Are Small Businesses the Engine of Job Growth?

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What do George W. Bush, Bill Clinton, Ronald Reagan and Barack Obama have in common (besides a conviction that the camera loves them)? They have all promoted the notion that small businesses are the engine of America’s economic growth. But new research shows that the role of small businesses has been overstated.

The Small Business Administration (SBA), an independent agency of the federal government, highlights the contributions that small businesses (defined as firms with fewer than 500 employees) make to the overall economy. According to an SBA publication, a major part of private-sector job generation takes place in the small-firm sector.

But according to recent studies, small-business employment has been misinterpreted for decades due to one critical issue: firm age. Newly formed firms have a disproportionate effect on net job growth, and many new companies are small.

But even that important distinction does not tell the whole story. Large firms play a key role in creating jobs and retaining employees.

A report by Goldman Sachs economist Kris Dawsey explains that comprehensive data tracking to account for firm age is now feasible. This data reveals “the process of young firms (which do tend to start out small) growing into larger firms is the true contributor to job growth.” Dawsey states that controlling for firm age also proves that “the vast majority of small firms start small and do not grow significantly.”

I will begin by explaining why small businesses have been and continue to be credited for contributing disproportionately to job growth. I will then look at the typical lifecycle of new, small firms and compare their economic value in terms of job creation to that of large mature, firms.

What started the misconception?

More than 30 years ago, academic David Birch became the first to publish a study that labeled small businesses as the engine of economic growth. Politicians and the business press have embraced this finding ever since. The SBA, in its publication noted above, goes as far as to praise Birch for
discovering “that the end result of small businesses’ creative destruction was a net increase in employment.” Moreover, the SBA claims, this finding was “the seed for the small business employment discussion that continues to this day.”

Birch’s research proved to be provocative. It triggered an exponential rise in statements from politicians supporting small businesses. For instance, in 1982, President Ronald Reagan said that a “vigorous small business sector is essential to a productive and competitive economy. … Most of the new jobs actually created are in small private enterprises.”

Birch’s findings are plagued with statistical and measurement errors. These analytical inaccuracies were identified by John C. Haltiwanger, a research associate of the National Bureau of Economic Research and a senior research fellow at the Center for Economic Studies at the U.S. Census Bureau. Haltiwanger argued that Birch published his results when there was a lack of suitable data. For example, Birch’s findings were usually presented in terms of gross job creation, rather than in net terms, which is the more economically meaningful metric.

These numbers failed to account for the high job-destruction rate of small businesses. Birch’s conclusions inflated the economic value of small businesses in terms of job creation.

The positive corollary was that his claims inspired more studies on small business. We are now seeing that the research he prompted is disproving the results of his papers.


**Progress in research**

The recent work of John C. Haltiwanger confutes the views popularized by Birch and argues that firm age influences employment generation.

The introduction of Census Business Dynamics Statistics (BDS) has allowed researchers to address most of the limitations that hindered prior research on small businesses. When I interviewed Haltiwanger, he explained that the BDS is the only source that accurately tracks firm growth and survival rate by firm age. This is because the BDS is not obstructed by statistical errors, such as firms that were created by mergers and acquisitions or ownership changes as being classified as “new.”

The BDS allowed Haltiwanger to accurately determine whether any identifiable groups of firms disproportionately created or destroyed jobs. He used BDS data to quantify the relationship between the size of a firm and its employment growth. (For our quantitatively minded readers, he did this with a non-parametric regression.) Using this model, he proved that “once we control for firm age, there is no evidence that small firms systematically have higher net growth rates than larger businesses.” In fact, he found that when the data is controlled for firm age, the negative relationship between firm size and employment could even reverse. The reversal occurs because this study accounts for the disproportionately high failure rates of small firms.
Haltiwanger’s most significant finding was that young businesses, which happen to be small, are the ones that contribute disproportionately to job generation.

He found that new firms account for approximately 20% of gross job generation, which does not account for the high destruction rate of new firms. Since almost every startup is small, small-business advocates use this as evidence that small businesses lead to job growth. But Haltiwanger’s findings reveal that statements, such as the aforementioned quote by Ronald Reagan, are misleading. It would be more accurate if Reagan had credited startups, rather than small businesses, for the creation of the most new jobs.

Reagan’s statement is also misleading because a vigorous small business sector is not essential to a competitive economy.

**Most small businesses fail**

For decades, the American economy has remained competitive despite the fact that most small businesses did not grow and failed within a few years. Small firms create jobs, but many of those jobs are short-lived because of the high failure rate among those firms.

