Reflections: Small Businesses

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* The views expressed here are my own and not necessarily those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.

Small businesses and entrepreneurship play important roles in the U.S. economy

An enviable aspect of the U.S. economy around the globe is our spirit of innovation, entrepreneurship, ease of business entry and exit, and labor market flexibility. These are key attributes of a dynamic economy, one that offers opportunities for people to live good and productive lives. Entrepreneurship – setting up and running one's own business – has always been part of the narrative of the American dream, an avenue to creating and growing wealth, contributing to the community, and leaving a legacy for one's family.

But beyond their benefits to individual business owners, small and new businesses play an important role in the health of the overall economy. The vast majority of firms in the U.S. are small businesses, with 500 or fewer employees. Three-quarters of U.S businesses have fewer than 10 employees. While it is true that large and mature businesses employ the most people, about 10 percent of private-sector jobs in the U.S. are at firms with fewer than 10 employees, a quarter of the jobs are at firms with fewer than 50 employees, and about half of the jobs are at firms with fewer than 500 employees.[1]

The start-up rate of new businesses has trended down until very recently

New firms play a particularly important role in our dynamic economy. In fact, young firms disproportionately contribute to both overall job creation and job destruction in the U.S.[2] Dynamism has contributed to economic growth and well-being in the U.S. More dynamic economies allow resources to

[1] Data from Supplemental Tables F and G of the *National Business Employment Dynamics Data*, U.S. Bureau of Labor Statistics indicate that as of 2021Q1, about 76 percent of U.S. firms had fewer than 10 employees, about 95 percent had fewer than 50 employees, and over 99 percent had fewer than 500 employees. Firms with fewer than 10 employees accounted for about 13 million jobs, or 11 percent of private-sector jobs; firms with fewer than 50 employees accounted for 33 million jobs, or 28 percent of private-sector jobs; and firms with fewer than 500 employees accounted for 63 million jobs, or 52 percent of private-sector jobs.

[2] See Haltiwanger, Jarmin, and Miranda (2013).

be reallocated from less-productive to more-productive businesses and provide workers with more opportunities for career advancement. This results in higher productivity growth and rising incomes.

Before the pandemic, a cause for concern about our economy was that the start-up rate of new businesses had been declining at least since 2000, and key innovative sectors like high-tech had seen a sharp slowing in the rate of start-ups.[3] While there was some recovery after the Great Recession of 2007-2009, the pace continued to be slow during the long expansion following that downturn. This slow pace of start-ups and more general decline in business and labor market dynamism likely contributed to the slowdown in productivity growth of the American economy.[4] Indeed, by some estimates, if the pace of job reallocation had remained the same as in the 1980s, total factor productivity growth in the U.S. would have been a third higher.[5] Some research also argues that the lower start-up rate has contributed to the so-called jobless recoveries seen in recent business cycles.[6]

The onset of the pandemic hit many small businesses very hard. From February to April 2020, the number of active small business owners dropped by 3.3 million, a record 22 percent decline.[7] Compared to small firms overall, Black-owned businesses were about twice as likely to close and Hispanic-owned businesses were about one-and-a-half times as likely to close. Government support, including funding through the Paycheck Protection Program (PPP) and COVID-19 Economic Injury Disaster Loan Program, helped to keep many small businesses afloat, even as they continued to face challenges. New business

[3] Haltiwanger (2015).

[4] Haltiwanger (2015), p. 9.

[5] Decker, et al. (2020).

[6] Pugsley and Şahin (2019).

[7] See Fairlie (2020). Researchers at the New York Fed point to a number of contributing factors, including these firms' weaker financial cushions, weaker bank relationships, and funding gaps that existed prior to the pandemic, plus less access to federal relief funds. See Mills and Battisto (2020).

registrations over this time fell more rapidly than those during the 2008 financial crisis and in the aftermath of 9/11.

But surprisingly, starting in May 2020, there has been a significant increase in new business registrations. Applications for Employer Identification Numbers (EIN) at the IRS, a good predictor of start-up activity, rose to record numbers in the summer of 2020, and were up about 20 percent in 2020 compared to 2019, with CARES Act funding being a significant driver of a strong pickup in business registrations in predominantly Black neighborhoods.[8] The increase in business formation has resulted in the share of private-sector employment accounted for by the smallest firms now being a bit higher than it was pre-pandemic.[9] Some of these new businesses were likely established out of necessity by people who had lost their jobs during the pandemic or by people who felt challenged in their workplace. Others were likely formed by people who saw and took advantage of an opportunity. In fact, even before the pandemic, when entrepreneurs were asked what motivated them to start a new business, they offered a variety of reasons. For example, the Black women entrepreneurs interviewed by the Kansas City Fed often cited positive factors like passion for the industry, the emergence of a business opportunity, and the ability to serve the community, but some also mentioned negative factors like not feeling valued at their workplace or a general dissatisfaction with their current employer.[10] It is not clear at this point how many of these new businesses will prosper, nor how many jobs they will create, since much of the surge in applications is for firms that do not employ any workers other than the owner.[11] At the same time, it is good to remember that many successful companies were started during recessions, including Microsoft, Trader Joe's, and Walt Disney Co.[12]

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[8] Fazio, et al. (2021) and Sablik (2021).

