The Job Hunt: New Clues for Small Business Job Creation

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Small and large firms have differing roles in the labor market. Today, there are new data available on job flows in small business—hiring, firing, retiring, and job-hopping. This information, as well as newly available data on firm size and age, gives us more insights into job creation in small businesses, where many net new jobs are born.

Today, we are talking with Brian Headd, economist with the U.S. Small Business Administration's Office of Advocacy. Brian focuses on small business data and has been quoted extensively in the press, including USA Today, BusinessWeek, and The New York Times, and has appeared on Bloomberg News and MSNBC.

Mr. Headd, thank you for joining me today.

Brian Headd: Thanks for the opportunity, Jessica.

Farr: Let's begin with the challenges to survival that small businesses face. What are the primary reasons that small firms fail, and why did a higher percentage fail during the last recession?

Headd: Businesses can close for personal or business reasons. Personal reasons can include retirement, job offers, or health problems, and business reasons can include lack of sales, having costs too high. Oddly enough, when a business closes, the owner may not even know the reason for the closure—for instance, small market, lack of marketing, bad customer service, "unpaids" not dealt with—because it really is unique to the business. But what isn't unique is focusing more on being a worker at the detriment of all the other components of running a business, such as getting the unpaids down, keeping your costs down, getting your sales up.

The main challenge has always been sales—right place, right time, right product or service. And because of the economy the last few years and individuals increasing their savings and cleaning up their balance sheets, sales, of course, have been the biggest small business problem.

Now, note that when we focus on a question like this, we really are talking about two different types of businesses: employer businesses and nonemployers. Of course, employers have employees, and nonemployers are essentially one-person operations. Employers have size advantages—they're bigger, so they can weather storms. But nonemployers also have a size advantage—they're smaller, more nimble. They can take hiatuses and often come back stronger than before, whereas an employer has trouble becoming more seasonal. But the number of employers tends to be cyclical, or follow the economy, and the number of nonemployers tends to be countercyclical—it tends to go up when the economy struggles.

Farr: Why has small business's share of private-sector employment declined over the last few decades, to below 50 percent?

Headd: Small business's share of the private-sector workforce goes up and down with the health of the economy, technology, consumer preferences, the fortunes of various industries and financing, etc. When the economy does well, the average company size grows, which would make small business's share of employment go down, and when it struggles, it shrinks.

But over the long term, the average business size is really determined by what economists refer to as "economies of scale." And economies of scale is at what size a business can exist to produce at optimal efficiency. So one person will struggle to make cars, but thousands will do quite well at it. So as you can understand, different industries will have differing technologies.

Now, over the last few decades, technological advances and consumer tastes in retail trade have increased the average firm size in that industry. Other examples include software development, which is becoming more driven by large firms. Maybe the cell phone apps phenomenon over the last few years will start to swing the pendulum back.

On the flip side, shrinking manufacturing technology has been a boon to mini-mills. With services trumps manufacturing and employment over the last few decades, small business's share of employment has dropped by a few percentage points, although that is actually reasonably significant.

Farr: It has been suggested that the growth in the number of entrepreneurs is partially attributable to worker layoffs at medium- and large-size firms. These new entrepreneurs often have significant skills, but these skills don't always translate to those needed to start or run a business. What unique challenges and opportunities do these entrepreneurs face?

Headd: Well, as the question illustrates, the tendency is to focus on what we're good at and avoid what we struggle at. New owners tend to have excellent skills in developing products and services, so they need to concentrate their efforts on lining up sales, possibly financing, and staying on top of the paperwork. Essentially, they should focus on the squeaky wheel. For example, a software developer will really need to focus on making sales, having...
solid customer support, and keeping unpaid invoices to a minimum.

Another issue is if you are laid off from an industry like construction, breaking out on your own in that same industry is going to be a struggle because the industry is suffering. So if you can take your skills to an industry that is thriving, of course, that is going to give you a better chance of success.

Farr: Many state and local economic development strategies focus on entrepreneurship and small business development. Does this approach make sense given that most small businesses fail within the first year? And is small business creation by laid-off employees a viable economic development strategy?

Headd: Actually, most businesses don't close in their first year. Only 30 percent of new employer firms close in their first year. And the many that do close have what I'll call sporadic businesses, where they are either contracting or selling their labor. So they're responding to a project not necessarily a continual venture. So, these businesses are not risking their life savings, they are selling their labor.

The nice thing about starting small and with little to no capital is that it is an easy-in, easy-out type of business. In this type of business, you can learn the ropes at a small scale, and this is invaluable because owners that have run these very small businesses have gone on in different businesses to be very successful years down the road. So, encouraging people to start businesses is not a problem, but, of course, we want to encourage financial prudence so they don't risk their life savings. We want people not to ruin their credit so they can have a second chance down the road. But rather than supporting start-ups, at this point, a more viable economic development strategy is probably to encourage existing companies to expand and hire employees.

Farr: What small business trends have you seen following the recession that may provide insight to economic developers so they may better support small business creation and growth that is sustainable?

Headd: If you're an economic developer, I would imagine that you are pretty discouraged from the economies of 2008 and 2009. But 2010 showed promise. Business closures slash bankruptcies declined, and business start-ups are up. The trend in the last few years has been for businesses to reduce hiring, but it also has been a trend for businesses to reduce separation in the last, say, year-and-a-half. So the labor market, while slowly improving, has a frozen aspect to it. Economic developers need to work closely with businesses that are trying to expand and with labor to try to make sure that the skills matches occur. If economic developers can do this well, then they will be a major catalyst at fixing our labor market woes.

Farr: Well, thank you, Mr. Headd, for joining us today.

Headd: Thanks for the opportunity, Jessica.

Farr: This concludes our podcast. We’ve been speaking with Mr. Brian Headd, economist with the U.S. Small Business Administration's Office of Advocacy. For more podcasts on this topic and others, please visit the Atlanta Fed's website at frbatlanta.org. If you have comments or questions, please e-mail sba.gov

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