ON THE MONEY

A Hannah News Service Publication

Vol. 130, No. 35 By Bill LaFayette, PhD, owner, Regionomics® LLC June 13, 2014

Ohio's Entrepreneurship Problem

Three recent studies are prompting an exploration of small business vibrancy in Ohio. The first is a just-released Brookings Institution study showing that entrepreneurship and business dynamism in the U.S. have been in decline for at least the past 35 years. The second is analysis of a wide variety of statistics – including three measures of entrepreneurship and small business concentration – for the 100 largest Metropolitan Statistical Areas (MSAs) in the U.S. The third is an examination of the health of the independent retail sector in all 363 MSAs nationwide. Applying the analysis of the first study to Ohio's economy shows that as bad as conditions are nationwide, in Ohio they are worse. The other two studies imply that small business development and the concentration of locally-serving businesses are much weaker in Ohio than they are elsewhere. This is a serious challenge for the economy of our state and the communities within it.

Why We Need Small Businesses

During the last 10 years, more than 200,000 businesses have been born in Ohio and more than 137,000 have died in a process that economists have for decades referred to as "creative destruction." Hathaway and Litan explain the importance of this economic churn in the Brookings study referred to above:

> Business dynamism is inherently disruptive; but it is also critical to long-run economic growth. Research has established that this process of "creative destruction" is essential to productivity gains by which more productive firms drive out less productive ones, new entrants disrupt incumbents, and workers are better matched with firms. In other words, a dynamic economy constantly forces labor and capital to be put to better uses.[1]

In other words, as new firms with innovative products and services are born into the market, they force existing firms to become more efficient and responsive to the marketplace to prevent the loss of market share, sales, and profits. Those that fail to respond adequately to the challenge will die and the more responsive firm will capture those sales and grow. On the other hand, if the new firm's product or service is not what the market needs, it will be forced out of business itself. Either way, the result is an efficient, dynamic economy that effectively allocates scarce resources to meet the ever-changing needs of consumers and businesses.

---

[1] Ian Hathaway and Robert E. Litan. "Declining Business Dynamism in the United States: A Look at States and Metros." The Brookings Institution, 5 May 2014, pg. 1. Web. 7 June 2014.

A second economic benefit of small businesses – particularly locally-owned, locally-serving ones – is that these businesses trap more consumer and business spending and keep it circulating within the local economy. Chain stores and other non-local businesses generally centralize distribution, purchasing, accounting, marketing, and other functions at their headquarters and other remote locations, so most of the dollars spent at these establishments leave the region immediately. Higher-paid corporate executives are also at the headquarters rather than in the local area. The consultancy Civic Economics has found that on average, sales at independent retail stores nationwide trap and recirculate 47.7 cents of every sales dollar in their local economy, while national retail chain sales recirculate only 13.6 cents. Meanwhile, local restaurant sales recirculate 64.9 cents, compared to national chain restaurants' 30.4 cents.[2]

This difference results from the fact that local retailers and other businesses tend to purchase much more within the local economy. Those purchases represent income for the suppliers, who in turn spend that income on goods and services to support their own activities and on wages and salaries for their workers. This continuing circulation of spending is called the "multiplier effect" because the impact of a dollar of spending has greater than a dollar's worth of impact as it continues to circulate within the economy. In addition, local businesses have upper management in town so average wages tend to be higher. Those high salaries and business profits stay in the local area as well. The overall effect is that a dollar spent at a local business generally has a far greater impact on local incomes, wealth, employment, and living standards than a dollar spent at a non-local business.

