DALLASFED

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Financial Insights

FIRM • FINANCIAL INSTITUTION RELATIONSHIP MANAGEMENT

CALENDAR OF EVENTS

June 10
Economic Roundtable
Houston

June 20
Payments Town Hall
Dallas

June 24
Payments Strategies Conference
San Antonio

June 26
Economic Roundtable
Waco, Texas

July 8
Economic Roundtable
Livingston, Texas

July 9
Economic Roundtable
Brenham, Texas

July 10
Economic Roundtable
Tyler, Texas

July 16
Dialogue with the Dallas Fed
Fort Worth

July 22
Economic Roundtable
Wichita Falls, Texas

July 29–30
Economic Roundtable
Bay City, Texas

Aug. 20
Economic Roundtable
Marble Falls, Texas

Aug. 28
Economic Roundtable
Beaumont, Texas

What Keeps Small Business Owners Up at Night?

by Thomas F. Siems

Small businesses are often cited as the engine of growth for the U.S. economy. They account for 50 percent of employment in the United States and have created 63 percent of net new private sector jobs since 1993, according to the Small Business Administration (SBA).[1] Small businesses also exemplify the entrepreneurial spirit that has been central to our nation's long-run prosperity. With 13 times as many patents per employee as large companies, U.S. small businesses are global leaders in innovation.[2]

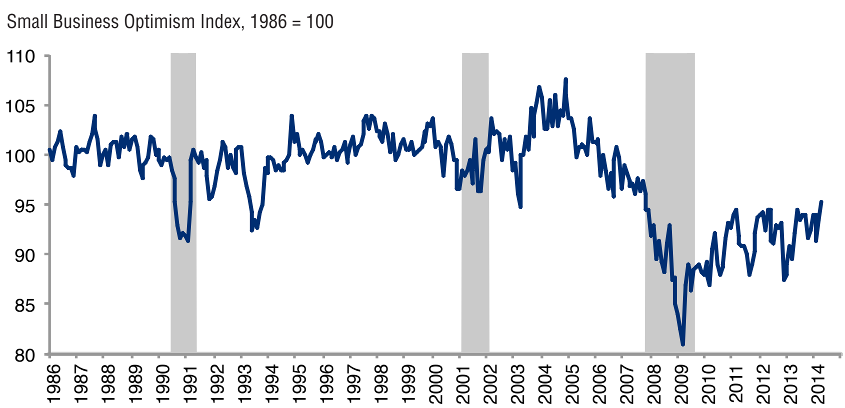
But a recent Brookings Institution study finds that "business dynamism and entrepreneurship are experiencing a troubling secular decline" in the U.S.[3] In other words, business dynamism—the process by which firms are born, fail, expand and contract—has suffered during the last few decades across a broad range of sectors and geographic locations. And because small businesses—particularly startups—play a critical role in this process and thus in creating new jobs, any further deceleration following the Great Recession of 2007–09 might imply slower economic growth and a less-dynamic economy in the U.S.

Most Important Problem

The Index of Small Business Optimism from the National Federation of Independent Business (NFIB) indicates that optimism has finally returned to its prerecession level (*Chart 1*). However, at 95.2, it is still about 5 points below its long-run average from 1986 to 2007. Indeed, the May 2014 NFIB report announcing the most recent survey results is titled "Small Business Optimism Improves, but Don't Get Too Excited."[4]

What might be restraining small business optimism? Or, put another way: What is keeping small business owners up at night? The NFIB survey provides some insight into this question by asking small business owners to select what they consider to be their single most important problem.

