THE SMALL-BUSINESS STORY IN VIRGINIA: WHAT A QUARTER CENTURY OF DATA REVEAL

Nineteenth-century author Horatio Alger's portraits of young Americans who started their own businesses and quickly went from rags to riches became part of the American Dream. One could start a business, perhaps even selling lemonade on a street corner, but by dint of personal energy, lots of hard work, determination and insight, end up a millionaire.

While some view the Alger stories as unrealistic, or myths, they do contain certain elements of truth. Yes, very few of us start our own businesses and become billionaires these days, and there is evidence that intergenerational economic mobility has declined.[1] Nevertheless, tens of thousands of Americans continue to start their own businesses and many experience conspicuous success. Further, one need not harken back to Andrew Carnegie or John Rockefeller to discover such examples. Witness the inspiring success stories of Ursula Burns, who grew up in poverty on the Lower East Side of New York City, but ascended to chairman and CEO of Xerox, or well-known individuals such as Ralph Lauren and Oprah Winfrey. All of them surmounted imposing barriers and achieved huge success.

These few examples, of course, are not indicative of a trend. How often do people really start their own businesses today? Is this more or less common than it used to be? Are small businesses being pushed out of existence by larger businesses? How well are small businesses doing? While we'll look at national data, we'll focus on Virginia as we provide answers to these questions.

1 Is the economic mobility glass half full, or half empty? See the work of the Pew Charitable Trusts, www.pewtrusts.org/en/multimedia/data-visualizations/2013/faces-of-economic-mobility.

New Startup Firms

For many people today, starting a firm remains an attractive proposition. In 2012, a total of 5,030,962 new firms were started in the United States. Some had multiple locations ("establishments"), so that the total number of new establishments was 6,667,322 (www.sba.gov).

Here in the Commonwealth, the U.S. Census tells us that 9,899 *firms* (7.5 percent of all existing firms) were less than a year old in 2012 and 7,588 firms had been open one year to two years in 2012. Thus, there is considerable new business formation in Virginia in a typical year and it is fair to infer that most are able to survive for at least a year.

Even so, the rate at which new *establishments* are being created has declined. Graph 1 reveals that roughly one in six (17.1 percent) of all establishments that existed in 1977 were created in that year. However, by 2012, the comparable number had declined to 11 percent. Further, this decline has been almost continuous except for a burst of new firm, new establishment activity that occurred in the middle of the previous decade. That particular surge often is attributed to a pre-Great Recession atmosphere that included rising real estate, financial asset and commodity prices, plus tax rules that favored certain types of business formation. Whatever the cause, that ripple of business startup activity has dissipated. A May 2014 Brookings Institution study suggested that this trend should be characterized as "declining business dynamism" and noted that this has been true in the United States since the mid-1970s. Further, since 2008, more firms have been dying than have been created, both nationally and regionally.

Virginia has not been exempt from the decline in the formation of new businesses. Graph 2 reports the percentage of all firms that were accounted for by new firms in 1988 through 2012. One can see that the rate of new business formation in Virginia exceeded national averages for both metropolitan and non-metropolitan regions in 1988. By 2001, however, the Commonwealth's advantage had disappeared with respect to all U.S. metropolitan regions, though it remained with respect to non-metropolitan regions. While we do not have data for non-metropolitan Virginia, it is worth noting that new business firm formation has fallen off dramatically in the non-metropolitan regions of the United States in the past few decades. This has paralleled a well-documented flow of more highly educated people into metropolitan regions nationally.[2]

Why have we seen such a noticeable decline in new business formation in the United States, metropolitan regions, non-metropolitan regions and Virginia? No one knows for certain, but at least one influential group of economists, led by Robert Gordon of Northwestern University, argues that we are in the midst of a "Great Economic Stagnation" that is unlikely to end in the foreseeable future.[3] They point to laggard productivity growth over the past decade as an indicator of this.

George Mason University's Tyler Cowen offers a nuanced version of this argument.[4] He argues that American economic growth has slowed, especially since 1973, because we have picked most of our "low-hanging fruit." We've occupied most of our available land, educated most of our people and no longer benefit from a constant flow of important new innovations such as electricity, gasoline engines and computers. Thus, many of our major engines for progress are sputtering. On the other hand, the GMU economist also contends that our economic history is characterized by unpredictable waves of innovation and hence we cannot say the current stagnation is a permanent state of affairs.

