MEETING AMERICA’S JOB CHALLENGE MEANS GROWING SMALL BUSINESS

Highlights

- A healthy labor market is characterized by churn – large numbers of workers leaving jobs alongside even larger numbers taking up new positions. Through churn, workers’ skills are better matched to employers and salaries rise at a faster rate.

- Small businesses exhibit labor churn at three times the rate of larger businesses. This reflects higher levels of failure, but also of success. Job growth is driven disproportionately by the success stories – a small number of high-growth firms that in almost all cases start out small.

- High-growth small businesses continue to bear the markings of the Great Recession and slow recovery. The number of start-up firms has been curtailed, as have the survivorship rate and hiring intentions.

- This has unique implications for younger Americans, who tend to see the greatest wage gains via churn and are also more likely to be employed at younger firms.

- Hiring rates will not return to normal without the express participation of small businesses. As the impediments to growth on high-impact small and medium sized firms lift, the prospects for economic growth will rise significantly. However, this will continue to be a gradual process.

In March, Federal Reserve Chairman Ben Bernanke stood in a room of several hundred economists and business leaders to discuss recent developments in the labor market. The Chairman noted that “the increase in employment since the end of 2009 has been due to a significant decline in layoffs but only a moderate improvement in hiring.” He was referring to the fact that a healthy labor market is characterized by large numbers of workers departing firms in any given month, alongside even larger numbers taking up positions within newly formed companies or expanding ones. This labor churn allows workers’ skills to be better matched with employers and permits salaries to rise at a faster rate. It even accelerates the rate at which younger workers are absorbed into the job market.

In our minds, Bernanke was effectively speaking on the importance of small businesses. Small and medium-sized businesses (SMBs) turn the crank that creates this churn. The higher level of churn amongst small businesses reflects higher levels of failure,
but also of success. And, aggregate job growth is driven disproportionately by the success stories.

Unfortunately, the recession and subsequent weak recovery presented a triple threat to these important job creators: it dramatically curtailed the number of start-up firms; it hit the survivorship rate of those that did get off the ground; and, it stunted the hiring intentions of small businesses in the face of tightened credit conditions, softened demand and persistent economic uncertainty.

High-growth small businesses are reclaiming the driver’s seat in job creation, but the speed of adjustment is a reflection of the legacy of the recession and its slow recovery. We anticipate it could be a year or more before they are in a position to push on the job churn accelerator. In order to do so, constraints need to lift further. In particular, the stabilization of home prices and greater progress in clearing excess inventory over the next year would go a long way to easing credit constraints faced by small businesses that rely on real estate as collateral. It would also shore up much-needed strength in consumer demand. This, alongside the improvement already seen in corporate balance sheets, would provide a solid foundation for a faster pace of hiring growth and labor market turnover.

Churning up a healthy labor market

On the first Friday of every month, the change in payrolls is reported and dominates media headlines. However, whether there was a sturdy 250,000 jobs created in the prior month or a measly 120,000 positions doesn’t reflect the underlying pulse of the job market. Beneath those numbers is a large flow of millions of workers starting new jobs and millions of others leaving old ones. The amount of labor market turnover (or churn) is arguably just as important an indicator of the economy’s health as the change in total jobs.

Much like overall employment, churn rises during expansionary cycles and declines during recessions. The decline in labor market churn during the Great Recession was particularly acute. Prior to 2006, an average of 5.3 million new hires occurred every month. On the flip side, people quitting or being fired from their jobs (referred to as total separations) averaged over 5.1 million. Since there were more new hires than separations, total employment grew by an average of 172,000 per month. At the height of U.S. job losses in 2009, the level of gross hiring fell sharply to just 3.8 million per month. Although separations also fell – to 4.3 million per month – it exceeded hiring, causing total employment to contract by a whopping 421,000 jobs a month.

In the first three months of 2012, the gross hiring rate has improved from its recessionary nadir, but at 4.3 million hires per month, it is well below its pre-recession level. Thus, job growth has firm ed up due to a continued decline in separations. And, the decline in separations is really a story of more cautious behavior or a lack of opportunity among existing employees. Prior to the recession, an average of 3.0 million people quit their jobs every month. That number is now less than 2.1 million.

The low level of churn is a sign of a still-troubled job market. The ability of workers to move between jobs raises the efficiency of the U.S. job market. Higher labor mobility allows workers to better match their skills with the demands of employers, and it also has a highly positive impact on earnings potential. On average, workers who move from one
job to the next without a spell of unemployment experience real wage gains of roughly 8%.

The impact of labor market turnover is particularly important for young people, who are the most mobile part of the workforce. Gains in wages are highest for people aged 21 to 31 years and diminish with each older age group. The sharp decline in labor mobility over the recession is particularly worrisome as it could mean lower life-time earnings for young people currently entering the job market.

More broadly, the decline in wage growth as a result of falling labor mobility makes it more difficult for households that are in a process of deleveraging to maintain spending growth. A recent study found that the decline in labor market churn associated with the recent recession reduced real GDP by 0.4% on an annual basis between 2008 and 2011.

