POLICY BRIEF

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The Future of Small Business Entrepreneurship:
Jobs Generator for the U.S. Economy

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As the nation strives to recover from the "Great Recession," job creation remains one of the biggest challenges to renewed prosperity. Small businesses have been among the most powerful generators of new jobs historically, suggesting the value of a stronger focus on supporting small businesses—especially high-growth firms—and encouraging entrepreneurship. Choosing the right policies will require public and private decision-makers to establish clear goals, such as increasing employment, raising the overall return on investment, and generating innovations with broader benefits for society. Good mechanisms will also be needed for gauging their progress and ultimate success. This brief examines policy recommendations to strengthen the small business sector and provide a platform for effective programs. These recommendations draw heavily from ideas discussed at a conference held at the Brookings Institution with academic experts, successful private-sector entrepreneurs, and government policymakers, including leaders from the Small Business Administration. The gathering was intended to spur the development of creative solutions in the private and public sectors to foster lasting economic growth.

Recommendations

What incentives and assistance could be made available to "gazelles" and to small business more generally? What policies are likely to work most effectively? In the near term, government policies aimed at bolstering the recovery and further strengthening the financial system will help small businesses that have been hard hit by the economic downturn. Spurred by the interchange of ideas at a Brookings forum on small businesses, we have identified the following more targeted ideas for fostering the health and growth of small businesses (and, in many cases, larger businesses) over the longer run:

- Improve access to public and private capital.
- Reexamine corporate tax policy with an eye toward whether provisions of our tax code are discouraging small business development.
- Promote education to help businesses struggling with shortages of workers with particular skills, and promote research to spur innovation.
- Rethink immigration policy, as current policy may be contributing to shortages of key workers and deterring entrepreneurs who wish to start promising businesses in our country.
- Explore ways to foster "innovation-friendly" environments, such as regional cluster initiatives.
- Strengthen government counseling programs.

The term "small business" applies to many different types of firms. To begin, the small business community encompasses an enormous range of "Main Street" stores and services we use every day, such as restaurants, dry cleaners, card shops and lawn care providers. When such a business fails, it is often replaced by a similar firm. The small business community also includes somewhat bigger firms—in industries such as manufacturing, consulting, advertising and auto sales—that may have more staying power than Main Street businesses, but still tend to stay relatively small, with under 250 employees. While these two kinds of small businesses contribute relatively little to overall employment growth, they are a steady source of mainstream employment. If economic conditions do not support the formation of new businesses to replace the ones that fail, there would be a significant net destruction of jobs and harm to local communities.

Yet another type of small business has an explicit ambition for rapid growth. These high-growth companies are sometimes known as "gazelles." According to the Small Business Administration, small businesses account for two-thirds of new jobs, and the gazelles account for much of this job creation. The most striking examples—such as Google and eBay—have tended to be in high-tech industries and were gazelles for a significant time before they graduated to be very large businesses. However, gazelles exist in all industry types and in all regions of the country, and the large majority are not grazing in the nation's technology-dominated Silicon Valleys. According to one expert, the three largest industry categories for high-growth companies are restaurant chains, administrative services and health care companies. One non-high-tech example is Potbelly Sandwiches, a restaurant chain that began in Chicago. Another is the San Francisco-based Gymboree Corporation, a provider of child development programs and children's clothing.

Fostering the Development of High-Growth Companies

High-growth small businesses represent only about 5 percent of total startups, making it important to determine how to spot and foster them. A key common characteristic is that growth is critically dependent on the entrepreneurs who start these companies; they are people on a mission, charismatic leaders who can inspire creativity and commitment from their staffs.

The age of these firms is highly correlated with when their growth is highest. Generally, the most dramatic growth occurs after at least four years of existence—and coincidentally lasts about four years—before it slows again to a more typical pace for small businesses. Of course, some firms such as Google defy this pattern and continue to experience high growth for many years.

Although dynamic small businesses can be found nearly everywhere and in many industries, some regions spawn more of them than others. These regions may have especially supportive features, such as a critical mass of potential workers with relevant skills, a social climate and network that encourage idea generation, locally available venture capital, or some combination of these factors.

Unfortunately, attempts to anticipate which companies or even industries are likely to produce gazelles are prone to error. Thus, excessive emphasis on national industrial policies that favor specific industries are likely misplaced. Without knowing how to target assistance precisely, broad strategies, such as assistance with funding, knowledge, contacts and other essential resources, may be the best approach to fostering high-growth businesses. Such support has the added value of also aiding Main Street businesses.