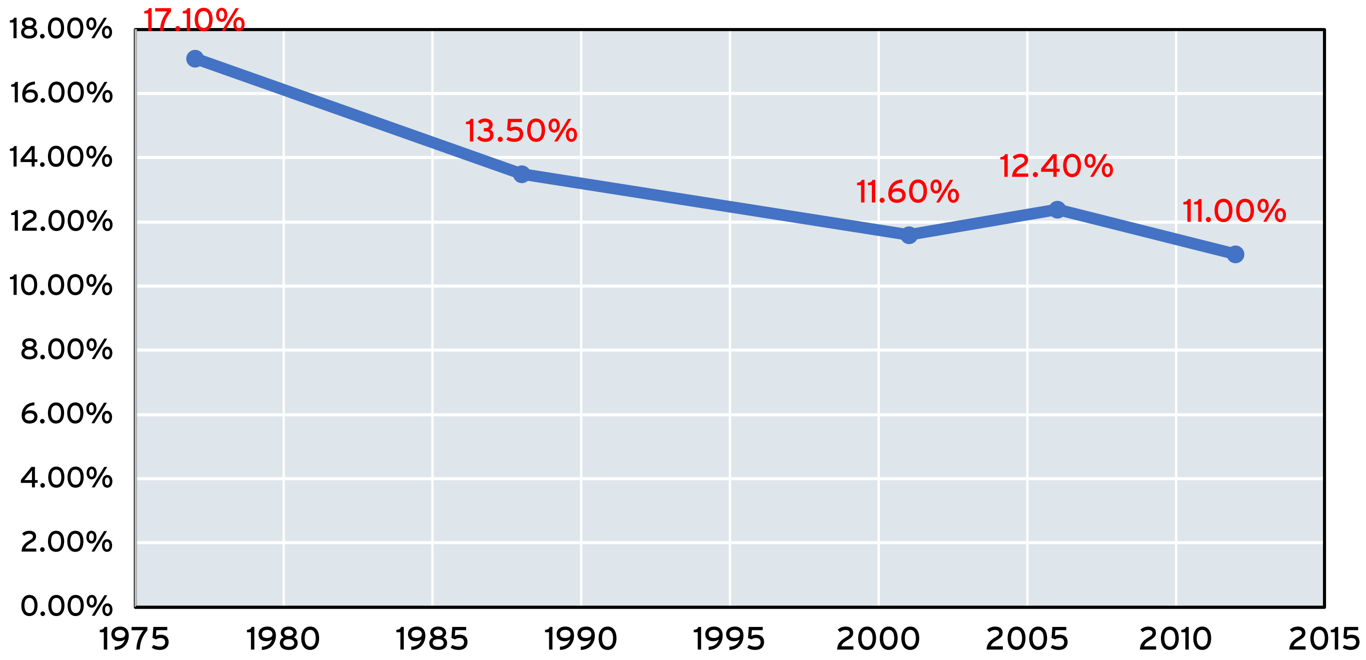
2 Ian Hathaway and Robert E. Litan, "Declining Business Dynamism in the United States: A Look at States and Metros," Brookings Institution, www.brookings.edu/~/media/research/files/papers/2014/05/declining%20business%20dynamism%20litan/declining_business_dynamism_hathaway_litan.pdf.

3 Robert Gordon, "Is U.S. Economic Growth Over? Faltering Innovation Confronts the Six Headwinds," National Bureau of Economic Research Working Paper No. 18315 (August 2012).

