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5 YEARS AFTER THE CRASH

Dr. Seyfried Discusses Small Business in the Aftermath of the Great Recession

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SMALL BUSINESS IN THE AFTERMATH OF THE GREAT RECESSION

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Most people recognize that the economy has had a difficult time shifting into high gear in recent years as it struggles to recover from the "Great Recession." Economic growth has been slower than in the past, averaging 2.3% since the official end of the recession in June 2009, compared to 3% in the five years before the recession (and 3.4%, on average, during both the previous 25 and 50 years, respectively). But what is the difference between 2.3% growth and 3% growth? If the economy had grown at its pre-crisis average of 3% per year, the U.S. economy would have produced an additional $1.25 trillion worth of goods and services during the four years since the end of the recession.

WHAT ABOUT THE JOB MARKET?

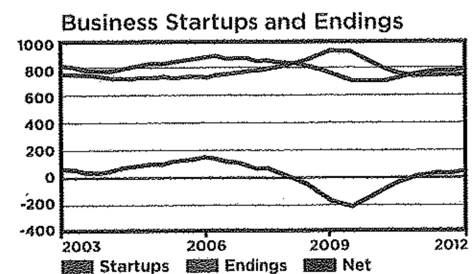
Unemployment fell from a peak of 10% in October 2009 to 7% as of November 2013. Though the economy has created millions of jobs in recent years, employment growth has only slightly outpaced population growth. The primary reason for the decline in the unemployment rate has been fewer people participating in the job market. As many may have heard, the labor force participation rate (ratio of adults participating in the job market to the noninstitutional adult population) has declined from 66% before the recession to 63% in November 2013, the lowest since 1978 (other than October 2013). Some of this was expected as baby boomers began to retire, but many researchers, including those working for the Congressional Budget Office and Bureau of Labor Statistics, attribute about half of the decline in the participation rate to demographics and the other half to the weak economic recovery (potential workers becoming discouraged and giving up looking for a job). If the decline in the participation rate reflected only long-term demographic changes, the unemployment rate would be about 9% as of November 2013.

BUSINESS DYNAMICS

Why the sluggish recovery? There are many reasons, including an extended period of deleveraging as consumers recuperate from the debt binge during the housing bubble. In this article, we will focus on a significant factor that has received limited attention, the performance of small businesses and new business startups in recent years. A rich source of data on this topic is the *Business Employment Dynamics Survey*, maintained by the Bureau of Labor Statistics, which includes considerable information related to the economic performance of businesses related to their age (how long they have existed) and size (based on the number of employees). Using this information, one can identify the underlying dynamics of business formation and destruction. In the following paragraphs, a new business is considered to be a business open for less than two years.

What has happened to the number of new businesses since 2000? During the 2001 recession and its immediate aftermath, the number of new businesses fell from 1.12 million in 2001 to 1.08 million in 2004, a decline of 40,000. From 2004 to 2007, the number of new businesses rose to 1.18 million, a net gain of 100,000. The next three years, the Great Recession, were disastrous for new business, as their ranks declined to 925,000 by 2010, a loss of more than 250,000 businesses. Since then, there has been a slight rebound, with 993,000 new businesses as of 2012; yet, still down significantly from before the recession. Consequently, employment by new businesses declined from nearly 7 million in 2007 to a low of less than 5 million in 2011 before rebounding slightly to 5.25 million in 2012.

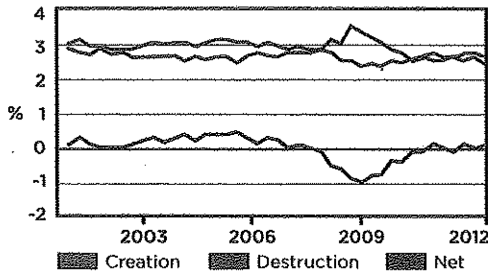
Digging a little deeper, the following chart reveals the trend of business startups and endings (those ceasing operations) in the last decade, including the net change in the number of businesses (quarterly data, includes the prior 12 months):



After adding between 850,000 and 900,000 new businesses per year from 2005 to 2007, the rate of business creation declined sharply to about 700,000 during the recession before rising to about 780,000 in 2012. On the other hand, the number of businesses that ceased operations rose from 725,000-750,000 per year beforehand to about 925,000 during the depth of the recession before declining to 750,000 in 2012. Net business creation reached a low of -200,000 in 2009 and did not turn positive until 2011, still remaining low into 2012.