Many of the most promising policies focus on removing obstacles that hinder entrepreneurs with solid business plans from launching and expanding their businesses.

Funding

As a result of the burst of the dot.com bubble in early 2000 and the recent financial crisis, small businesses have found the availability of venture capital funds drastically diminished. The crisis has also made it more difficult to obtain funding from banks and other conventional means. These trends particularly affect the "missing middle" of small businesses—roughly, those with between 10 and 100 employees.

The venture capital market: Historically, venture capital has financed only a relatively small portion of small businesses, but those financed have tended to be the ones with the greatest growth potential. In recent years, firms that eventually grew to where they could issue initial public stock offerings generally relied more heavily on venture capital financing than the average small business.

The dollar value of venture capital deals funded today is only about one-fifth the size it reached at its peak. While the peak amount may have been too large, today's value is probably too small. With their capital heavily invested in a small range of industries and locales, it seems likely that venture capital firms have missed a high proportion of potential investment opportunities. Further, "once burned, twice shy" funders have increasingly focused on larger, later-stage ventures. Consequently, mezzanine financing, which new companies need to survive and thrive in the critical early stages, is scarce.

The funding problems partly stem from venture capital firms today having less money to invest. Some investors who formerly contributed to such firms have become more risk-averse, and worse performance figures have discouraged new investors. Lack of venture capital affects some industries more than others, and even some green

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energy companies—viewed by some as one of the nation's more promising industry sectors—have moved to China, where financial support is more readily available.

Bank lending: In contrast to large businesses, which can turn to capital markets for funding, many small businesses are dependent on banks for financing. Although the worst of the 2008–09 credit crunch is behind us, many small businesses still find it difficult to obtain bank loans. Community banks, a key source of small business financing, have been hard hit by losses in commercial real estate, which have limited their lending capacity. Further, many small business owners who historically would have used real estate assets as collateral for expansion loans can no longer do so because of declines in real estate prices. In addition, small businesses that have, in the past, used credit cards to purchase equipment and supplies have been hindered by reductions in credit limits.

Overall economic conditions

The high degree of uncertainty currently surrounding the economic and financing climate may have prompted many entrepreneurs and would-be entrepreneurs to hold off on growth plans. Despite their reputation as high-flying risk-takers, good entrepreneurs take only calculated risks, where the benefits outweigh the dangers. Uncertainties about the future trajectory of the economy merely increase risk without raising potential rewards.

Government policies

Government policies affect the climate for small businesses in many ways. For example, small businesses face substantial hurdles when entering the complicated world of federal grants and contracts. At the state level, severe budget shortfalls mean that even well-designed initiatives to boost small businesses may founder.

The Small Business Administration (SBA) assists the full continuum of small businesses through a variety of means. These include: an $80 billion loan guarantee portfolio; specialized counseling and training centers; specialized business development programs targeting the socially and economically disadvantaged; oversight to ensure that at least 23 percent of federal government contracts go to small businesses (with certain preferences for minority and women-owned businesses); and the Small Business Innovation Research and Small Business Investment Companies programs.

The Obama administration is attempting to broaden support for small businesses by bringing the SBA into multi-agency initiatives that tackle common problems. For example, the Departments of Energy, Commerce, Housing and Urban Development, Education, and Labor, along with the National Science Foundation and the SBA, are supporting a five-year, nearly $130 million Energy Regional Innovation Cluster.

Strength of "social capital"

Through the 1990s, the United States was a worldwide leader in fostering innovation and entrepreneurship and reaped the reward of employment growth. Current international comparisons suggest that we are now closer to tenth place among some 70 nations in our ability to support innovation. Much of what has kept our nation from remaining in the top spot appears to relate to insufficient cultural support for entrepreneurship.

Strong social networks in specific geographic regions appear to substantially bolster the growth of innovative businesses. These networks are built around entrepreneurial dealmakers who serve as the nodes of the network, forming connections among researchers, entrepreneurs and investors. Unfortunately, many regions and industries lack strong networks.

Access to decision-making information: Entrepreneurs need an array of information and advice

People wait in line at a jobs fair in New York.

about how to tackle the problems that arise at different stages in business development. The SBA reports that companies that have taken advantage of their long-term counseling programs, for example, have higher growth than companies that have not.