4 Tyler Cowen, *Average Is Over: Powering America Beyond the Age of the Great Stagnation* (New York: Penguin, 2013).

GRAPH 1

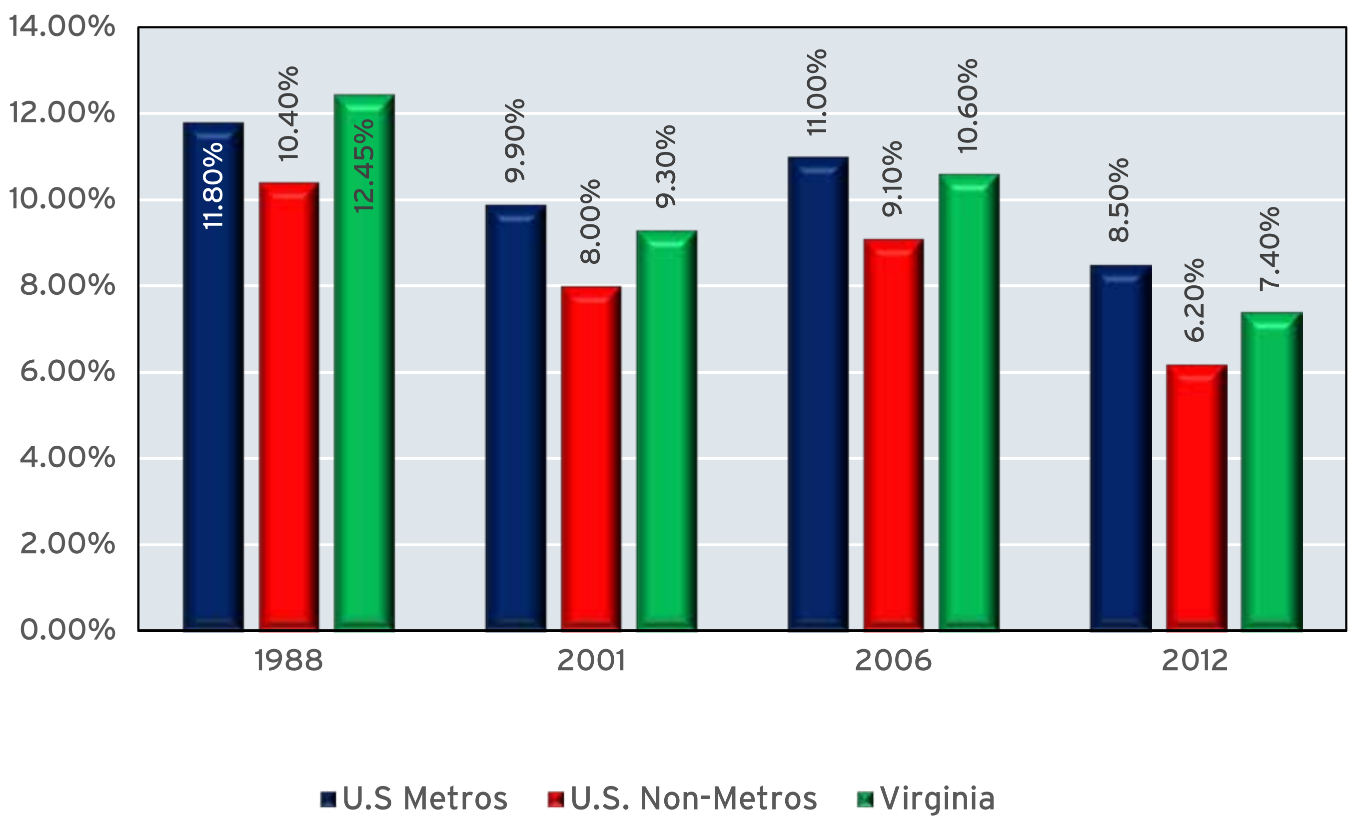
PERCENTAGE OF ALL ESTABLISHMENTS ACCOUNTED FOR BY NEW FIRMS: U.S., 1977, 1988, 2001, 2006 AND 2012



Source: U.S. Small Business Administration, www.sba.gov

GRAPH 2

PERCENTAGE OF ALL FIRMS NEWLY FOUNDED IN 1988, 2001, 2006 AND 2012: U.S. METROS, U.S. NON-METROS AND VIRGINIA



Source: U.S. Small Business Administration, www.sba.gov

But Small Firms Have Become Relatively More Numerous

Let's accept as an empirical truth: The rate at which new firms are being created has declined in recent years, both nationally and in Virginia. Nevertheless, when we set aside the issue of the age of firms in Virginia, very small firms – those that have 0 to 4 employees – have fared rather well. Indeed, as Graph 3 reveals, the percentage of all firms in Virginia that have four or fewer employees actually has increased in recent years, from 56.58 percent in 1988 to 58.25 percent in 2012. Relatively speaking, there were more very small firms in Virginia in 2012 than in 1988.

The relative increase in small firms arguably reflects two different influences. First, there could be an increasing tendency for people, especially those who have recently become unemployed, to start their own firms. Such individuals may be the one and only employee of their firm before they are able to spread their wings. Second, quite apart from the influence of recessionary economic conditions on entrepreneurship, it may have become more common for people to strike out on their own as consultants who work part time and have multiple employers.

