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By Christiana McFarland, J. Katie McConnell and Caitlin Geary

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Small Business Growth: U.S. Local Policy Implications

The recent recessionary period has focused new attention on the role of small businesses in generating economic growth. Small businesses represent 99.7 percent of all employer firms and have generated 64 percent of new net jobs over the past 15 years.[1] What's more, small business outputs make up more than half of gross domestic product (GDP) and over 30 percent of all exported goods and services.[2] Many city leaders are interested in supporting and growing their small business community in order to realize these tangible economic impacts.

The National League of Cities (NLC) recently conducted research on the impacts of local policies on the growth of small businesses between 2007 and 2008 at various stages of development to better understand local government roles in creating a nurturing business environment. The analysis, based on a 2009 NLC/ICMA survey of chief administrative officers, included policies reported by local governments as those most often used to support small business development, including: access to capital programs (revolving loan funds); management development (Small Business Development Centers); regulatory and permitting assistance; and marketing assistance. Also included in the analysis is whether the local government partners with the small business community for policy development.

The research finds that the most effective ways local governments create opportunities for small businesses are to provide an efficient regulatory environment and to provide avenues for local businesses to engage with policy makers. Additionally, the research reveals that other local tools to support small businesses, including management development assistance, revolving loan funds and marketing assistance, do not have the expected impact on small business growth.

SMALL BUSINESS GROWTH

"Small businesses" refer to a diverse group of entities of different sizes, growth aspirations, industries and outputs. Studies of small businesses have found that, despite these differences, businesses move through *stages* of development that reflect a high level of uniformity of management, technical, financial and other challenges and needs.[3] Examining small business growth in various stages of development offers a strategic way for researchers and local leaders to understand and address the unique challenges and needs of the business community.

NLC's research measures and analyzes small business growth (openings or expansions) in the self-employed, first and second stages.

Self-employed: Businesses in this stage result from an entrepreneur's ability to turn a good idea into a product or service. In this earliest stage, challenges typically revolve around ensuring survival of the business, including the ability to build assets, create a solid business model, assemble resources, develop a business plan or marketing strategy and create networks. The success of the venture is almost exclusively dependent on the competencies of the small business owner. In 2008, self-employed businesses comprised 36 percent of all resident establishments in the U.S. and 7 percent of jobs nationally.[4]

Stage One: Businesses in this stage include lifestyle businesses, commonly referred to as "mom and pop" establishments, and new start-up businesses typically with 2 - 9 employees. These firms are focused on building market share, building a customer base, developing a product or service and securing external financing to cover start-up costs and/or expansion. Much of the venture's success is dependent on the owner's talents and capacity to accomplish these tasks. Although growth is the goal for many stage one companies, many businesses will not survive past stage one or will remain in this stage for the duration of the business' existence. In 2008, stage one companies comprised 56 percent of all resident establishments in the U.S. and were responsible for 32 percent of jobs nationally.

1 U.S. Department of Commerce, Bureau of the Census, http://www.census.gov/.

2 Nonfarm private GDP; U.S. Department of Commerce, International Trade Administration, http://trade.gov/ and U.S. Department of Labor, Bureau of Labor Statistics, http://www.bls.gov/.

3 For example, see Lichtenstein, Gregg A. and Thomas S. Lyons. Managing the Community's Pipeline of Entrepreneurs and Enterprises: A New Way of Thinking about Business Assets. *Economic Development Quarterly*, 20(4) (2006): 377-386 and Churchill, Neil C. and Virginia L. Lewis. The Five Stages of Small Business Growth. *Harvard Business Review*, 61(3) (1983): 30-49. This research defines stages according to the Edward Lowe Foundation.

4 Resident establishments are either standalone businesses in the area or businesses with headquarters in the same state. Nonresident establishments sector are businesses that are located in the area but headquartered in a different state. Edward Lowe Foundations' Youreconomy.org makes the distinction between resident and nonresident sectors because resident companies have more influence on job creation than businesses headquartered outside the state.

Stage Two: Second-stage companies have grown past the start-up stage but have not grown to maturity and typically have between 10 and 99 employees. At this stage, a company typically has a proven product, a niche in the market, a committed customer base and an employee pool, including professional managers. It is also at this stage where owners must make the decision to grow or to remain at current size. Companies that choose not to grow will most likely be able to remain at this stage, provided no major environmental shifts change the operating landscape. Companies that choose growth are faced with a new set of challenges, such as management training, funding expansion and regulatory barriers. Success of the business mainly depends on the management capacities of the owner and managers, financing capabilities and the regulatory environment. In 2008, second-stage companies comprised about 8 percent of all resident establishments in the U.S. and provided 35 percent of jobs nationally.