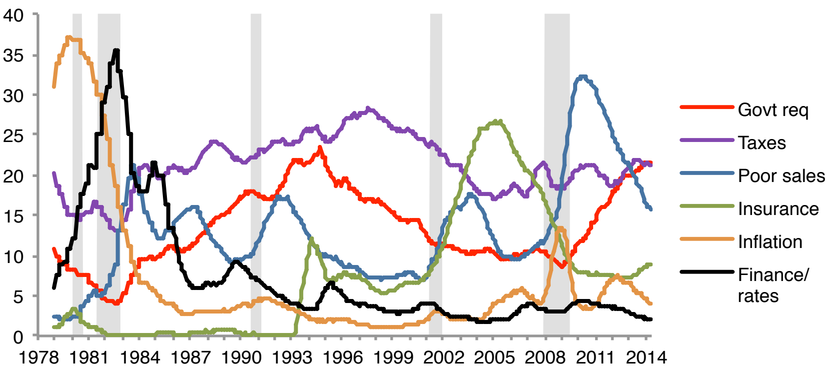
Chart 1 Small Business Owners' Optimism Below Long-Run Average



NOTE: Shaded areas represent U.S. recessions.
SOURCE: National Federation of Independent Business.

The problem most often mentioned by small business owners has fluctuated through the years (*Chart 2*). In the late 1970s, most small business owners cited inflation. In the early 1980s, their most-cited concern was finance and interest rates, and from the mid-1980s to the early 2000s, it was taxes. In the mid-2000s, small business owners were most concerned about the cost and availability of insurance, but once economic growth contracted during the Great Recession, the concern mentioned most was poor sales.

Chart 2 What Keeps Small Business Owners Up at Night?



*12-month moving average.

NOTE: Shaded areas represent U.S. recessions.
SOURCE: National Federation of Independent Business.

Based on a 12-month moving average, most small business owners today cite government requirements and red tape as their No. 1 concern, followed closely by taxes:

- The percentage of small business owners citing government requirements and red tape as their top concern rose from 10.4 percent just before the recession began to 21.4 percent today. With an average of 15 percent since 1986, small business owners clearly see government requirements and red tape as a more important concern now than in the past.
- Most recently, 21.2 percent of small business owners cite taxes as their top concern—but taxes is the most-mentioned concern since the NFIB survey's inception, averaging 21 percent since 1978 and ranging from a low of 14 percent to a high of 28 percent.
- At 15.8 percent, poor sales is the third most mentioned problem cited by small business owners since the start of the recession. This is up from the 11.6 percent reported just as the recession began but far less than the high of 32.4 percent reached just after the recession ended.

In summary, when examining small business owners' list of the single most important problems before and after the Great Recession, the NFIB finds that government requirements and red tape is the fastest-growing concern and that taxes once again is a top concern. It appears that uncertainty about the implementation of new and existing regulations such as the Affordable Care Act, the tax code and proposed government policies all greatly contribute to holding back small business optimism.[5]

Effect on Employment Growth

How is small business optimism affecting employment growth in the post-Great Recession recovery?

Using the Business Employment Dynamics dataset from the Bureau of Labor Statistics, Chart 3 compares the share of net jobs created according to firm size for the period leading up to the recession (from third quarter 1992, when the series was established, through 2007) to the period following the recession (from second quarter 2010, when quarterly net job creation turned positive, through 2013, the most recent data available).

DALLAS FED RESOURCES

Economic Updates

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International—"Low Inflation and Slower Medium-Term Growth Accompany Uneven Recovery"

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April 2014 Summary

Dallas Fed Annual Report
"The Long-Awaited Housing Recovery"

Economic Letter
"Central Bank Transparency Anchors Inflation Expectations"

Southwest Economy
"Strength of Economy, Limited Benefit Eligibility in Texas Curb Long-Term Unemployment Rate"

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"The Long-Awaited Housing Recovery"

Find other resources on the Dallas Fed website at www.dallasfed.org.