In my interview with Erik Hurst, professor at the University of Chicago Booth School of Business, he explained that his research found that small businesses tend to enter industries with limited growth potential. The overwhelming majority of startups enter industries that employ skilled craftsmen (i.e. plumbers, electricians), skilled professionals (i.e. lawyers, accountants) or shop keepers (i.e. gas station owners). In general, these small businesses do not provide new services to the economy, and they have little potential to innovate. Thus, it is not surprising that the success rate of these startups is extremely low.

The SBA document referenced above also states that “most small firms start small, stay small, and close just a few years after opening,” which aligns with Hurst’s findings. This common lifecycle calls into question the economic value of young small businesses. If they contribute disproportionately to job creation, it is inconsistent that they would also have a remarkably high failure rate.

Haltiwanger explained that this occurs because a few “high-growth young firms make up for the failure and the lack of growth of the median-young firm. The high-growth young firms contribute enough so that after about five years, a new cohort still retains about 90% of its original size.” Although young small businesses do provoke creative destruction, the bottom line is that “out of each new cohort of firms, there are a small fraction of high-growth firms that make a durable contribution to jobs.”

Haltiwanger’s latest studies show that the growth rate distribution of young firms is substantially skewed. He found that “high-growth firms overall account for about 50% of job creation, and these are disproportionately young.” Despite this reality, the economic worth of the typical small business continues to be overstated.

**Small businesses are still promoted**
Politicians and small-business advocates are quick to glorify the rare young, small business that achieves remarkable growth. They often point to stories like the extremely successful Chipotle Mexican chain, which started as one small restaurant in Denver. Indeed, Chipotle has created many American jobs. But one cannot typically predict from which industry or geographic location a firm like Chipotle will emerge.

Small business promoters neglect to identify Chipotle as an outlier. They disregard the fact that Chipotle's increase in size is not typical. They portray Chipotle as a common small business, thereby promoting a social perception that the majority of small firms will experience similar growth.

This social perception is additionally reinforced when misleading statistics are used to embellish the success of small business. For instance, depending on how one defines "small" firms, their job-creation advantage disappears. Consider the following. If small businesses were defined as those with less than 300 employees, instead of the standard 500-employee definition, the small-business job-creation advantage would disappear.

Statistics can also be manipulated with un-weighted figures. Haltiwanger gives the following example: “In terms of un-weighted statistics, more than half of newly established firms fail within five years, according to the BDS. In terms of employment-weighted statistics, the fraction is just about a half. The difference is associated with the fact that very small young businesses are more likely to fail.”

These methods of data manipulation cause a large discrepancy between the statistics that small-business advocates proffer and those that are generated by academic researchers like Haltiwanger.

Large businesses

The discrepancy between the statements of small-business advocates and academic researchers also extends to the topic of large businesses.

The SBA often cites that opening a new firm has a larger impact on employment than expanding a business does. From a numerical standpoint, this is correct. According to Haltiwanger, "There is still substantial restructuring among large, mature firms, so some are growing and some are shrinking, but there is not much impact on net growth.” However, this SBA statement does not take into consideration the qualitative value of large businesses.

Haltiwanger emphasized that large, mature firms play a critical role in the economy because they generate stable and high-quality employment opportunities. That is, large-firm job growth is important because those jobs have lower turnover than jobs in small firms. Large firms are also more inclined to offer their employees benefits and retirement provisions. These jobs are a vital part of the U.S. economy by reason that, as stated by the SBA, they account for approximately half of American jobs.

“The large, mature firms we all know well had some period of rapid growth,” Haltiwanger said. “And at the risk of being redundant, this tends to happen when firms are young (in the first 15 years or so after a firm is created).” Put differently, most of the job growth in small firms is concentrated among a relatively small number of high-growth firms that transition to large firms.
This transition has beneficial implications for the American economy. As stated in Haltiwanger’s paper, “the most productive businesses are the largest businesses.” It is not the small business sector that drives productivity growth — it is the expansion of existing large businesses. The large-firm productivity advancement is essential to GDP growth and wealth creation in the United States.

**Conclusion**

Political debate is flooded with inaccurate declarations, such as President Obama’s recent one that “small businesses have always formed the backbone of the American economy.”

Policy that simply focuses on supporting small businesses with the rationale that it supports job growth is misguided. An example is the almost $13 billion allocated to small business loans within the past few years. Policy should focus on supporting startups in high-growth industries and should not indiscriminately subsidize small companies. In addition, if the goal is to support job growth, equal emphasis should be directed to large firms.

Classifying small businesses as the engine of economic growth is misleading. Almost all small firms do not grow or fail within a few years. A select few startups will evolve into powerful large firms. Those firms, along with existing base of large corporations, are the true engines of job growth and value creation in the American economy.

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