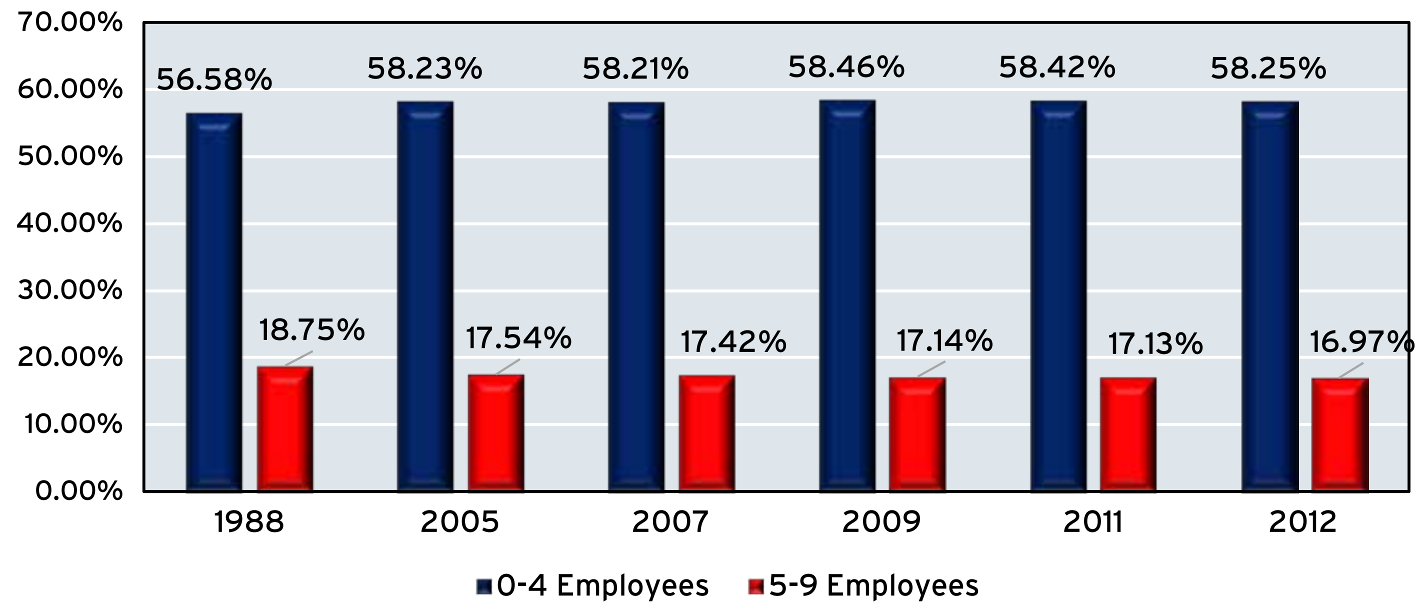
We should be cautious, however, to accept a so-called "gig economy" explanation of firm creation whereby increasing numbers of single individuals behave as economic free agents and flit from one employer to another, either working on short-term contracts or as part-time employees. A July 26, 2015, article in The Wall Street Journal reported that the percentage of all employees nationally who either are self-employed and unincorporated, or have multiple employers, has declined significantly over the past 20 years. "Gigging" actually has been declining rather than increasing, perhaps due to improving economic conditions.

Returning to Graph 3, we can also see that there has been a decline in the percentage of all Virginia firms that have 5 to 9 employees. This size class of small firms has become relatively less important quantitatively. Not shown are data that reveal that this relative decline also generally holds true for firms with 10 to 99 employees. Not surprisingly, it is easier to start a new firm than it is to grow that firm.

Graph 4 divulges that at the same time very small firms have become more common in Virginia, the proportion of large firms in the Commonwealth has increased. Both the percentage of all firms that had 100 to 499 employees in 2012 and those that had 500 or more employees in that year increased. This tells us that intermediate-sized firms have become relatively less common in Virginia.

GRAPH 3

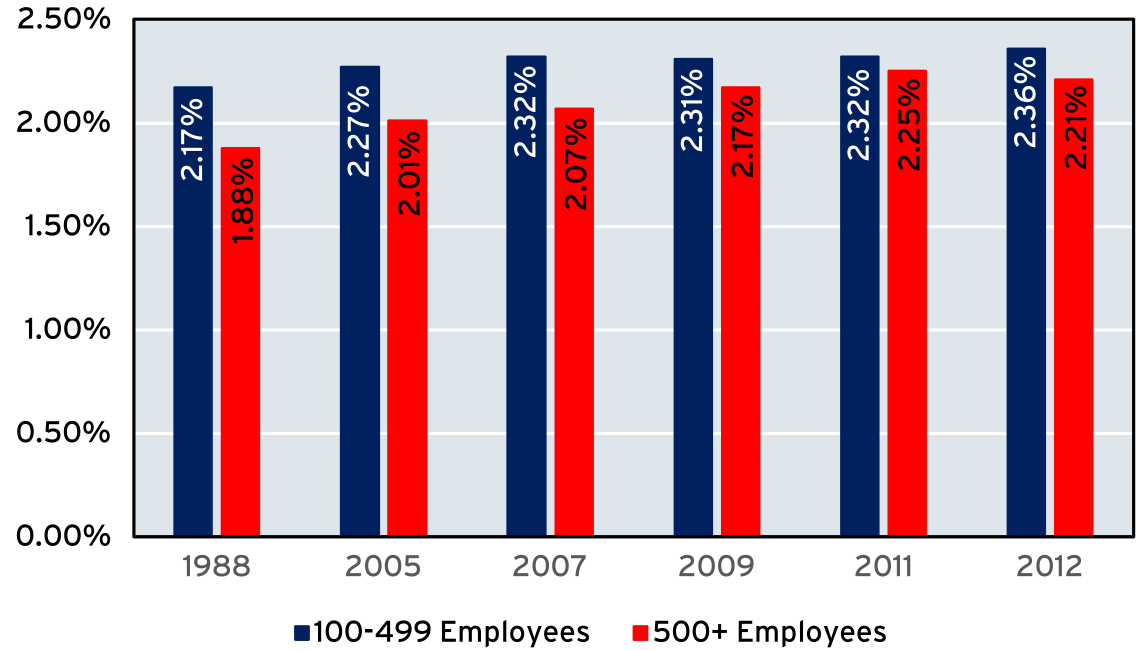
VERY SMALL BUSINESSES ARE HOLDING THEIR OWN IN VIRGINIA



Source: U.S. Small Business Administration, www.sba.gov

GRAPH 4

THE PROPORTION OF LARGE BUSINESSES IN VIRGINIA HAS INCREASED GRADUALLY BETWEEN 1988 AND 2012



Source: U.S. Small Business Administration, www.sba.gov

What About Employment And Payrolls?

