Trends newsletter, the two dozen research papers presented at the October small business conference, and other resources are available on this site.

This article was written by Charles Davidson, a staff writer at EconSouth.