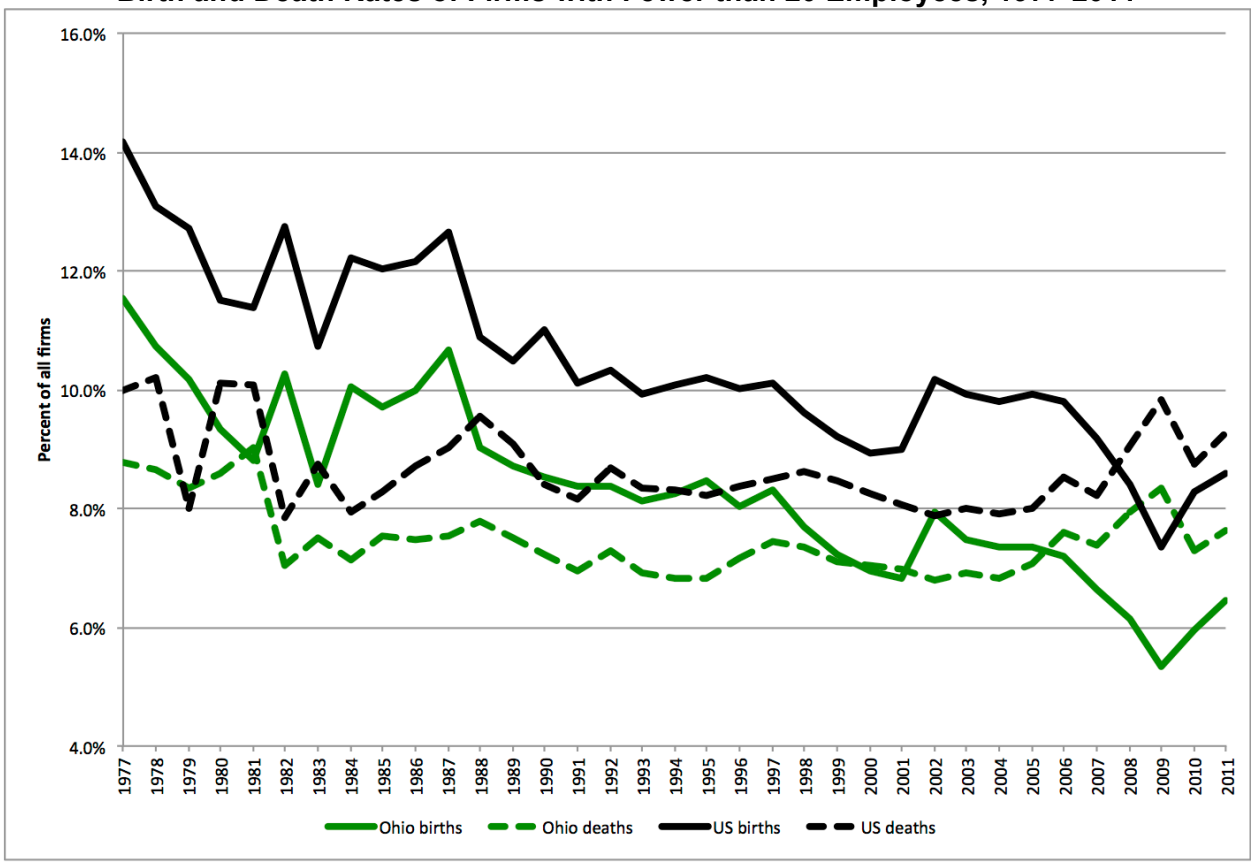
Dynamism in Decline

Hathaway and Litan use a Census Bureau database, the Business Dynamics Statistics (BDS), to analyze business birth and death rates since the late 1970s for the U.S. and MSAs. They find that firm births have steadily declined – from close to 15 percent of all firms in 1978 to eight percent of all firms in 2011. Meanwhile, the firm death rate has generally held steady at around eight to nine percent. The troubling implication is that more firms are now dying than are being born.