Opportunity for all: Social networks are self-selecting, and some people have to work extra hard to gain entry to a region's network of entrepreneurs. While various organizations exist to help women and people of color access entrepreneurial skills and information, these efforts may not suffice. Under-representation of any group presumably would filter out a number of potential high-growth companies.

Workforce issues

A long-time strength of the American workforce, worker mobility has declined. This trend has been attributed in part to an aging population and in part to the current difficulty people have in selling their homes. Businesses report difficulty finding employees with the right training, especially at the technician level, where straightforward vocational training could help.

Global competition

Increasing global competition for good projects, entrepreneurs and capital is a positive trend from an international perspective, but runs counter to the national goal of promoting rapid growth in U.S. industry and employment. Today, many entrepreneurs can choose among starting a business here, in their home country, or even in a third, more hospitable nation. At the same time, current U.S. immigration policy hinders entrepreneurs from coming here to launch their companies. A recent report from The Brookings-Duke Immigration Policy Roundtable concluded that "educated workers with the knowledge and skills to innovate are critical" to the United States and recommended increasing the annual number of skilled visas.

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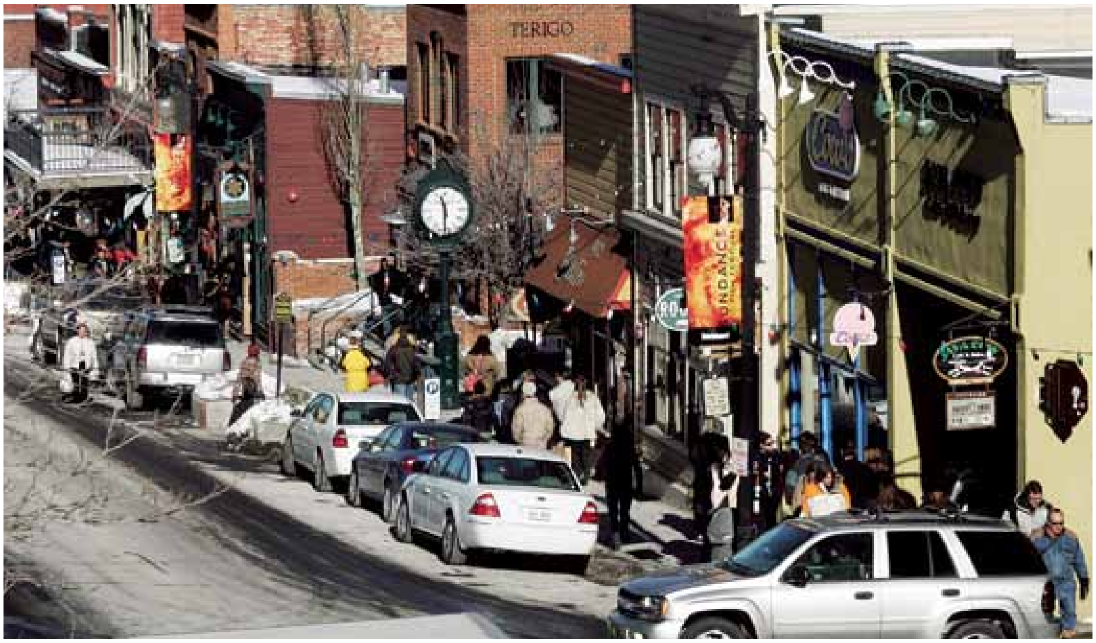

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The main street of Park City, Utah.

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Douglas J. Elliott and
Martin Neil Baily
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Breaking the Immigration Stalemate: From Deep Disagreements to Constructive Proposals
(The Brookings-Duke Immigration Policy Roundtable, 2009)

"Clusters and Competitiveness: A New Federal Role for Stimulating Regional Economies"
Karen G. Mills, Elisabeth B. Reynolds and Andrew Reamer
(April 2008)

Policy Goals for Small Business

Measuring Results

More work is needed to identify key policy goals and priorities related to small business success. Critically, what would constitute "improvement" in public policy regarding small business employment, and how would we measure it? Clearly, increasing the total number of jobs created each year (by both small and large businesses, net of job destruction) would be a positive outcome, all else being equal. Another potential goal would be improving the "quality" of the jobs created, as measured by average compensation or by job creation in new industries or geographic areas where unemployment is high. Creating "good jobs" that bring generous compensation would seem to be always desirable, but this outcome could conflict with other social goals, for example, if the jobs created required skills out of the reach of groups that are traditionally difficult to employ.