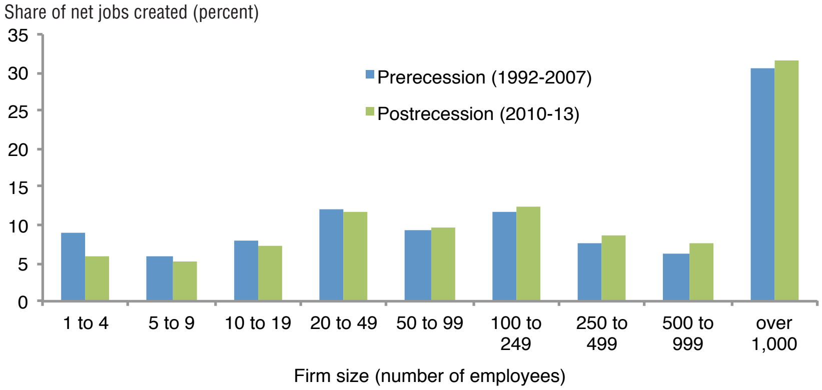
ABOUT *FINANCIAL INSIGHTS* AND FIRM

Financial Insights is published periodically by FIRM – Financial Institution Relationship Management – to share timely economic topics of interest to financial institutions.

FIRM was organized in 2007 by the Federal Reserve Bank of Dallas as an outreach function to maintain mutually beneficial relationships with all financial institutions throughout the Eleventh Federal Reserve District. FIRM's primary purpose is to improve information sharing with district financial institutions so that the Dallas Fed is better able to accomplish its mission. FIRM also maintains the Dallas Fed's institutional knowledge of payments, engaging with the industry to understand market dynamics and advances in payment processing.

FIRM outreach includes hosting economic roundtable briefings, moderating CEO forums hosted by Dallas Fed senior management, leading the Dallas Fed's Community Depository Institutions Advisory Council (CDIAC) and Corporate Payments Council (CPC), as well as creating relevant webcast presentations and this publication. In addition, the group supports its constituents by remaining active with financial trade associations and through individual meetings with financial institutions.

Chart 3 Job Creation Slows for Small Businesses



SOURCE: Census Bureau.

The chart shows that the firms in each of the four smallest size classes created a smaller share of net jobs following the recession. During the prerecession period, firms with fewer than 50 employees created 34.9 percent of all net jobs in the private sector, but their share fell to 29.8 percent during the postrecession jobs recovery. For each of the five larger firm size classes, the share of net jobs created increased in the postrecession period.

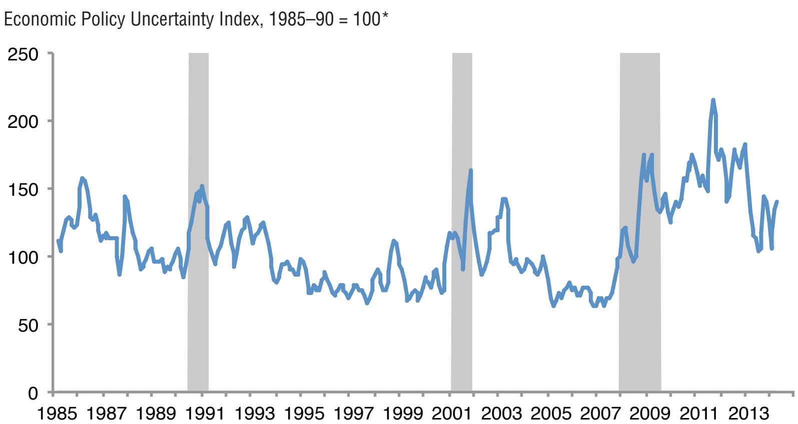
In the recovery, the smallest firms are not forming, expanding, or hiring new employees at the same rate they did prior to the recession. Thus, small businesses apparently are not the engine of growth for the economy that they once were.[6] Something is holding them back. And according to the NFIB survey, increasing concerns about government requirements and taxes are at the heart of the matter.

Policy Uncertainty Heightened

Chart 4 reinforces this perception by showing an index of economic policy uncertainty since 1985.[7] The chart indicates that economic policy uncertainty has been more pronounced during the post-Great Recession recovery than prior to it. From 1985 through 2007, the uncertainty index averaged 98. The index averaged 136 over the 26 months from the start of the recession (December 2007) until the time net job creation turned positive (February 2010), and it averaged 153 during the jobs recovery through April 2014.

Heightened economic policy uncertainty has a negative impact on the optimism of businesses and consumers and can cause them to sit on the sidelines awaiting a better and more certain economic environment.

Chart 4 Economic Policy Uncertainty Persists



*Three-month average.