[9] U.S. Bureau of Labor Statistics, *National Business Employment Dynamics Data*.

[10] Gines (2018).

[11] Dinlersoz, et al. (2021).

[12] Sablik (2021).

Access to credit is a key ingredient for starting and growing a successful small business, but gender, racial, and regional disparities exist in the availability of credit

Small businesses play a key role in promoting a healthy, dynamic, and innovative economy that benefits individuals and communities, and access to financial capital is a key ingredient for starting and growing a successful business. However, there are racial, gender, and regional disparities in the availability of credit. The Federal Reserve Banks' Small Business Credit Survey documents some of this disparity. Launched in 2010 by the New York Fed, the survey provides information on small business credit performance, financing needs and choices, and borrowing experiences. The Cleveland Fed now leads this survey effort, which has been a collaboration among all 12 Reserve Banks since 2016.[13]

Between September and November 2021, more than 17,000 businesses participated in the survey.[14] The findings indicate that small businesses with employees fared better in 2021 than in 2020 but the revenues and employment levels of many small businesses have not recovered to their pre-pandemic levels. The survey also indicates that some troubling trends have continued. Businesses owned by people of color were particularly hard hit by the pandemic, and they were less likely to have their funding needs satisfied by the pandemic relief programs. This continued long-standing difficulties that such businesses have had in accessing financial capital to support and grow their businesses, and other well-documented barriers to entrepreneurship faced by minority-owned firms.[15]

The 2016 Fed survey indicated that compared to small firms with white ownership, those with Black ownership were about half as likely to have obtained financing from a bank in the past five years, relying

[13] The survey's web page at www.fedsmallbusiness.org provides background on the survey, survey data, and analyses using the data.

[14] The 2021 Small Business Credit Survey gathered responses from 17,750 small business owners, including 10,916 firms with 1 to 499 employees ("employer firms") and 6,834 firms with no employees other than the owner. See Federal Reserve Banks (2022).

[15] See Chatterji and Seamans (2012) and Bates (2011).

more on online lenders.[16] Analysis of the 2018 survey data suggests that even controlling for firms' creditworthiness, Black-owned firms were less likely than white-owned firms to be approved for financing, especially at banks.[17] Financial shortfalls during the pandemic were more common among Black-owned firms than white-owned firms.[18] A recent study, co-authored by a Cleveland Fed researcher, used data from new questions on credit access that were added to the Census Bureau's 2021 Annual Business Survey. This study finds that minority-owned businesses were as likely to have applied for credit in 2020 as white-owned businesses, but less likely to have received all the credit they sought.[19] Cleveland Fed researchers have also found that during the pandemic, compared to small businesses owned by men, those owned by women faced more operational and financial challenges and were less likely to receive financing.[20] These disparities partly reflect other gender differences; in particular, the women-owned businesses tend to be newer and smaller; they are more often led by people of color and more often they do not have workers other than the owner. But even among firms with strong credit scores, women-owned firms were more likely to be denied credit than men-owned firms. Small businesses in low-income areas, including rural communities, have also faced greater challenges in attracting financing, partly due to the lack of banking services in these areas.[21] One study found that, adjusted for inflation, the value of small loans to rural businesses declined by more than half between 2004 and 2017.[22]

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[16] See De Zeeuw and Barkley (2019) and Federal Reserve Banks (2017).

[17] The survey data indicate that compared to white-owned firms with similar profitability, credit risk, and other factors, Black-owned firms that applied for financing were 7 percent less likely to obtain credit overall, 20 percent less likely to have received financing from large banks, and 17 less likely to have received financing from small banks. See De Zeeuw and Barkley (2019), p. 16 and Figure 1.

[18] Federal Reserve Banks (2021), pp. 26-28.

[19] Meyer and Schweitzer (2022).

[20] Wiersch and Misera (2021).

[21] Mills, Battisto, and Lieberman (2019).

[22] Belson (2020).

This disparate treatment has several consequences. Because minority-owned firms have historically had less access to credit, they have tended to start their businesses with less initial capital, more personal debt, and on a smaller scale, making it harder to grow and become profitable.[23] This hurts the individual business owners because owning a business is an avenue to greater wealth. Indeed, one study found that the wealth gap between Black and white business owners is about a quarter of what it is for households overall.[24] The disparity also makes it harder for communities with larger minority populations to gain the economic development benefits from entrepreneurship.

During the pandemic, the lack of a banking relationship made it harder for some small businesses to get their financing needs met through the PPP.[25] When the program first launched, applications for PPP financing could only be submitted through lenders that had previously been approved as SBA lenders, and these institutions were mainly banks. Black-owned small businesses are more likely to use community development financial institutions, credit unions, and nonbank online lenders, and many of these institutions were not certified as SBA lenders. Similarly, women-owned businesses and those located in rural areas often turn to alternative sources of financing rather than banks.

