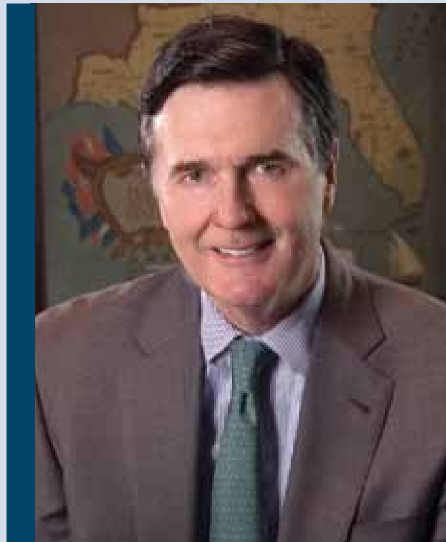
Start-ups, Job Creation, and Financing



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Start-up businesses account for a great deal of our country's private-sector job creation, but this important source of new jobs is losing strength and needs attention. During the recession, the pace of new business formations slowed markedly while the failure rate of businesses spiked. A slow rebound in formations since the downturn has not revitalized the start-up sector's job-generating vigor. Accelerating start-up business activity and the accompanying job creation is a worthy mission, particularly amid a jobs crisis.

This is a big challenge. The ecosystem in which start-up companies hatch and grow is highly fragmented and unorganized. It does not lend itself to clear-cut, large-scale solutions. To seriously confront the challenge of strengthening the country's start-up sector, we must understand the underlying commercial reality, including the role of banks as a source of capital.

We often hear that start-ups have insufficient access to capital. This relates importantly to persistent joblessness. If only the banks would lend entrepreneurs more money, the thinking goes, then entrepreneurs would start more businesses, which would create more jobs.

But that claim doesn't hold up. The reality is that banks have not traditionally been the primary financial backers of start-up companies. Entrepreneurs have been far more likely to finance start-ups with personal savings or credit cards than by borrowing from a bank, according to research, including a 2007 survey from the U.S. Census Bureau. So constrained bank credit does not appear to be a major impediment to new business formation and therefore job creation.

Scalable start-ups are the jobs generators

It is important to distinguish between *small* businesses and *new* businesses. Based on sheer numbers, small business as a category is indeed a big employer. Of the nearly 6 million U.S. businesses with paid employees, nearly 80 percent of them employ fewer than 10 people.

Still, it's new businesses, not small businesses generally, that make the most difference in creating jobs. In particular, it's start-ups that grow into medium-sized or large employers—as opposed to

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Editor's note: Throughout this issue, Southeast refers to the six states that, in whole or in part, make up the Sixth Federal Reserve District: Alabama, Florida, Georgia, Louisiana, Mississippi, and Tennessee.

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inherently small-scale or mom-and-pop firms—that are the true drivers of job creation. About 40 percent of new jobs in a given year come from the fastest-growing 1 percent of businesses, according to a 2010 Kauffman Foundation study. Three-quarters of those high-growth businesses are less than five years old.

One source of new jobs, then, is scalable-growth businesses that often aim to commercialize innovation. Scalable start-ups need capital. As mentioned above, banks supply some but hardly the bulk of that capital. Banks' historic reluctance to finance start-ups generally is understandable, given that banks need to make loans with a very high probability of repayment. Start-ups by nature lack any record of repayment. This is why most entrepreneurs turn elsewhere. While the most common source of start-up capital was personal saving, also important was personal bank credit, including home equity loans and credit cards, according to the Census Bureau survey.

The reality is that banks have not traditionally been the primary financial backers of start-up companies.

Only 19 percent of owners of firms said they started their businesses with a bank loan, according to the survey. That number could be even lower today, as banks in recent years have reduced their direct financing of start-ups. A 2011 Atlanta Fed poll found that Southeast businesses less than six years old were much less likely to have used a bank loan when they started than were older firms, and were more likely to have relied on personal savings.

The Census Bureau findings may help explain some of the decline in new business formation during the recession. Home equity lines, for example, are more difficult to obtain because of falling residential real estate values since 2007. Home equity lines haven't been the only pool of start-up capital to have shrunk—both the number of credit card accounts and limits on these accounts are well below prerecession levels, according to the third quarter edition of the New York Fed's *Quarterly Report on Household Debt and Credit*.

We need more start-up activity

Through good times and bad, the U.S. economy constantly creates new businesses and jobs while destroying other businesses and jobs. The problem today is that the balance of creation and destruction has tilted negatively because of a slowdown in new business formations. The number of new business establishments peaked at about 870,000 in 2006, then fell to 700,000 in 2009, and reached 720,000 in 2010, according to the U.S. Bureau of Labor Statistics.

From 1992 to 2005, more businesses were formed than closed, so the total number of establishments increased over time. That dynamic has since reversed. Bank credit constraints, however, are not a primary reason for that reversal.

Clearly, many of the traditional sources of funding have shrunk. How, then, do we channel capital to start-ups and early-stage enterprises in the interest of job creation?

There are no simple answers to this question. Capital formation for scalable start-ups and early-stage businesses is a serious challenge for both the private sector and public policymakers.

Still, it's clear that we need more activity in the start-up sector of our economy. While it is tempting to look to the commercial banking sector to stimulate start-up activity, that view is too narrow. To begin formulating ideas that can revive this sector and thereby create more jobs, we must first have a practical grasp on commercial reality, including the role of banks. ∎

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