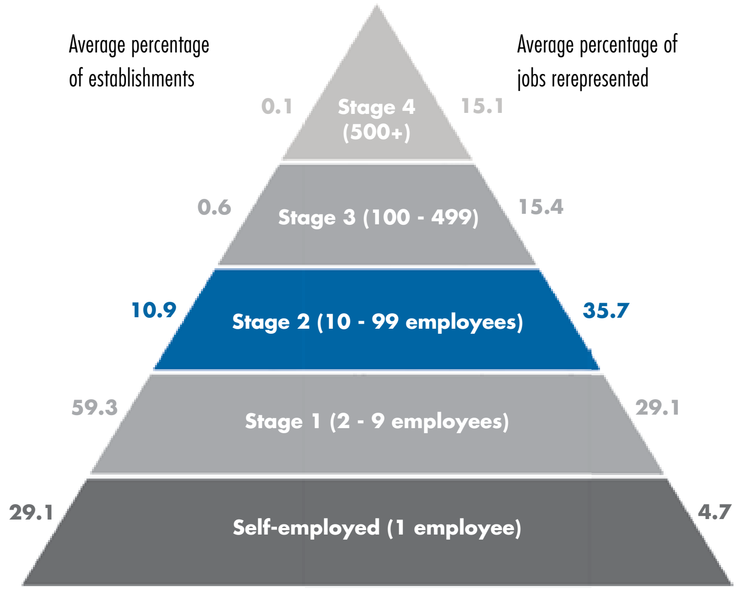

Figure 1: Average Percent of Establishments and Jobs at Each Stage, 1993 - 2008

Many, but not all, second-stage companies can be described as gazelles, or "high growth" firms. High growth companies have annual revenues between $750,000 and $50 million, a proven business model and the capacity for growth. Second-stage companies and growth entrepreneurs are significant job creators and have the greatest economic impact locally. Most offer goods and services to markets outside their local area and have a large appetite for growth and expansion.

Figure 1, developed by the Edward Lowe Foundation, depicts the average percentage of establishments and average percentage of jobs represented in various stages of business growth between the years 1993 and 2008.[5] While an overwhelming proportion of businesses are identified as self-employed or stage one establishments, it is clear that stage two establishments represent a disproportionate share of job creation.

LOCAL GOVERNMENT POLICIES

Local governments recognize the important role small businesses play in local economic success and often create policies and programs to assist the growth and survival of these enterprises. The most common small business policies are management and skills development, market expansion and assistance, regulatory assistance, access to capital and local government partnerships with the private sector (See Figure 2).

Management and Skills Development: Lack of management and business skills is a common culprit in small business failure. Local programs for small business management and skills development typically include general management training, financial advising, assistance with formulating a business plan and other technical assistance associated with business ownership. These programs are often offered by local government through a partnership with a Small Business Development Center (SBDC). For the purpose of this research, management and skills development is measured by the presence (or lack thereof) of an SBDC.

Market Expansion Assistance: Market expansion can be the most daunting challenge for entrepreneurs and small business owners because of their lack of resources and specialized marketing knowledge. Local programs to assist small businesses in expanding the market for their goods and services typically include programs such as buy-local campaigns or group marketing systems. These programs are often focused on the local and regional consumer base. For purposes of this research, market expansion assistance is measured by whether or not the local government has a small business marketing program.

Regulatory Assistance: Ideally, a local government's regulatory processes — permitting and zoning — exist to guard against detrimental development, preserve local assets and safeguard citizens. However, regulatory processes can also present barriers to small businesses, imposing time-consuming bureaucratic requirements, complex rules and regulations and inefficient processes. The speed and efficiency of regulatory processes is an indicator of local government responsiveness to small businesses that often do not have the time or resources to navigate bureaucratic steps. One way that local governments do this is by providing streamlined permitting and zoning assistance to small businesses. Regulatory assistance is measured by the presence (or lack thereof) of permitting and zoning assistance.

Access to Capital: Even in good economic times, the relatively high failure rate of new small businesses tends to limit their financing options. Most state and local government financing programs, such as revolving loan funds and microenterprise programs, traditionally have better loan terms and are geared toward businesses that are above average risk and may not be able to participate in traditional lending markets. In addition, many times these financing programs are offered by local governments in response to a perceived market failure; in geographically isolated areas or where particular industries are underserved by private venture capital firms. Access to capital is measured by whether or not the local government has a revolving loan fund.