Small businesses at which the owner is the only paid employee, which make up about 81 percent of U.S. businesses, many of them owned by women, also had a particularly hard time taking advantage of pandemic programs.[26] Many reported that they were unaware of the range of programs and uncertain about the eligibility requirements. In light of this, the Federal Reserve Banks hosted webinars with small businesses and intermediaries to raise collective understanding of the programs and to better understand the challenges associated with accessing them. Community-based organizations, including Neighborhood

[23] Fazio, et al. (2021).

[24] See De Zeeuw and Barkley (2019).

[25] Federal Reserve Banks (2021).

[26] Pacetti and Thompson (2021).

Allies in Pittsburgh, PA, and MidTown Cleveland, in Cleveland, OH, engaged in outreach with small businesses, helping them navigate the relief programs.[27] Community outreach proved to have an important impact, informing changes to the second round of PPP funding that made it more available through nonbank lenders and to small businesses without payroll costs.[28]

It might seem like it shouldn't matter where a small business obtains its financing, but respondents to the Fed's survey who use online lenders for funding continue to report that these lenders have provided less satisfactory service. According to the 2022 report on the Fed survey, 77 percent of small business respondents reported having challenges with an online lender, while 49 percent reported having challenges with a small bank. Compared to their experiences with banks, a smaller share of respondents reported long wait times for credit decisions from online lenders as an issue, but a considerably larger share reported problems with high interest rates and unfavorable loan repayment terms.[29]

Making credit more accessible

While the PPP was an important source of funding for distressed small businesses during the pandemic, we have learned that funding is not enough. Firms also need to know what types of funding are available, what the eligibility requirements are, and how to go about applying for it. In other words, the funding needs to be accessible. This takes coordination among government entities, community development organizations, lenders, and the small businesses themselves. And this coordination is happening. Government programs now being established to encourage small business development are incorporating education and technical assistance for the firms seeking funding. For example, as part of the American Rescue Plan Act of 2021, the federal government has provided a combined $10 billion to states to fund the State Small Business Credit Initiative (SSBCI). The program is intended to increase access to credit

[27] Pacetti and Thompson (2021).

[28] Pacetti and Thompson (2021).

[29] Federal Reserve Banks (2022), p. 23.

for small businesses by offering financing and technical assistance to firms seeking government funding. The state of Ohio also recently launched two new loan programs to support small business formation. The Women's Business Enterprise loan program is intended to support the growth of existing women-owned businesses by providing loans at or below the market rate of interest, and the Ohio Micro-Enterprise Loan Program is intended to encourage the growth of new and existing businesses by providing micro-loans at zero percent interest.

Based on the small business credit survey results, lenders have an opportunity to reexamine their business practices, change those that are found to be sources of disparities, and improve their transparency so that potential customers can make more informed choices about credit products for their businesses. A study co-authored by a Cleveland Fed researcher found that the information provided on online lenders' websites differs across lenders and lacks detail, making it difficult for borrowers to compare terms.[30] Industry trade groups are now working to increase the standardization of disclosures to help potential customers compare products across online lenders and banks; several states have passed legislation to require standardized disclosures; and last November, bills were introduced in the U.S. House and Senate to apply the Truth in Lending Act to small business financing.

Policymakers are also working to strengthen policies meant to address inequities in credit access. The Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) are currently working together to strengthen and modernize the regulations that implement the Community Reinvestment Act (CRA). The act was passed in 1977 to help address concerns about disinvestment in low- and moderate-income neighborhoods and the impact of illegal practices such as redlining. The CRA reaffirmed that insured depository institutions must serve the communities in which they are chartered to do business and evidence shows that the CRA has provided

[30] Lipman and Wiersch (2019).

tangible benefits to low- and moderate-income neighborhoods.[31] With the many changes in banking since the 1970s, federal banking regulators are considering how best to assess CRA compliance and provide clarity on what activities are eligible for CRA credit. A notice of proposed rulemaking (NPR) is expected to be released soon.[32]

The Cleveland Fed will continue to do its part, by providing data through the Small Business Credit Survey and distributing our analyses of credit conditions in our region and in the nation. We will continue to engage with small businesses and community development organizations to inform ourselves about the challenges small businesses and start-ups are facing, and also to provide information on how to access the sources of available funding. Our biennial Policy Summit brings together researchers, policymakers, and practitioners to address the issues important to community development, including equitable access to credit and entrepreneurship. I invite anyone interested in learning more about our efforts to visit our web pages at https://www.clevelandfed.org/en/community-development/about-us.aspx.

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[31] Mester (2018).

[32] The Board of Governors issued its Advance Notice of Proposed Rulemaking (ANPR) to strengthen, clarify, and tailor the CRA regulation, and other materials summarizing the ANPR on September 21, 2020. All three agencies submitted a March 2022 target in the OMB regulatory unified agenda for issuing an interagency NPR. See Board of Governors of the Federal Reserve System (September 21, 2020); Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency (July 20, 2021); Office of Management and Budget (Fall 2021); and Board of Governors of the Federal Reserve System, CRA Proposed Rulemaking web page.

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