Where Should Civic Leaders Focus Their Economic Recovery Efforts?

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When the current health crisis subsides, civic leaders will be faced with replacing the scores of businesses that have been lost and creating jobs for the legions of people who are out of work. However, with state and local budgets severely depleted by the pandemic, they will need to focus economic recovery efforts where they can make the biggest difference, on those businesses that have the most potential to promote job growth and economic inclusion.

Similar to the pandemic, their decisions will need to be based on science, rather than anecdotes, fads or wishful thinking, which has too often been the case in economic development. I've reviewed some of the relevant academic research that's been published over the past decade to see what might offer useful guidance. Here are a few findings that stood out.

New Businesses

A logical place to start with economic recovery is by launching new businesses to replace the ones that have been lost, since it's commonly assumed that new businesses create the most jobs. But not all new businesses are alike.

A key factor to consider is whether the new business has been launched out of economic necessity or in response to a market opportunity. Typically, necessity entrepreneurs are responsible for around 16 percent of new business startups, but during an economic downturn that number goes up, as unemployed workers look for new ways to support themselves and their families. During the

Great Recession, the number of necessity entrepreneurs grew by 63 percent, while the number of opportunity entrepreneurs fell, a pattern typical of economic downturns. That pattern is sure to be even more pronounced this time around.

However, civic leaders will need to be cautious about going with the flow. Research suggests that new businesses launched by necessity entrepreneurs are less likely to grow and more likely to fail than those launched by opportunity entrepreneurs. Moreover, studies have found that most necessity entrepreneurs return to paid work once jobs become available that offer more than they are making through self-employment.

As in earlier downturns, there is likely to be strong interest in training unemployed workers to start their own businesses. However, very little is known about the effectiveness of those programs. One particularly rigorous evaluation of entrepreneurship training programs for unemployed workers found that they did increase the startup rate of new businesses in the short run, but they did little to improve the success rate of those businesses in the long run.

These findings suggest that while programs to support necessity entrepreneurship may offer invaluable short-term benefits to program participants and have sound social policy objectives, they are unlikely to have a lasting impact on the local economy.

Another key factor to consider is whether the new business is an employer or a non-employer business. Typically, the vast majority of new businesses – around 81 percent – are non-employer businesses, which means that they have no employees. One in four of non-employer businesses report that they anticipate hiring employees in the near future. However, very few ever do so. One study found that over a three-year period, only 3 percent of non-employer businesses actually hired additional employees.

One reason is because so many non-employer businesses are in occupations that lend themselves to solo employment, such as skilled craftsmen (e.g., plumbers, electricians, contractors, painters), skilled professionals (e.g., consultants, lawyers, accountants, and architects), insurance and real estate agents, doctors, dentists, mechanics, and beauticians.

Another reason is because so many people enter self-employment for the lifestyle. Half of the founders of non-employer businesses report that the primary reason for starting their business was to gain more control over their work life, as opposed to making more money or creating a new product. Most of these “lifestyle entrepreneurs” never make a profit and end up earning less in their first year of self-employment than in their last year of paid work. As a result, one in four return to paid work after one year, and nearly half return to paid work within five years.

The lesson for civic leaders is that investing in non-employer businesses is the quickest way to boost the number of startups, but those businesses are not likely to create jobs for very many people besides their founders, or still be around in a few years.

A third key factor to consider is whether the new business is local-serving or in the traded sector. Typically, two-thirds of all jobs in the local economy are in businesses that serve the needs of local residents. Since that segment of the economy has been particularly hard hit by the pandemic, it would be natural to focus recovery efforts there.

However, it’s hard to grow the local economy directly, since the size of the local economy is largely a function of how much wealth there is in the community at large. When the level of wealth in the community goes up, the local economy expands. When the level of wealth goes down, the local economy contracts, which is what is happening now, since trillions of dollars in wealth have been wiped out by the pandemic.

To get wealth to go back up, local businesses will need to sell more of their goods and services to others outside the community. Research suggests that for every job created in those “traded sector” businesses, additional jobs are also created in the local economy through a multiplier effect, making traded sector businesses the economic engines of the local economy.

A final key factor to consider is the age and experience of the founder. The conventional wisdom is that young people are most likely to launch successful new businesses. However, the reality is quite the opposite.

Research suggests that the mean age of founders of employer businesses (those that have hired at least one employee) is around 42, while the mean age of founders of the highest-growth new businesses is 45. Moreover, the success rate of the new business rises dramatically with the age of the founder. As it turns out, founders in their early 20s are the least likely to launch a successful new business, mainly because they lack the experience, skills, resources, and connections that their older counterparts have acquired over time.

Studies have also found that prior employment in the same sector as the new business increases the founder's chance of success. And the longer and closer experience the founder has had with customers and suppliers in that same sector, the greater the likelihood of their business success.

These findings suggest that the most successful founders of new businesses are likely to be older, more experienced, and less disruptive than the popular stereotype of a young creative type in the media.

And taken together with the other three factors outlined above, these findings suggest that when it comes to new businesses, civic leaders ought to focus on employer businesses in the traded sector launched by mature opportunity entrepreneurs with years of experience in the same sector as their new business.

High-Growth Businesses

But it would be a mistake for civic leaders to focus solely on launching new businesses. Although new businesses create the most new jobs in the short term, most new businesses start small and stay small, and most fail or exit within 10 years. Among those that survive, however, are a small number, between 3 and 6 percent, that experience high growth and end up accounting for almost 50 percent of all new job growth over time. Clearly, that's a promising place to focus economic recovery efforts.