The founding or operation of a firm doesn't necessarily inform us about its economic importance as measured by variables such as the number of employees or the size of the payroll. Graph 5 reports the percentage of total *employees* in private-sector firms in Virginia that were accounted for by firms of various sizes in 1988 and 2012. It is immediately apparent that large firms (those with 500 employees or more) increased their share of total private-sector employment in Virginia during this time period. **More than half of all private-sector employees in the Commonwealth now work for a firm with 500 or more employees. The share of employment accounted for by firms with 0 to 4 employees fell to 4.77 percent in 2011 from 5.17 percent in 1988.**

The slowly increasing economic dominance of large firms in Virginia extends even more decisively to *payrolls*. Graph 6 reports that the percentage of all private-sector payrolls in Virginia accounted for by firms with 500 or more employees rose from 52.13 percent in 1988 to 58.24 percent in 2011. Meanwhile, the percentage of private-sector payrolls accounted for by firms with 0 to 4 employees declined from 5.03 percent to 3.79 percent. The same general picture holds true for firms with 5 to 9 employees.

Thus, while small firms have become relatively more numerous in Virginia's economy over the past quarter century, they have become relatively less important in terms of employees and payroll.

What lesssons can we draw from all of this?

- Relatively speaking, Virginia has proven to be a more attractive place for new business formation than the United States as a whole. The proportion of small private-sector firms with 0 to 4 employees has increased in the Commonwealth. "Striking out on your own" is common in Virginia.

- At the same time, the proportion of all private-sector firms that have 500 or more employees also has increased, as have both the total number of employees of these large firms and their payrolls.

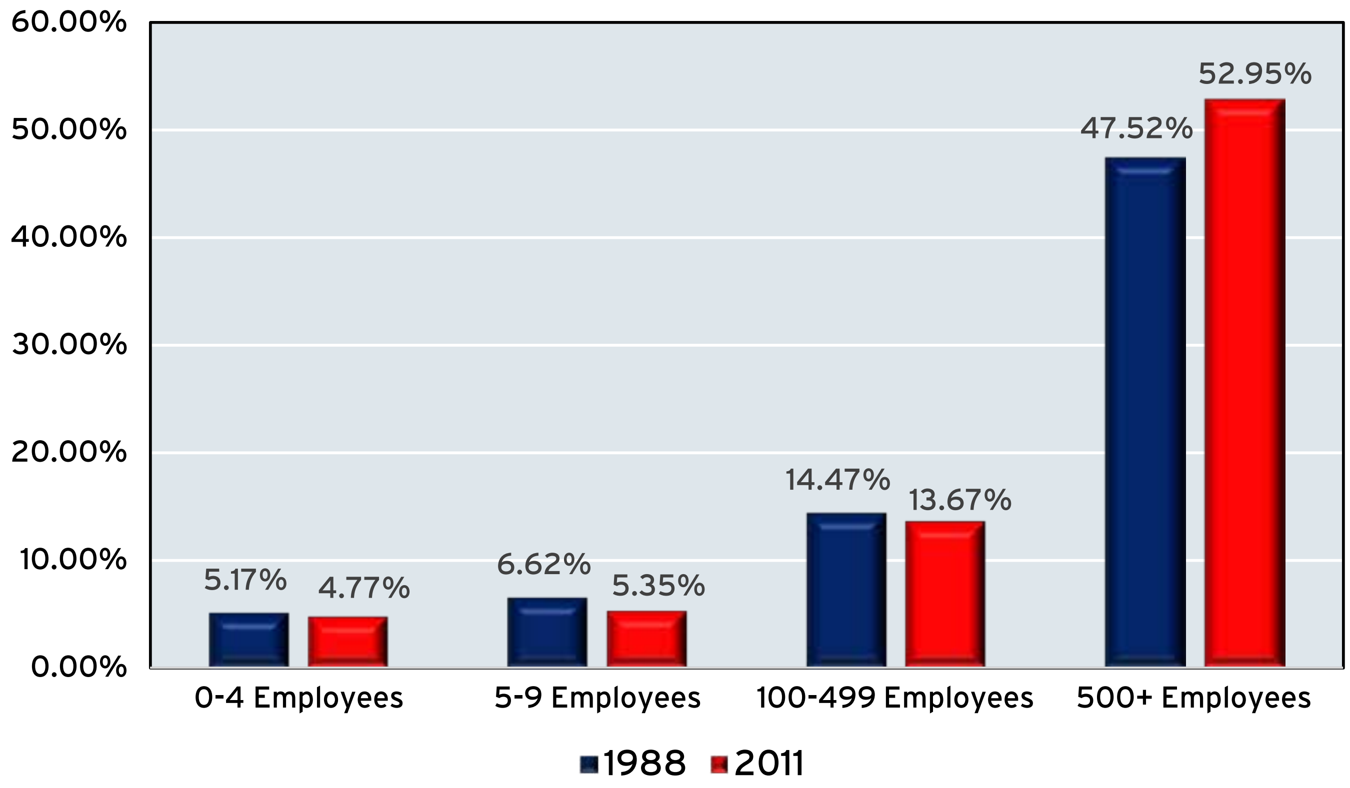
- **Virginia has proven to be a good place to start a business, when compared to other states, but the data also tell us that it is challenging for those firms to grow out of their small-firm status.** Plausibly, public policy could devote increased attention to moving small firms to the "second stage," in which they expand, acquire both employees and sophistication, and probably require additional capital to do so. Available national empirical evidence suggests that small firms often encounter roadblocks as they expand. These impediments may involve a lack of expertise in specific areas, such as information technology or marketing, or a simple lack of management competence and sophistication.