One can also look at this in terms of the rate of business creation (ratio of new businesses compared to total existing businesses) and destruction (percent of existing businesses that cease operations) per quarter.

Rate of Business Creation and Destruction per Quarter



As can be seen on the chart above, the rate of business creation was in the range of 3-3.5% per quarter during the early-to-mid 2000s before falling to 2.5% during the recession and rebounding to just under 3% in recent years. Meanwhile, the death rate for businesses rose from about 2.75% prior to the crisis to a high of 3.5% during the recession before falling to 2.6% in 2012 (equal to the recent low in 2006). Net business creation is still quite low (between 0 and 0.2% recently) compared to the expansion of the 2000s when it tended to be approximately 0.5%. A key takeaway from all of these numbers is that the bulk of the recovery in net business creation since the end of the recession was due to fewer firms going out of business as opposed to a significant rebound in business creation. In other words, the *Business Employment Dynamics* survey suggests that the U.S. economy is not as dynamic as it was prior to the financial crisis.

ECONOMIC GROWTH: SMALL BUSINESS VS. LARGE BUSINESS

Besides the job market, another way to assess the performance of the economy is to consider GDP or economic growth. The government normally does not release information about the relative contributions of small and large businesses to GDP. However, the Small Business Administration released a study in early 2012 that sought to fill this void by estimating the contribution of each (defining a small business as one with fewer than 500 employees and a large business as one with 500 or more employees). There is quite a bit of interesting information available, including details by industry, but we will focus on the big picture.

The following chart shows economic growth for small businesses and large businesses since 2003. The growth rates were similar from 2006-2009, with firms of all sizes suffering deep declines in 2009. Coming out of the recession, economic growth of large firms greatly exceeded that of smaller ones. Why the underperformance of small businesses? One reason was the type of industries that tend to operate as small businesses as opposed to large businesses (for example, real estate and construction tend to be dominated by small businesses). However, even within specific industries, small businesses tended to underperform larger ones.

