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Why Small Businesses Aren't Hiring... and How to Change That

by Jeff Stibel

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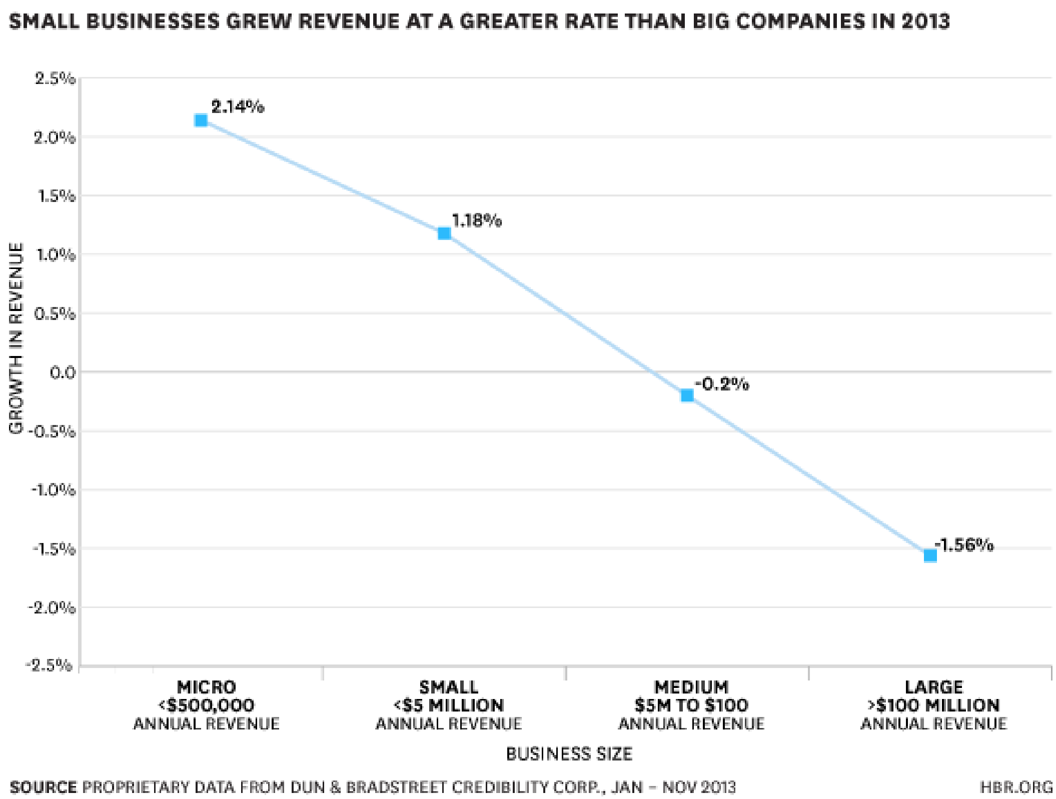
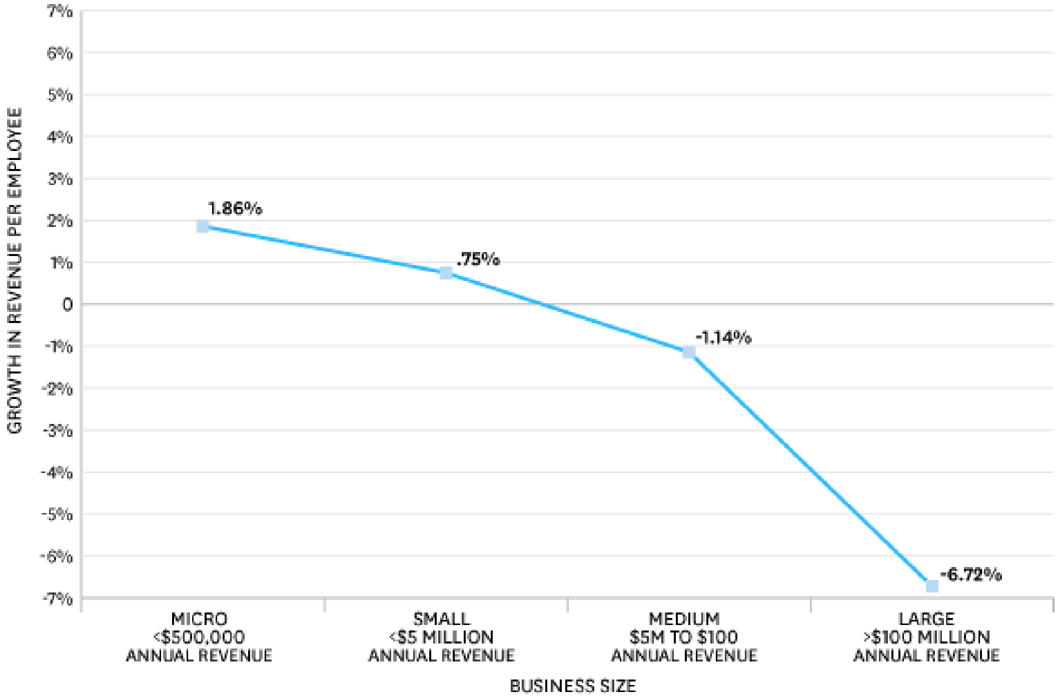
Despite the economic progress driven by business performance since the recession, the country has not recovered jobs at the same pace. Job growth, while improving, is slow by post-recession standards: The *New York Times* reported last year that percentage change in payroll, from business cycle trough to business cycle peak, averaged from all previous recessions, is 15%. For the current recovery it is 2%. By contrast, in an average recovery, corporate profits rise 38 percent from trough to peak. In this recovery, they have risen 45 percent. We have better than average profitability and much, much lower than average job growth.