Slowing job destruction could be as important as increasing the creation of new jobs, but discouraging layoffs without increasing performance would do more harm than good. The trick is to raise the quality of marginal firms so that their improved performance allows them to retain employees they would otherwise have to let go.

A final key factor in setting policy goals that would support small businesses is measuring the cost to taxpayers of the initiatives that flow from the goals. This includes the subsidy cost contained in the federal budget, as well as costs and tradeoffs in society at large.

Changing Key Policies

Small businesses face both short-run and long-run challenges. With regard to the former, many small businesses have been hard hit by the recession and appear to be lagging behind larger businesses in their recovery. The cyclical struggles of this sector in part reflect the dependence of many small firms on the still-strained banking system for their financing; they also reflect the high toll that our extremely soft labor markets have taken on demand for Main Street goods and services.

Thus, government policies aimed at broadly bolstering the recovery and further strengthening the financial system will yield important benefits to small businesses.

The government, in conjunction with the private sector, can also take steps that will foster an economic environment that is supportive of entrepreneurship and economic growth over the long run. Specific policy steps that might help small businesses (and, in many cases, large businesses) include:

Improve access to public and private capital. Implementing serious financial reform will reduce the likelihood that we will see a repeat of the recent credit cycle that has been so problematic for the small business sector. When credit market disruptions do occur, policymakers should be attentive to whether temporary expansions of the SBA loan guarantee program are needed to sustain lending to creditworthy borrowers. The SBA should also consider expanding the points of access to its loan programs through an expansion of its lending partners. Finally, the SBA (or a similar entity) might encourage venture capital funds to broaden their investments beyond familiar areas by systematically bringing these investors together with entrepreneurs from neglected geographic regions and business sectors.

Reexamine corporate tax policy. More thinking is needed about whether provisions in our tax code discourage small business development in a way that is harmful to the broader economy and that places the United States at a relative disadvantage internationally. For example, Congress might consider whether it would be beneficial, on net, to lower employment taxes as a way of spurring hiring at businesses with high-growth potential. In addition, some analysts believe there would be gains from increasing tax credits for research and development and further lowering taxes on capital equipment. A design priority in all cases should be simplicity, as complicated rules can limit take-up among smaller firms that do not have extensive accounting or legal expertise.

Promote education and research. Entrepreneurs report difficulty in finding workers with the skills they need for manufacturing, technology and other jobs that do not require four-year college degrees. Access to such educational opportunities, including tailored vocational training, should be affordable and ubiquitous.

At the university level, improvements are needed in the way academic research is brought to the commercial market. Continued public and private support for basic research might be wise, particularly if we are in a trough between waves of innovation, as some analysts believe. The large investments by the National Science Foundation, National Institutes of Health, Defense Advanced Research Projects Agency, and other ambitious public and private programs laid the groundwork for many of the high-growth businesses of today. It may be worth exploring whether support for research in "softer" areas than the sciences might do an equal or better job of inspiring innovations.

Rethink immigration policy. A reconsideration of limits on H1-B visas might help entrepreneurs struggling with shortages of workers with particular skills. In addition, current immigration policy discourages immigrants who want to establish entrepreneurial businesses in America. Any efforts to expand immigration are frequently perceived as "taking jobs away from Americans," but studies have shown that new businesses create jobs for Americans.

Explore ways to foster "innovation-friendly" environments. Some regions of the United States clearly do a better job of encouraging innovation. Silicon Valley is the classic example, but there may be as many as 40 such clusters scattered around the country. While clusters often arise organically, typically near major universities, some states have made an explicit commitment

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to innovation and entrepreneurship. Examples include the Massachusetts Technology Collaborative and California's Biological Technologies Initiative, involving community colleges statewide. Federal, state and local policymakers should keep a keen eye on ways of adapting best practices from these initiatives as information becomes available about which elements are most effective.

Strengthen government counseling programs. The SBA might do more to expand and tailor its already successful growth counseling programs to better meet the needs of both Main Street and potential high-growth businesses, as well as firms at different developmental stages. Any effort to expand small businesses' opportunities for federal grants and contracts should be accompanied by significant streamlining of the application process. ■

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