Figure 1 essentially replicates Hathaway and Litan's approach to show these trends for the U.S. and Ohio, with one important difference: births and deaths are measured only for those firms with fewer than 20 employees. While these small firms account for around three-quarters of all births in Ohio and more than 97 percent of deaths, focusing exclusively on these firms excludes much of the impact of larger firms' relocations and expansions, which usually involve far greater employment totals. The U.S. pattern shown in Figure 1 is very similar to that found by Hathaway and Litan. The birth rate is lower because it considers only a subset – but a large subset – of all births. But dynamism in Ohio has consistently been less than average, with both birth and death rates of small firms less than the comparable U.S. rate for all years. Ohio's small firm birth rate in 1977 was 11.5 percent of all firms (versus 14.2 percent for the U.S.), but had declined to 6.5 percent by 2011 (compared to a U.S. rate of 8.6 percent). A total of 14,772 small firms opened their doors in 2011, but this was 11,500 fewer than would have been created had the birth rate remained constant. The national birth and death rates converged in 2008, but despite the lower Ohio death rate, the rates first converged in 2000-2001, immediately before and during a recession that was much more serious in Ohio than elsewhere. The rates converged again in 2006 – two years earlier than the nationwide convergence – and the small business death rate in Ohio has exceeded the birth rate ever since.

[2] "Indie Impact Study Series." *Civic Economics.* Civic Economics, n.d. Web. 9 June 2014.

Figure 1
Birth and Death Rates of Firms with Fewer than 20 Employees, 1977-2011

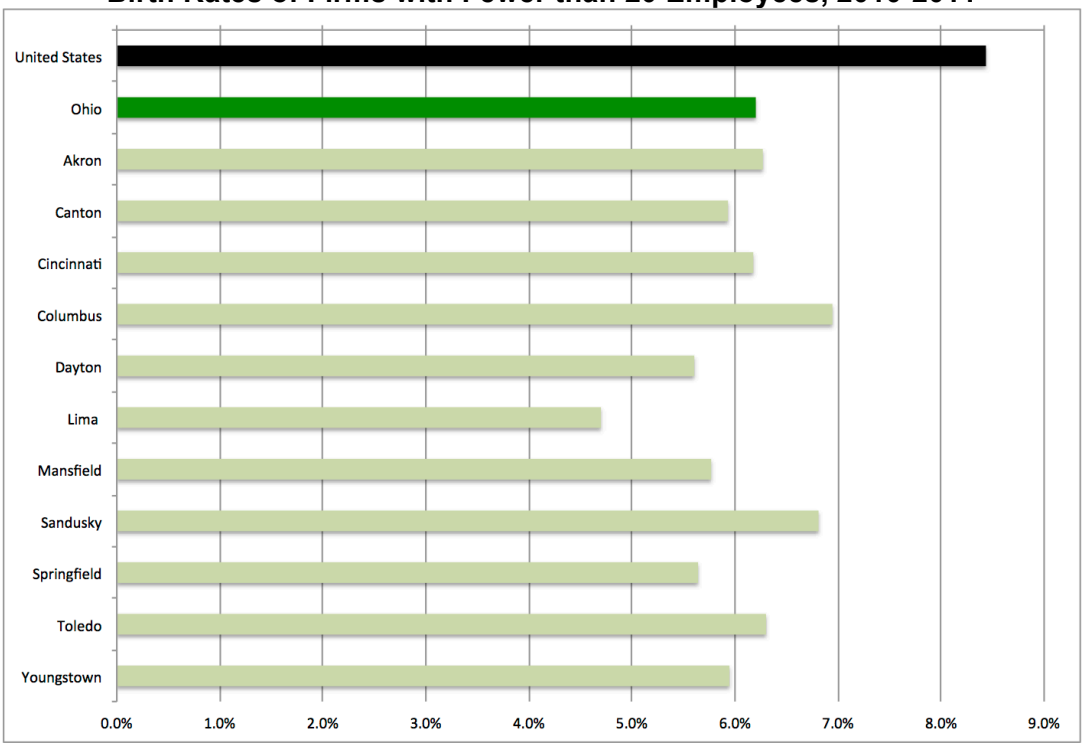


Source: Business Dynamics Statistics, U.S. Census Bureau; author's calculations.