For their part, small businesses are growing revenues faster than larger businesses. D&B Credibility Corp. proprietary data shows that the smallest businesses have been growing revenues the fastest: In 2013 alone, micro business revenue on average grew by 2.14% while small business revenue grew by 1.18%. Yet medium business revenue stayed relatively flat, losing 0.2% overall. The large businesses on average in our data decreased revenue by 1.56%. (Microbusinesses are defined as those earning less than $500,000 in annual revenue, small businesses earn less than $5 million, medium-sized businesses earn between $5 million and $100 million, and large businesses earn over $100 million.)



While the smallest businesses are growing revenues the most quickly, they are adding jobs the most slowly: From January to November 2013, micro businesses experienced 1.86% growth per employee, small businesses 0.75%, medium businesses -1.14%, and large businesses -6.72%. Strong sales and greater productivity, without employment growth, yields a jobless recovery.

SMALLER BUSINESSES EXPERIENCED MORE GROWTH PER EMPLOYEE IN 2013



SOURCE PROPRIETARY DATA FROM DUN & BRADSTREET CREDIBILITY CORP., JAN – NOV 2013 HBR.ORG

Why aren't successful small businesses adding more jobs?

We tend to equate job growth with business success but the reality is far more nuanced than that. Adding jobs is a capital investment, not a cash flow issue. In other words, crude as it may sound, additional employees are hired for future growth, similarly to the way business owners purchase computers, software, and other capital goods. For large businesses, the cost of employment is relatively low, so this point becomes largely academic. As revenues and profits rise, the largest businesses simply dip into their capital reserves to hire more people and grow their businesses. But small businesses do not have reserves significant enough to support new employment growth. It is a far bigger investment for a small business to hire an additional employee than for a larger business to do so.

Today, access to capital for small businesses is a significant problem. The largest businesses are able to secure financing with relative ease and on strong terms, including historically low interest rates. But as business size gets smaller, access to capital shrinks dramatically. For example, a recent Pepperdine University study showed a large discrepancy in bank loan approval rates: 75% of medium-sized businesses that sought a bank loan were successful, compared with 34% of small businesses and only 19% of microbusinesses.

Without capital, small businesses are not in a position to increase employment. This explains why even though small businesses have increasing revenues and remain optimistic, they are still not adding jobs.

This is alarming because small businesses drive economic recoveries. They not only employ almost half of the private sector, but they are also responsible for the lion's share of *new* jobs created. In the past 20 years, about two-thirds of all net new jobs were created by small businesses. SBA data show that small businesses (those with 500 or less employees) amount to 99.7% of all businesses and employ 49.1% of private sector employment. Clearly, small business job growth is critical after a recession.

It's not that the banks aren't lending. Banks actually increased large business loans (defined by the FDIC as loans over $1 million) by 23% from 2007 (pre-recession) to 2012 (post-recession). Unfortunately they decreased small business loans (defined by the FDIC as loans $1 million and under) by 14% during the same time period.

In 2011, Vice President Biden and former U.S. Small Business Administration (SBA) Administrator Karen Mills announced that 13 of the nation's largest banks would increase small business lending by $20 billion over three years. In September, the SBA announced that the banks had already increased their small business lending by $17 billion, putting them on track to meet their goal by the end of 2014. This is great news, but there is a caveat. The banks were allowed to form their own definition of "small business." And many of the banks consider a small business as having up to $20 million in revenues. And there is incentive for banks to lend towards the higher end of the scale.

In general, the larger the business, the less likely it is to default. Hence, banks tend to focus on lending to larger businesses. The government has tried to stem this trend with positive results by providing backstops through the Small Business Administration. (The SBA currently guarantees 85% of the value of loans up to $150,000 and 75% of the value of loans of more than $150,000.) While this has had a positive effect on small business lending, there may be greater benefit in having that distinction be focused, not on loan size, but on business size. For example, the SBA could guarantee 85% of the loan value for microbusinesses, 75% for small businesses, 50% for medium-sized businesses, and zero for larger companies. This would effectively tier the risk for banks and incentivize them to lend to the smallest businesses.

Businesses at every stage, whether start-ups or the largest companies, need access to capital to grow, but the risks of lending that capital vary widely. If the SBA were used to level the playing field, more small companies could get the access to capital they need to add jobs.

For more about this topic, see my testimony given before the House of Representatives Committee on Small Business on December 5, 2013.

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