- **Frequently, however, it is the inability of small firms to attract capital that derails their growth.[5] Wise public policy here does not imply that the Commonwealth should become a banker and provide that capital (although North Dakota does operate a very successful state bank). Few governmental agencies have demonstrated long-term expertise in choosing winners and losers in the business arena. Instead, the Commonwealth should focus on developing user-friendly programs that connect demonstrably successful small businesses with financial institutions and angel investors. It will not be easy either to develop such a program, or to find ways to supply such assistance in nonthreatening circumstances. Nevertheless, the numbers provided in Graphs 3 through 6 tell us that our very small firms are encountering problems moving to the second stage, and public policy should react accordingly.**

5 Benjamin Ryan, "Starved of Financing, New Businesses Are in Decline," Business Journal (September 4, 2014), www.gallup.com/businessjournal/175499/starved-financing-new-businesses-decline.aspx.

GRAPH 5

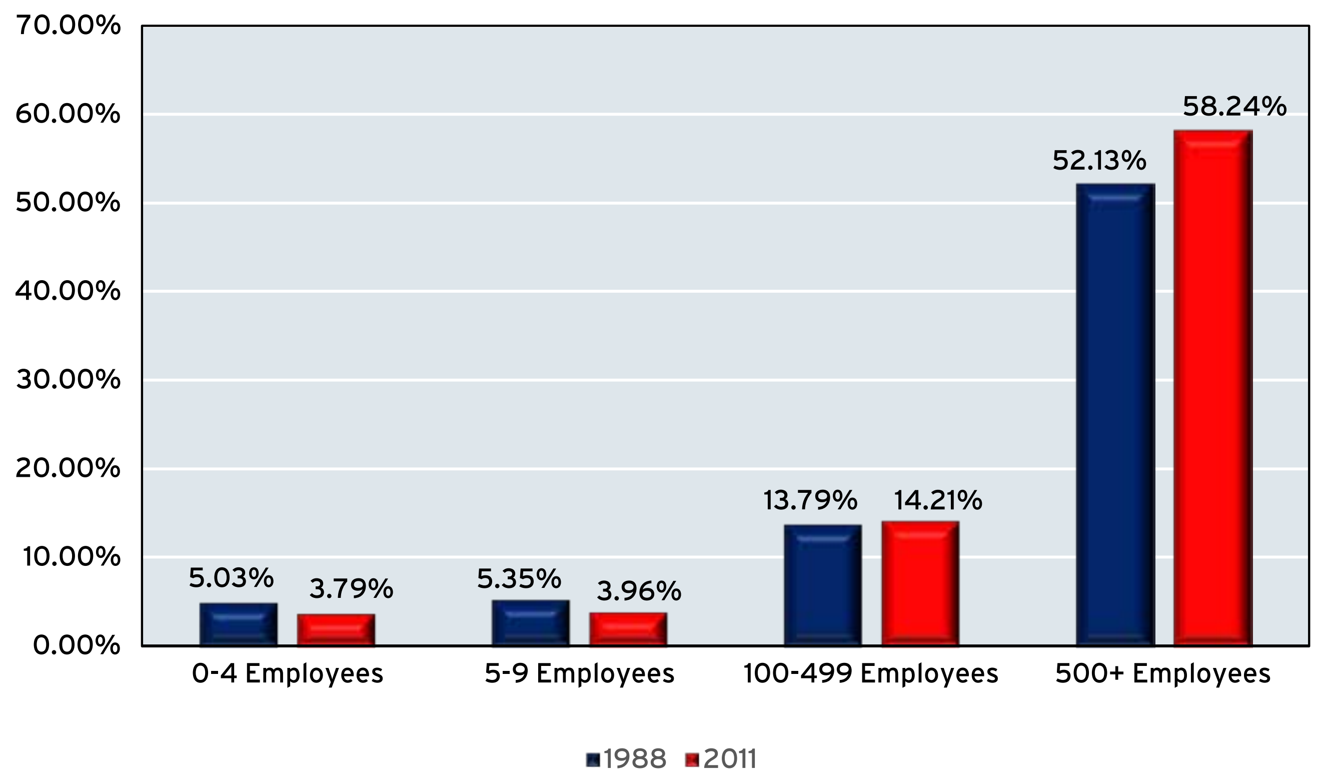
THE PERCENTAGE OF EMPLOYMENT ACCOUNTED FOR FIRMS OF VARIOUS SIZES: VIRGINIA, 1988 AND 2011