Figure 2 on the next page compares the small business birth rate of all Ohio MSAs to state and national averages. Rates are measured as a 2010-2011 average to reduce variability and reflect performance during the recovery. The rates remain somewhat variable, ranging from 4.7 percent in Lima to 6.8 percent in Sandusky and 6.9 percent in Columbus, but as is true of the state average, all birth rates are far less than the national average.

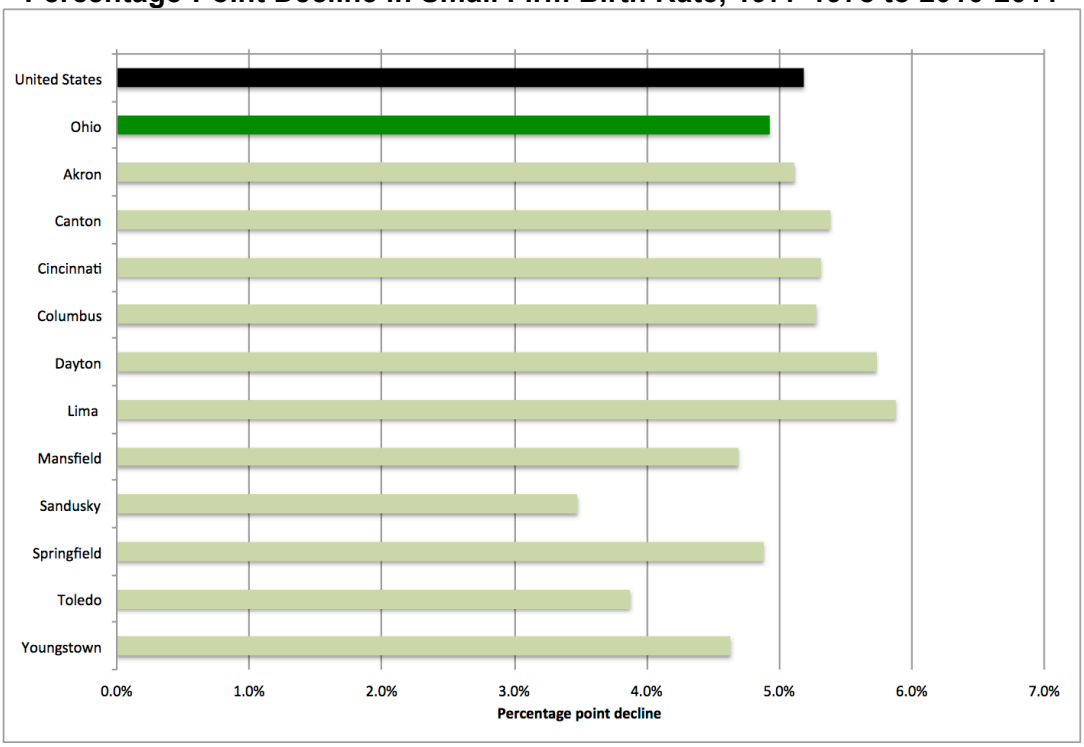
One of the other findings of the Hathaway-Litan study is that the decline in dynamism over the past 35 years has been nearly universal across states and MSAs. Figure 3, also on the next page, confirms this finding for Ohio by computing the percentage-point decline in the small business birth rate from 1977-1978 to 2010-2011. All birth rate declines are close to or greater than the 5.2 percentage-point national average except for Sandusky and Toledo, at 3.5 and 3.9 percentage points, respectively.

Figure 2
Birth Rates of Firms with Fewer than 20 Employees, 2010-2011



Source: Business Dynamics Statistics, U.S. Census Bureau; author's calculations.

Figure 3
Percentage-Point Decline in Small Firm Birth Rate, 1977-1978 to 2010-2011



Source: Business Dynamics Statistics, U.S. Census Bureau; author's calculations.