NOTE: Shaded areas represent U.S. recessions.
SOURCE: Economic Policy Uncertainty, www.policyuncertainty.com.

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Entrepreneurs and small businesses can once again be the engine of growth for the U.S. economy—but trends in small business optimism, perceptions of the most important problem and job creation suggest they will need greater clarity about economic policies and the impact of government regulations and taxes.

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NOTES

[1] See "The Small Business Advocate," Small Business Administration (SBA), vol. 33, no. 3, April 2014, www.sba.gov/advocacy. The SBA Office of Advocacy defines a small business as an independent business having fewer than 500 employees. A threshold this high results in the designation of more than 99 percent of U.S. firms as small businesses. Even so, new and young firms have contributed disproportionately to net job creation in the U.S. According to census data, businesses less than three years old created almost 40 percent of all net new jobs from 1978 to 2009, despite accounting for less than 10 percent of employment.
[2] See "Restarting the U.S. Small-Business Growth Engine," by John Horn and Darren Pleasance, McKinsey & Co., November 2012.
[3] See "Declining Business Dynamism in the United States: A Look at States and Metros," by Ian Hathaway and Robert E. Litan, Brookings Institution, May 2014.
[4] See "May 2014 Report: Small Business Optimism Improves, But Don't Get Too Excited," by Bill Dunkelberg, National Federation of Independent Business, May 2014.
[5] A recent survey of small businesses in Texas reaches a similar conclusion. See "New Survey Finds Optimism, Challenges among Small Businesses in Texas," by Emily Ryder Perlmeter, Federal Reserve Bank of Dallas, Texas Small Business Needs Asessment Poll, May 2014.
[6] Of course, the role of big businesses in creating jobs and generating economic growth is also important, and public policy should protect firms of all sizes from unnecessary taxes and regulation. See "Big Business: The Other Engine of Economic Growth," by Alan D. Viard and Amy Roden, American Enterprise Institute, AEI Tax Policy Outlook, June 2009.
[7] This monthly index is composed of three components that measure economic policy uncertainty. The first quantifies media coverage of policy-related economic uncertainty, the second reflects the number of federal tax code provisions set to expire in future years, and the third examines the level of disagreement among economic forecasters. See "Measuring Economic Policy Uncertainty," by Scott R. Baker, Nicholas Bloom and Steve Davis, Stanford University mimeo, 2012.

Noteworthy Items

Dallas Fed President Richard Fisher speaks at the Bush Institute about his views on the effects of monetary policy and the Federal Reserve's response to economic crises (May 19, 2014)
Fisher explains why Texas is making the most economic improvement relative to other areas in the economy and also discusses the dangers of dependency on monetary policy. He also shares his views on problems with fiscal policy and what should be the real priority of Republicans and Democrats: job creation.

Federal Reserve Chair Janet Yellen presents before Congress on the outlook for the U.S. economy (May 7, 2014)
Yellen covers topics such as the improvement in the labor market, rebound in spending and production, and continuation of low inflation amid the postrecession economic expansion. Yellen also focuses on the Federal Reserve's fight against unemployment and explains how the Fed has helped promote financial stability in the U.S. economy.

Federal Reserve Chair Janet Yellen speaks at the Independent Community Bankers of America 2014 Washington Policy Summit about tailored supervision of community banks (May 1, 2014)
Yellen says much of the research received on community banks has reflected a concern about regulatory burden. She explains that the Federal Reserve will address this burden whenever possible or appropriate by judging which policies should apply to community banking organizations. Saying that community banks play a crucial role in the overall financial system, she discusses how the Federal Reserve is committed to considering the effects of policy on these banks.

Dallas Fed President Richard Fisher speaks in Hong Kong about the shift from quantitative easing to forward guidance as a tool used by the Federal Reserve to help stabilize markets (April 4, 2014)
Fisher talks about the popularity of quantitative easing as a tool to help jump-start the recovery after the Great Recession. Fisher sees the need to slowly but effectively trim these large-scale asset purchases to fulfill the Federal Reserve's mandates from Congress—to preserve price stability and achieve full employment—while simultaneously avoiding market turbulence.