Source: U.S. Small Business Administration, www.sba.gov

GRAPH 6

THE PERCENTAGE OF PAYROLL ACCOUNTED FOR FIRMS OF VARIOUS SIZES: VIRGINIA, 1988 AND 2011



Source: U.S. Small Business Administration, www.sba.gov

Which Kinds Of Small Firms Are Doing Best In Virginia?

The U.S. Department of Commerce's Small Business Administration (SBA) publishes interesting data concerning the number of firms that operate in large sectors of the economy. The SBA utilizes the North American Industrial Classification System (see text box for explanation) to slot a firm in one economic sector or another and then collects voluminous data about the firms in each classification. Further, it breaks down the information by state. Frequently, these data go unused, but a determined researcher can mine the information and find useful numbers that provide a detailed picture of what is happening in either the United States or Virginia.

Graph 7 provides data on the number of firms in a variety of different sectors of the economy in 1998 and 2011. For example, in the education sector, there were 89 percent more very small firms (those with 0 to 4 employees) in Virginia in 2011 than in 1998. This produces the 1.89 value in Graph 7 for the education sector. In the United States as a whole, however, there were only 46 percent more firms of all sizes in the education sector in 2011 compared to 1998, and so Graph 7 records a value of 1.46 for the country. In general, an index greater than 1.00 indicates a sector in which there were more firms in 2011 than in 1998.

Graph 7 reports all of the NAICS two-digit economic sectors where Virginia clearly outpaced the United States between 1998 and 2011. In some sectors, the absolute number of firms in the U.S. actually declined during this period. This was true in transportation, retail trade and management.

Further, Graph 7 reveals that Virginia was an especially fertile location for very small firms involved in education, accommodations, professional services, real estate and administration. Bear in mind, however, that we've already shown that new business formation did not slow down as much in Virginia as it has nationally (review Graph 2), and since 1998, the Virginia economy has grown faster than the economy of the United States. Thus, one might expect Virginia's 2011 to 1998 ratios in Graph 7 frequently to be higher than those for the entire country.