Research suggests that high-growth businesses tend to be young and small, but high growth doesn't happen right away. One study found that the employment effects of high-growth businesses don't really kick in until after year two. After that, growth tends to be concentrated in the first five years, according to a longitudinal study of new businesses in the UK. That same study also found that new businesses with five or more employees were twice as likely to grow than those with fewer than five employees. That puts a premium on businesses younger than five years old with five or more employees.

However, high-growth businesses can be very hard to find and support. Studies have found that they are spread across a wide variety of industries and, contrary to popular belief, are overrepresented in services rather than in high tech. In addition, they tend not to seek assistance or join established business organizations, making them less likely to appear on anyone's radar.

Moreover, their growth tends to be episodic and serendipitous, materializing in sudden, largely unpredictable spurts due to market opportunities, buyouts, recapitalizations, new management, and often just luck.

Most are "one-hit wonders," meaning that their episodes of high growth are short-lived and rarely repeated. One study found that only a third of high-growth businesses ever experienced more than one episode of high growth in a ten-year period, and very few of them ever experienced more than two episodes.

As a result, despite their promise and all the attention they've gotten over the past decade, high-growth businesses have proven to be very difficult to target for economic development purposes.

Sustained-Growth Businesses

An alternative is to focus on small businesses that manage to sustain their growth, rather than grow in fits and starts. For one thing, they are easier to find. Also, like the tortoise and the hare, these sustained-growth businesses may be responsible for the biggest cumulative job gains over time.

Research has found that the faster a small business grows in one period, the less likely it is to grow again in the future, while the more times a small business grows, the more likely it is to grow again. That's because rapid growth puts a lot of stress on the business, and as the pace of growth increases, that stress becomes increasingly unmanageable. Alternatively, slow, incremental growth allows the business to gradually build its capacity to support continued growth as it moves up the learning curve and acquires additional experience. As a result, the frequency of growth may be the best predictor of future growth.

Sustained growth is also less serendipitous than fast growth, less dependent on external events, and more dependent on internal performance excellence. Studies of sustained-growth businesses have found that the key to their sustained growth is consistently executing on critical dimensions of management.

Chief among those dimensions is talent. The majority of sustained-growth businesses are "good" to "excellent" in attracting and retaining talent, training talent, ensuring a skilled workforce, and keeping the workforce engaged. That is reinforced by a strong culture with common core values and high levels of transparency about the where the business is headed, how it's going to get there, and how well it's doing.

Employees of sustained-growth businesses benefit in other ways as well. Because growth is sustained, their jobs offer stability, security, longevity, and opportunities for advancement, as well as sustained income growth. In other words, high levels of job quality.

A close look at sustained-growth businesses shows that they are spread across rural areas, small towns, small cities and large urban areas alike, making it possible to spread the benefits of growth across an entire region. Moreover, they comprise a broader range of occupations than those in high-tech or knowledge-intensive industries, making them a more likely source for middle-skill jobs.

Taken together, these findings suggest that the sweet spot for long-term job growth, and possibly economic inclusion, may be supporting sustained-growth businesses and getting other businesses to adopt similar management practices.

Minority-Owned Businesses

As it turns out, that may also be the sweet spot for closing the racial wealth gap. Over the past decade, a lot of effort has gone into expanding the ranks of minority entrepreneurs to build wealth among people of color and to revitalize low-income communities. But the same dynamics outlined above for new businesses in general are also at work among minority-owned businesses. In fact, they are even more pronounced.

Research by the Small Business Administration suggests that minority-owned businesses are much more likely to be launched out of economic necessity than white-owned businesses. They are twice as likely to be non-employer businesses. They are much more likely to be local serving. And they experience more churn, create fewer jobs, and have higher rates of failure than white-owned businesses.

Expanding minority entrepreneurship is clearly economically necessary and socially desirable, but doing so indiscriminately isn't likely to close the racial wealth gap. That will require focusing on those businesses that have the most potential for growth, particularly growth in the income of minority workers.

Research by the Federal Reserve Bank of Cleveland suggests that higher incomes are decisive in accumulating wealth over time for minority workers. That in turn suggests that stable employment in good jobs with opportunities for advancement for minority workers could go a long way toward closing the racial wealth gap. If the research cited above is on the mark, those good jobs are most likely to be found in sustained-growth businesses.

Balancing Act

So, where does that leave us? The research cited above offers useful guidelines, but just like the choices the pandemic poses between lives and livelihoods, economic recovery will require balancing short-term and long-term objectives.

For example, in the short-term, most job growth comes from new businesses, while in the long term, most job growth comes from businesses that have been around for a few years. Both are critical, since an adequate supply of growing businesses tomorrow depends on getting enough new businesses into and through the pipeline today.

Similarly, in the long term, reducing unemployment requires focusing on those businesses that can create the most jobs. However, in the short term, helping the unemployed start their own businesses offers them a way to support themselves and their families, even if most are likely to return to paid work when jobs do become available.

The same is true when it comes to minority entrepreneurship. Equipping more people of color to start their own businesses may not be sufficient to close the racial wealth gap in the long term. But in the short term, it can unleash untapped economic potential, create more role models and mentors to inspire and guide others, and normalize entrepreneurship as a viable option in communities of color, which can increase the likelihood of more successful minority businesses down the road.

Civic leaders will need to find the right balance between these long-term and short-term objectives. That will require a “bifocal,” rather than a binary, approach, and a recognition that, just like the pandemic, there are no easy answers or silver bullet solutions. Just a lot of trial and error.