Additional evidence of the weak position of Ohio MSAs for entrepreneurial activity comes from two other studies. The first of these is *Benchmarking Central Ohio 2013*, the latest edition of a report released biennially by the Columbus Partnership and the Columbus Foundation. The study is prepared by the Columbus-based research nonprofit Community Research Partners (CRP).[3] (Disclosure: I serve on the CRP Board of Directors and have been a member of the steering committee for this project since its inception in 2007.) This study compares the status of the Columbus MSA to that of 15 other MSAs nationwide across a growing array of statistical indicators – currently 92 – measuring population vitality, economic strength, personal prosperity, lifelong learning, and community wellbeing. Among the indicators are three addressing small business concentration and development: the percentage of self-employed workers; very small business firms as a percentage of all firms; and the birth rate of very small firms – the same indicator analyzed above with the same 20-employee limit.

Among the 15 MSAs in the benchmarking sample are Cincinnati and Cleveland; these MSAs as well as Columbus repeatedly rank poorly in these three small business measures. But significantly greater insight is possible because along with the report CRP releases a workbook including all 92 indicators for the 100 largest MSAs in the U.S., including the six largest in Ohio. Tables 1, 2, and 3 show the rankings of these MSAs, the rate being ranked, the number to which the rate corresponds, and the number if each MSA's rate were equal to the national average.

The ranking in Table 1 refers to the percentage of all workers who are self-employed. (Because this information was collected from households, the percentages and numbers are for workers living in the MSA; their business may be located outside the MSA.) All percentages are far less than the 9.4 percent average for all 100 MSAs. In even the smaller Ohio MSAs, an average ranking would imply thousands more business owners than actually exist – 66,000 more across all six MSAs.

Table 1
Self-Employed Workers in Ohio MSAs as a Share of All Employed Residents, 2011

	Rank out of 100	Percentage	Number	Number if average
Akron	81	7.8%	25,572	31,006
Cincinnati	88	7.6%	76,460	94,256
Cleveland	90	7.6%	71,664	89,032
Columbus	75	7.9%	71,284	84,730
Dayton	87	7.6%	28,315	34,824
Toledo	91	7.5%	21,721	27,165
Average, 100 largest MSAs	--	9.4%	--	--

Source: Columbus Partnership and Columbus Foundation, *Benchmarking Central Ohio 2013*; American Community Survey, 2011 One-Year Estimates, U.S. Census Bureau.

[3]Columbus Partnership and Columbus Foundation. *Benchmarking Central Ohio 2013*. Community Research Partners, August 2013. Web. 8 June 2014.

Cleveland's ranking of 43rd in Table 2 – the percentage of all employer firms in the MSA with 20 employees or fewer – is the one ranking in these three small business measures in the top half, but even this is not good enough to produce a higher-than-average concentration of small firms. However, the percentages are fairly tightly clustered in this measure, so the differences between the actual totals and those assuming an average concentration are not vastly different.

Table 2
Firms of 20 Employees or Fewer in Ohio MSAs as a Share of All Employer Firms, 2011

	Rank out of 99*	Percentage	Number	Number if average
Akron	83	79.2%	9,495	10,152
Cincinnati	71	80.2%	25,253	26,686
Cleveland	43	82.8%	30,258	30,951
Columbus	80	79.4%	20,957	22,343
Dayton	96	77.4%	9,484	10,378
Toledo	90	78.4%	8,197	8,859
Average, 100 largest MSAs	--	84.7%	--	--

*Statistics are not available for the San Juan, Puerto Rico, MSA.
Source: Columbus Partnership and Columbus Foundation, *Benchmarking Central Ohio 2013*; Business Dynamics Statistics, U.S. Census Bureau.

The small firm birth rates in Table 3, though, are far less than average, with no MSA ranking higher than 82 and the birth totals substantially less than what an average ranking would imply. (At the average rate, the six MSAs would have generated almost 4,000 more startups than they did.) Note that the rank is out of 99 MSAs, not 100, because these statistics are not available for San Juan, Puerto Rico. Thus, Dayton's rank of 99 means that it has the lowest small firm birth rate of any large MSA in the U.S.