5 Edward Lowe Foundation, http://www.edwardlowe.org/.

Partnering with Small Businesses: A supportive local government culture and proactive leadership are key ingredients in encouraging participation and open communication with the business community. Local governments can create partnerships with private businesses and industry leaders in order to gain insight into the needs of businesses and develop economic development strategies. For purposes of this research, a supportive culture is measured by whether the local government reports creating partnerships with private businesses and industries for policy input.

POLICIES THAT WORK

Between 2007 and 2008, self-employed firms and stage one firms, on average, experienced about 12 percent growth, whereas stage two businesses, on average, experienced a slight decrease in growth. Although stage two firms are typically acknowledged as stronger economic drivers in communities, employment in these and other existing firms during recessions tends to be sensitive to the business cycle, whereas job creation at younger, smaller startups tends to remains stable.[6]

In comparing small business growth with local government small business development policies, it is apparent that certain policies are more influential that others, both in general and by business stage. Local government policies and several control variables, including human capital, industry density, population growth and unemployment growth, were analyzed using regression analysis to better understand the relationship between local government policies and growth variations among the stages of small businesses.

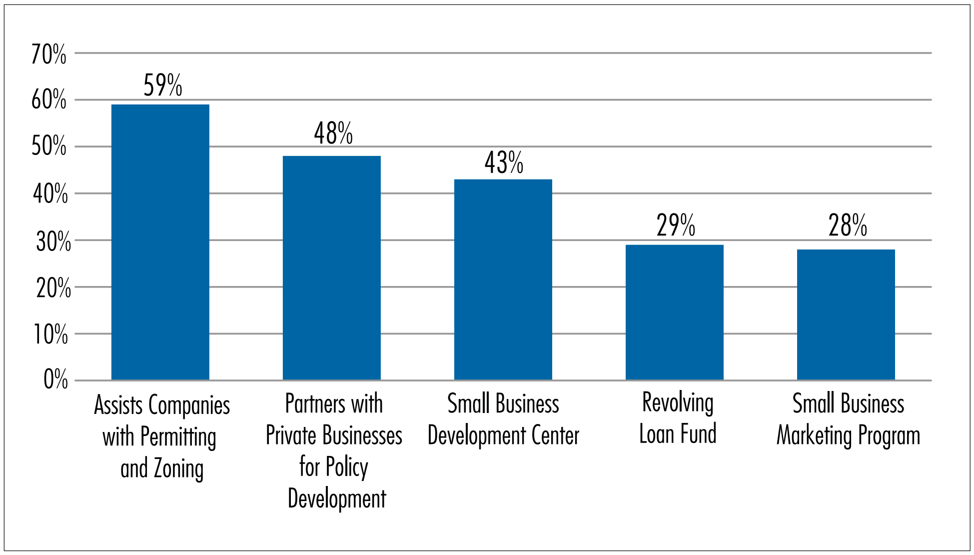

Figure 2: Percent of Local Governments Using the Policy

The policies most influential for growth in the *self-employed stage* are regulatory assistance and market expansion assistance. These policies, while important at each stage, are particularly integral to entrepreneurs looking to bring a business-idea to fruition. The policies most influential for growth in stage one are a partnering with small businesses and regulatory assistance. Stage one businesses require ease to market and are focused on building market share, which makes a supportive policy and regulatory culture beneficial. The policies most influential for growth in stage two are regulatory assistance and partnering with small businesses. Because second stage companies are past the start-up phase and have a higher potential for growth, debilitating bureaucratic steps and regulatory procedures may significantly hinder their growth or development.

For cities looking to get a handle on their business landscape, the Edward Lowe Foundation has created a free tool that allows users to access data about businesses and jobs at the state, metropolitan statistical area (MSA) and county levels. To learn more, visit www.YourEconomy.org.

When examining each policy across stages we find that regulatory assistance and partnering with small businesses contribute most to small business growth.

- *Regulatory Assistance*: Permitting and zoning assistance programs strongly contribute to small business growth. In fact, it is the most influential policy that was examined, particularly for self-employed and stage two businesses that may interact with the regulatory environment more frequently. These businesses tend to have strong growth prospects, product and facilities expansion requirements, and need for speed to market with services and products.