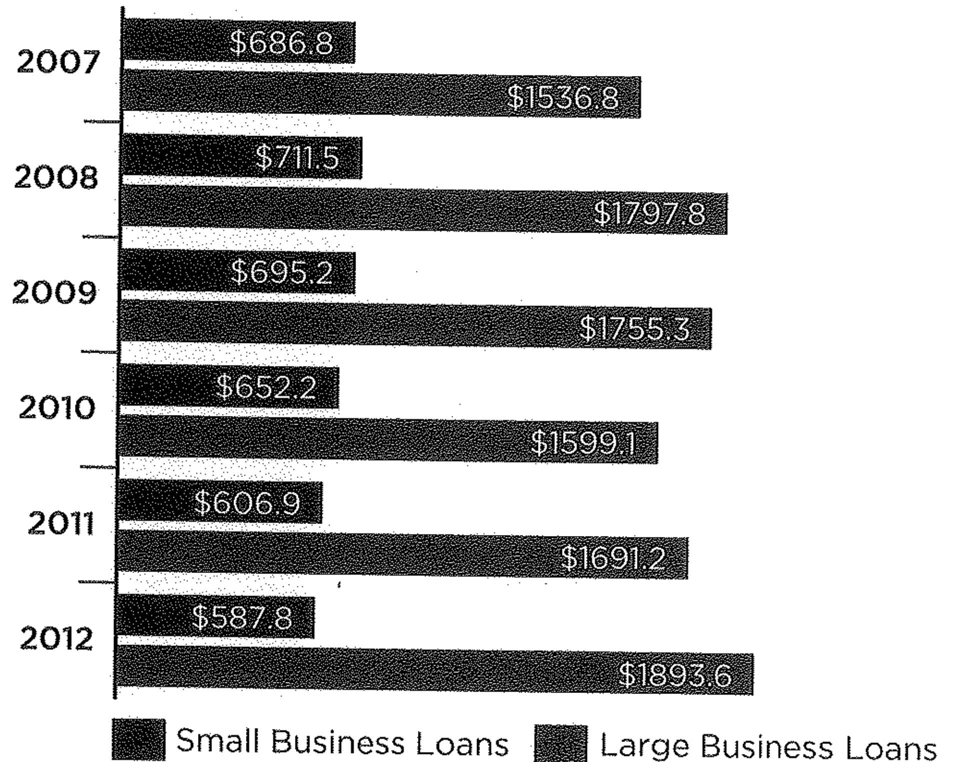
Small Business
Large Business

2003 2004 2005 2006 2007 2008 2009 2010

SMALL BUSINESS ACCESS TO CREDIT

Given that there was a financial crisis; access to credit played an important role in the relative weakness of small business. Though there are many different sources of credit for firms, the graph to the right presents data on an important source—the volume of loans outstanding by depository institutions from 2007-2012.

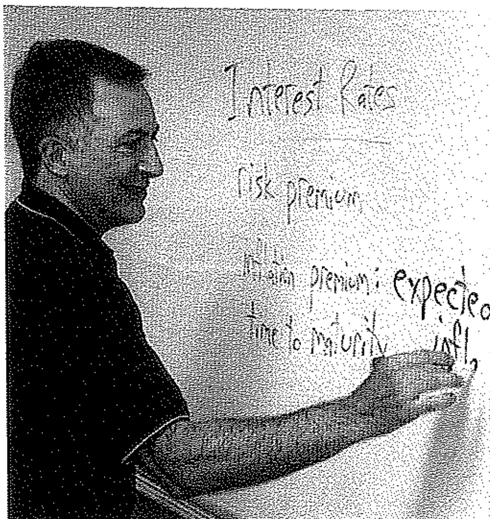
Note that outstanding loans declined for both small and large businesses between 2008 and 2010, down 8.3% for small businesses and 11.1% for large businesses. Over the next two years, outstanding loans for large firms rose by 18.4% while those for small firms continued to decline, falling an additional 9.9% for a total decline of 17.4%. But did the weakness in small businesses lead to less demand for loans or did less credit available lead to weakness in small businesses? In some cases, small businesses lacked opportunities for which they would need to borrow and invest, while in other cases lending became more difficult to obtain, whether due to tighter lending standards by banks or less credit-worthiness on the part of small business. Though both factors played a role, various surveys indicate that tighter credit impacted small business significantly more than larger ones in recent years.



Source: SBA, FDIC

SUMMARY

The Great Recession was unlike any downturn since the Great Depression. Though it ended more than four years ago, the recovery has been weak by almost any standard. There are many reasons for the sluggish recovery, but one has been the underperformance of small business compared to recent history. Though the rate of businesses ceasing operations has declined to pre-recession levels, the rate of business startups has experienced only a slight rebound, remaining significantly below levels that existed prior to the financial crisis. Thus, the underlying U.S. economy appears to be less dynamic than before the recession, at least for now. As of the end of 2012, there were nearly 200,000 fewer new businesses compared to before the recession, employing about 1.75 million fewer workers. To achieve a stronger economy, the U.S. needs to improve the underlying dynamics of business creation.



Dr. William Seyfried's expertise is in the areas of macroeconomics, including the Fed and monetary policy, as well as the interaction of the financial system and the economy. He has published extensively in professional journals including *The Australian Economic Review, The American Economist, Journal of Economics and Finance*, and *Applied Econometrics and International Development.* He has also authored instructor's manuals for leading textbooks in the areas of money, banking and financial markets, as well as international economics. Dr. Seyfried currently serves on the Econometrics Council of the Florida Chamber Foundation.