Table 3
Births of Firms of 20 Employees or Fewer in Ohio MSAs as a Share of All Employer Firms, 2008-2009

	Rank out of 99*	Rate per 1,000	Number	Number if average
Akron	90	62.6	864	1,197
Cincinnati	93	61.7	2,324	3,267
Cleveland	87	63.0	2,552	3,510
Columbus	82	66.0	2,215	2,909
Dayton	99	52.3	831	1,377
Toledo	97	56.7	700	1,071
Average, 100 largest MSAs	--	86.7	--	--

*Statistics are not available for the San Juan, Puerto Rico, MSA.
Source: Columbus Partnership and Columbus Foundation, *Benchmarking Central Ohio 2013*; Business Dynamics Statistics, U.S. Census Bureau.

One final assessment of small business health refers specifically to independent retail. This is the "Indie City Index" developed by Civic Economics for the American Booksellers Association.[4] Recall that a healthy local retail sector traps more dollars within the economy so that the multiplier impact of retail sales is greater. This index measures the health of independent retail

[4] American Booksellers Association and Civic Economics. *The Indie City Index 2011: A Measure of Independent Retail Vitality in Every American Metropolitan Area*. January 2011. Print.

in each MSA by determining the percentage of retail sales accounted for by national chains; MSAs with a lower percentage of sales at chain stores presumably have a more healthy retail sector. Because this ranking is produced for all 363 MSAs, a ranking is available for all Ohio MSAs. Rankings for all MSAs with a central county in Ohio are shown in Table 4. The concentration of independent retail in Ohio MSAs is generally far less than average, with Cleveland seven slots and Columbus 13 slots from the bottom. Weirton-Steubenville, however, is far better than the other Ohio MSAs and slightly higher than the national average.

Table 4
Indie City Index: Ranking of the Vitality of Independent Retail in Ohio MSAs, 2011

MSA	Index (100 is average)	Rank out of 363
Akron	79.1	301
Canton	82.3	281
Cincinnati	76.0	318
Cleveland	52.6	356
Columbus	58.2	350
Dayton	87.8	243
Lima	76.1	317
Mansfield	61.2	345
Sandusky	58.2	351
Springfield	91.6	209
Toledo	91.4	211
Weirton-Steubenville	108.7	86
Youngstown	87.3	247

American Booksellers Association and Civic Economics. *The Indie City Index 2011: Data Appendix*. January 2011. Print.

Why Is Entrepreneurship Weak?

This article has argued that the substantial weakness in small business concentration and entrepreneurship is a serious problem for Ohio's economy. If we are to address this problem, we need to identify a cause or causes. Unfortunately, no clear answer has as yet surfaced. Hathaway and Litan write in the conclusion to their national-level analysis:

> Our findings stop short of demonstrating why these trends are occurring and perhaps more importantly, what can be done about it… But it is clear that these trends fit into a larger narrative of business consolidation occurring in the U.S. economy—whatever the reason, older and larger businesses are doing better relative to younger and smaller ones. Firms and individuals appear to be more risk averse too—businesses are hanging on to cash, fewer people are launching firms, and workers are less likely to switch jobs or move.[5]

The database from the CRP benchmarking study offers the opportunity to explore relationships between the small business variables and a wide array of other social and economic variables. To identify any relationships that might exist, simple correlations were computed between the small business variables and all of the others. This is not an especially powerful technique: while it is able to identify a relationship between two variables, it cannot determine whether the phenomenon measured by the socioeconomic variable is specifically causing a response in the

[5] Hathaway and Litan, pg. 6.

small business variable – which is what we need to know here. In any case, this analysis turns up no systematic relationships. The implication is that we cannot point to demographic characteristics, population size, population growth (or lack thereof), economic structure, or the degree of local economic strength as influential in small business formation and strength. One important finding in this analysis, however, is that the correlation between the small business birth rate and the amount of local venture capital per capita is 14.5 percent – meaning that there is essentially no relationship. This is a point that makes sense on reflection: while venture capital is crucial for technology startups, it is only available to technology startups and these are only a small share of all prospective and new businesses. Thus, developing venture capital is by no means sufficient to ensure improvements in small business development overall.