Small businesses churn the crank that grows the economy

Knowing how important job churn is to the health of the economy, it’s natural to ask who drives the churn. The majority of it takes place among small and medium sized businesses. Businesses with fewer than 250 employees simultaneously create and destroy three times the number of jobs as their larger peers.

The high degree of competition and the important role of startups explain the higher rate of churn amongst small businesses. New firms almost always start out small and while many of them fail before they become large, those that succeed create more jobs than older and larger firms. In fact, new job growth is driven disproportionately by a very small number of high-growth firms – often termed “gazelles”. In any given year, just 1% of all companies generate 40% of the new jobs. The majority of these firms are less than five years old.

Unfortunately, there has been a sharp decline in the rate of new firm creation since the recession. This is hardly surprising given the drying up of the credit spigot three years ago, however the surprise is in how long the effect continues to linger. The number of jobs created by startups continued to fall in 2010, even while the number of jobs destroyed by existing firms fell (see chart below). While more up-to-date data on startups by this measure are not yet available, there is a close proxy and it fell in the first three quarters of 2011 compared to 2010. This is a signal that there has yet to be any significant improvement in new firm formation even in the second year of economic recovery.
Credit availability likely continues to be a constraining factor for new small business formation. Small business credit standards on commercial and industrial (C&I) loans have eased since the dark days of the recession, but they are still higher than before to the recession. In addition, small businesses still face difficulty in tapping into real estate as collateral. According to the National Federation of Independent Business (NFIB), 22% of small businesses rely on mortgages to finance business activity. Property values remain severely depressed and are unlikely to see much improvement until the shadow supply of distressed properties works through the system.

**Great Recession still reverberating for the nation’s job creators**

The legacy of the Great Recession doesn’t end there. Research shows that firms started during a recession have lower levels of employment three and four years later, compared to firms started during economic expansions. Startups that originate in mild recessions eventually close the gap with their non-recession compatriots, but for firms that weather deeper and more prolonged recessions, employment is still lower five years later.5

Since young employer firms exhibit high rates of gross job creation and destruction, the decline in the number of younger firms in this cycle has contributed to the decline in labor market turnover. Once again this has unique implications for younger Americans who are not only more likely to change jobs, but also more likely to be employed at younger firms. According to a recent study by the U.S. Census Bureau, around 45% of those employed at firms five years or younger are under the age of 35 and 70% are below 45 years of age. In comparison, in firms that have been in existence for over 20 years, less than one-third of employees are under 35 years of age and half are over 45.6

**Meeting the conditions for small business growth**

Since job churn is a function of a healthy labor market and small businesses drive churn, as the challenges faced by small businesses fade, so too will the restraints on the speed of labor market improvement. In this regard, there is some positive news. While credit standards can’t be characterized as ‘loose or easy’, they have been sufficiently loosened to permit a rebound in supply. Commercial and industrial lending, which fell by a whopping 26% between October 2008 and October 2010, was up 13.5% in early April from year ago levels. It is difficult to break out loans to small businesses versus loans to large businesses, but the value of small loans (under $100,000) have seen the strongest growth rates over the past year. Spreads on small loans have also fallen from their post-recession highs and according to the Senior Loan Officer Survey, banks have, on net, been lowering spreads on C&I loans. Finally, demand for these loans among small businesses is up considerably. The increasing desire for lending indicates that opportunities are out there for small businesses to grow.

One of the biggest challenges reported by small businesses in the current environment is poor sales. But, here too improvement is evident. In early 2010, 34% of small businesses reported this as their biggest single challenge. In April 2012, that figure had fallen to 19%. Although this is a big drop, we are doused with the reality that it has
merely returned the index to the peak levels reached in past recessions. This speaks to the nature of this recovery. It’s a marathon not a sprint, and we draw comfort from the fact that the changes in sentiment are in the right direction. For instance, personal consumption expenditures over the next year are expected to grow by 2.2%, up from 1.7% in 2011. This is not a dramatic change, but it’s a positive one nonetheless. Likewise, although real estate prices will be slow to recover, we are confident that a bottom will be reached this year. With time, this will accelerate the repair of household balance sheets, boost consumer and business confidence, and open up access to another credit channel for small businesses. The one area where we have less clarity is on the legislative and regulatory burden. According to the NFIB survey, a growing number of firms have cited this as a key concern. While there may be greater clarity on the direction of government policy in 2013, if uncertainty lingers, it could restrain the recovery in job churn. The longer the uncertainty lingers on this front, the more important it is for a strengthening economic backdrop to provide an offsetting influence.

**Bottom Line**

After nearly three years of economic recovery since the end of the Great Recession, the U.S. unemployment rate remains over four percentage points above its pre-recession level. While the private sector has added jobs consistently for the past three years, job growth has yet to gain the momentum needed to close the gap. As Chairman Bernanke noted, “to achieve a more rapid recovery in the job market, hiring rates will need to return to more normal levels.” However, hiring rates cannot return to normal until conditions for small businesses do. Unfortunately, this is likely to be a slow grind upward.

All told, as the impediments to growth on high-impact small and medium sized firms lift, the prospects for economic growth will rise significantly.

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Endnotes


4. Proxy reflects the number of jobs created by opening establishments in firms with fewer than 250 people


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