- *Partnering with Small Business*: The presence of partnerships with the private sector strongly contributes to small business growth, particularly for stage one and two businesses. Local governments with private sector partnerships have a better understanding of the challenges facing the local business community and can better respond to their needs.

- *Management and Skills Development*: The presence of SBDCs does not appear to contribute to the growth of small businesses. This may simply reflect the constant "churning" of self-employed and stage one businesses, those most likely to benefit from SBDC services.

- *Market Expansion Assistance*: Small business marketing programs do not appear to substantially contribute to small business growth. These programs more likely recirculate wealth, or attract new customers from the jurisdiction and region, but do not substantially increase the penetration of small businesses into new, external markets.

6 Kane, Tim. *The Importance of Startups in Job Creation and Job Destruction.* Kansas City, MO: The Kauffman Foundation. 2010.

- *Access to Capital*: The presence of a revolving loan fund does not appear to contribute to small business growth. Local governments are often too financially constrained and may not have detailed market knowledge to provide specialized financing for small business development. Additionally, although these programs may be helpful to a handful of businesses, issues of scale of the capital made available may prevent broader impacts.

IMPLICATIONS FOR LOCAL LEADERS

The current national dialogue promoting small businesses as drivers of economic recovery have increased local policy attention toward homegrown sources of growth, namely the development of small businesses. Understanding the current relationship between local policies and small business growth may help provide a framework for policy makers as they determine appropriate directions for their community. Overall, these preliminary findings suggest that local policies that most significantly create opportunities for small business growth create a supportive culture between the local public and private sectors and provide regulatory assistance. These are facilitative roles of local government that lie squarely within their purview. The findings also suggest that the primary local policy used for providing small businesses access to capital — revolving loan funds — likely has little of the desired impact on small business growth. Other mechanisms or issues of scale of the capital made available, need to be considered. Similarly, while the results confirmed expectations about the general directional relationship between management and skill development and market assistance efforts, the results also suggest that the specific policies utilized — SBDCs and marketing assistance programs — may need to be further explored at the local level. These preliminary findings also suggest that some local policies may be more likely than others to influence the growth of small businesses in different development stages. In order to better understand the variations, further research over longer time intervals is needed.

For most local governments, the first step in supporting small business is to understand the landscape of the business community. Understanding what types of businesses are in the community and what challenges they have can help drive small business development policy. In order to begin to forge these connections, local governments can seek out community partners that commonly interact with the local business community, such as chambers of commerce, technology councils, universities, small business development centers and economic development organizations.

DATA AND METHODOLOGY

NLC's analysis examines the impact of local government policies on growth of small businesses from 109 counties. The small business data are derived from the National Establishment Time Series (NETS) Database via youreconomy.org, a website database with records for more than 37 million U.S. establishments developed by the Edward Lowe Foundation using statistics from Dunn & Bradstreet. The data for the local policy variables are derived from the 2009 economic development survey conducted by the International City/County Management Association and the National League of Cities. The economic development survey is the longest standing economic development survey in the field; it has been conducted for more than 20 years on a five-year basis. The survey was mailed in October 2009 to chief administrative officers in all 556 counties with a population of 50,000 and over, as well as all 3,283 municipalities with a population of 10,000 and over. Location variables are derived from the American Community Survey. Those variables are human capital, measured by the percent of the civilian labor force in 2007 with professional and/or management experience; industry density, measured by total number of self-employed, stage one and stage two small businesses relative to the population of the county in 2007; population growth, measured by the growth in the total population between 2007 and 2008; and unemployment growth, measured by the change in unemployment in the civilian labor force between 2007 and 2008. Merging the available data for small businesses, local policies and location factors results in counties being the most readily available unit of analysis.

ABOUT THE PUBLICATION

Christiana McFarland is research director and program director and Katie McConnell is senior associate in the Finance and Economic Development program in the Center for Research and Innovation at the National League of Cities.

The National League of Cities is the nation's oldest and largest organization devoted to strengthening and promoting cities as centers of opportunity, leadership and governance. NLC is a resource and advocate for more than 1,600 member cities and the 49 state municipal leagues, representing 19,000 cities and towns and more than 218 million Americans.

Through its Center for Research and Innovation, NLC provides research and analysis on key topics and trends important to cities, creative solutions to improve quality of life in communities, inspiration and ideas for local officials to use in tackling tough issues and opportunities for city leaders to connect with peers, share experiences and learn about innovative approaches in cities.