One tantalizing possibility comes from four variables that were not part of the CRP database, so had to be added: variables that refer to the location of each of the 100 MSAs in one of the primary regions of the U.S. The correlation between small business births in a given MSA and that MSA being located in the West is a moderately positive 48 percent and the correlation of business births with the MSA being located in the Midwest is a moderately negative 41 percent. Thus, there seems to be some degree of relationship between geography and the tendency to form new businesses, with development less likely in the Midwest. (Recall that this relationship has nothing to do with the economic characteristics of the two regions.) It may be to some degree a stereotype, but to the extent that Midwesterners are more conservative and risk-averse than their counterparts elsewhere, this may be impacting decisions both to form small businesses and to patronize them. There is no question that quitting a job to start in business for oneself is a risky proposition – but so is a purchasing manager's decision to sign a contract with a smaller local firm rather than a large, well-known national firm. It is important to recognize that geography is only a possible influence. It is not an answer to the question, which we still do not know.

What Can We Do?

Without a clear answer to the reasons why entrepreneurship has slowed so much nationally and is even weaker in Ohio, we are mostly limited to treating the symptoms. However, if we in Ohio truly are hampered by a greater degree of risk aversion, that is an attitude and attitudes can be changed. We need to hold up entrepreneurs as role models – as ordinary people who swallowed hard and took a risk. We should celebrate these risk-takers for the benefits that they provide to our communities. We should also network these entrepreneurs both for mutual support and to support emerging entrepreneurs. Some entrepreneurial businesses fail because it is one thing to dream up a great idea and convince others that it is a great idea, but quite another to run a business on a day-to-day basis. These individuals likely need legal, accounting, and marketing help, but may not be able to afford it. They also may need capital, access to health insurance coverage, and affordable retail or office space. Business incubators are one way that at least some of these needs can be met fairly economically.

It is important to foster small business both from the supply side and the demand side – supply of small businesses and demand for their products and services. In addition to the strategies suggested above, we should think of entrepreneurial development as a workforce development strategy. Workforce development is generally thought of as a way of developing workers' skills and linking them with jobs, but we should present self-employment as a viable alternative for some of these individuals. Workforce development training programs could thus include an entrepreneurship alternative – one that takes a cold-eyed look at both benefits and costs of owning a business. Some who would like to start a business do not know where to turn first.

We should promote existing programs and services more effectively – and provide these programs with the resources they need to meet a greater demand.

Campaigns that encourage consumers to buy locally are well-known and can be effective. The message should not be to avoid chains entirely – which is impractical – but merely to think about where purchases are made and make those purchases from local providers when it makes sense to do so. As made clear above, even small shifts in purchase patterns can yield large benefits to the local economy.

But possibly even greater benefits can be realized by encouraging local purchasing on the part of "anchor institutions." Strictly speaking, anchor institutions are those with a permanent position in the local area – schools and universities, hospitals, and government, for instance – but can include major private-sector employers as well. These institutions have a vested interest in the well-being of their community, and can be encouraged to shift some of their purchases to local vendors from that standpoint. In some cases, this may have to include making it easier for small firms with limited resources to do business with the institution.

For government, the argument to buy locally is especially compelling: a greater share of procurement funds spent in the local economy can lead to a greater number of full-time jobs with benefits, increased taxable income of local indirect suppliers, reduced social service and public assistance costs, increased local charitable giving, and a stronger, more resilient local economy. The tax revenues received and costs avoided as a result of these impacts can thus more than offset any difference in the value of a contract. Analyzing the monetary value of these benefits can be quite complex, but an understanding of their general nature can help government policy-makers "internalize the externality" of doing business with local suppliers.