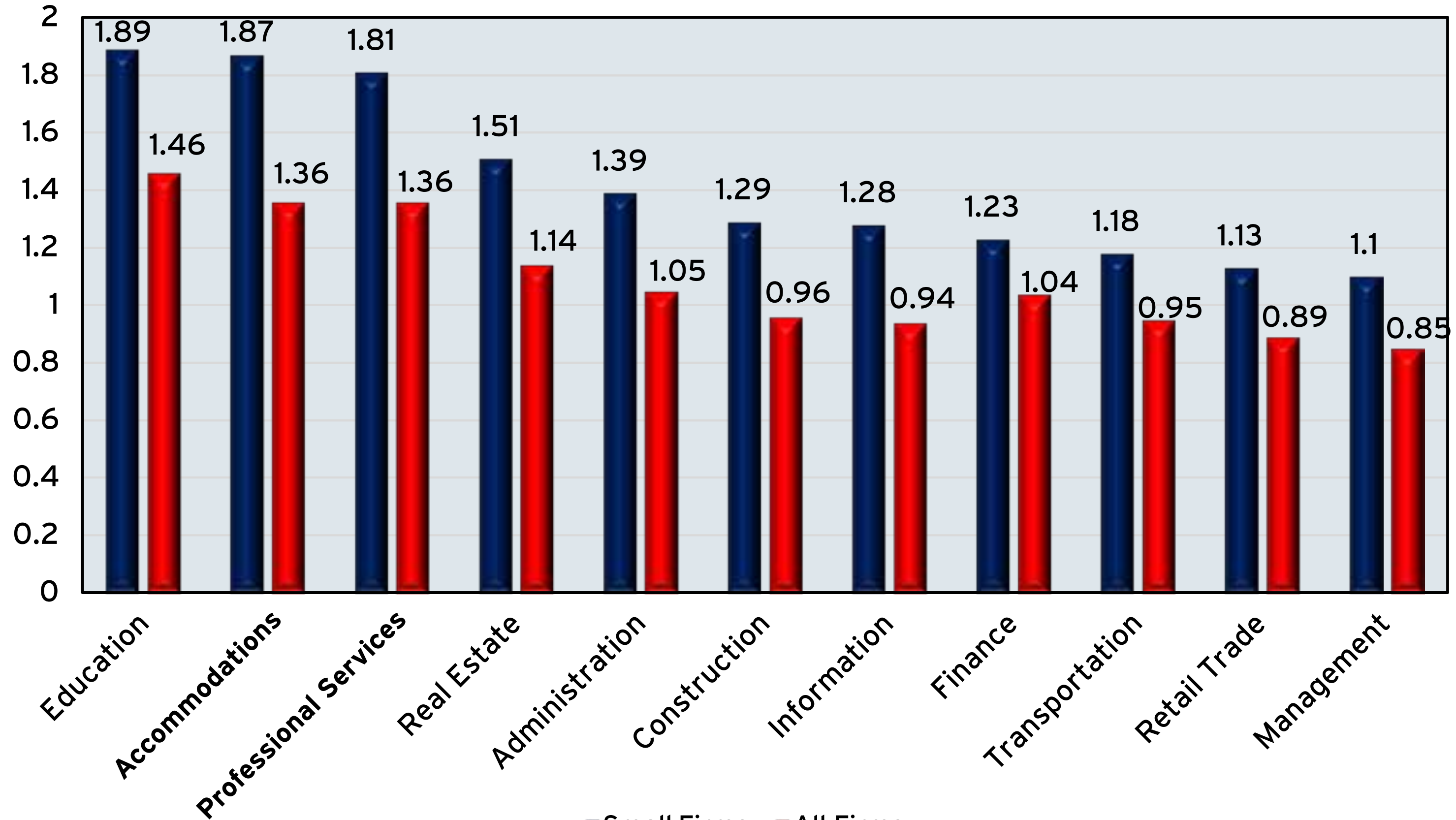
The relevant point, however is this: There have been many major sectors of the Virginia economy where very small firms (those with 0 to 4 employees) have been able to plant their feet successfully.

Which economic sectors were the least friendly for very small firms in Virginia between 1998 and 2011? Forestry, utilities, wholesale trade, transportation, management and health care. Pervasive economies of scale in utilities drove several very small, localized Virginia utilities to the wall during this time period, while mergers and consolidations eliminated some very small health care providers. Interestingly, there are some signs of a reversal in this trend in 2015 as alternate energy providers (think solar) and very small, private health care providers have begun to appear in greater numbers in both urban and rural Virginia locations.

NAICS, the North American Industrial Classification System, is widely used by federal agencies to standardize their classification and record keeping. Thus, construction is assigned the two-digit code 23, while the construction of buildings is 236 and residential construction is 2361. New single-family housing construction is 236115. The entire American economy is categorized in similar fashion.

GRAPH 7

SMALL FIRMS VERSUS ALL FIRMS IN VIRGINIA: WHERE WERE THE OPPORTUNITIES BETWEEN 1998 AND 2011?



Source: U.S. Small Business Administration, www.sba.gov

Summing It Up

Data provided by the Small Business Administration disclose that very small businesses (0 to 4 employees) have been holding their own in Virginia, while intermediate-sized businesses (10 to 99 employees) have been losing market share when measured by the percentage of firms in that size category, or the relative size of their workforces and payrolls. Larger businesses (100-plus employees), and especially those businesses with 500 or more employees, have been expanding their market shares.

Very small businesses in Virginia actually have become relatively more common in recent years, and Virginia's rate of new business formation (startups) exceeds that of the United States. However, very small businesses now account for a lower proportion of total employment and payrolls in the Commonwealth than was true 15 and 25 years ago.

The data reveal that Virginia is a good place to start a new small business. Challenges, however, appear to arise as these firms seek to grow larger. Many small firms have difficulties gaining traction as they attempt to move beyond their modest origins.

Policymakers often give considerable attention to generating new business startups, particularly those that are technology based. This is laudable and needs to continue, but we should recognize that a healthy majority of new business startups, especially those that are very small, are not technology based (though these firms usually are technology users). Further, additional attention needs to be given to moving small startup firms from infancy into what might be termed second-stage development – that is, growth beyond the 0 to 4 employee range.

The data suggest that energetic entrepreneurs with great ideas, particularly those who found and operate very small firms, often are not necessarily well equipped to deal with the tasks they subsequently confront as they attempt to grow. Increasingly, they face information technology, marketing and capitalization challenges in addition to day-to-day management issues. The data suggest many are not prepared for all of this. Hence, it is here that agencies such as the Small Business Administration and Virginia's Department of Commerce and Trade can provide critical assistance and guidance.