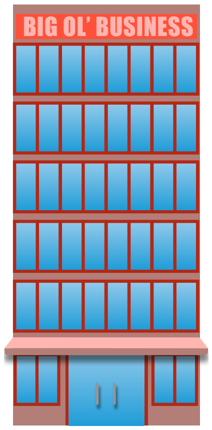
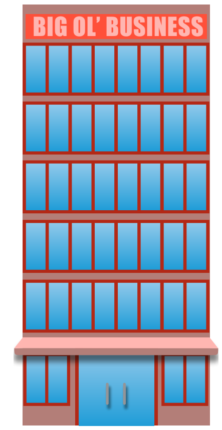
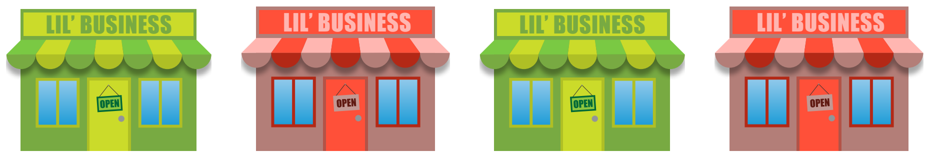


Fact or Myth:

Checking what you know about Business Size in Montana

by Barbara Wagner, Senior Economist





Small businesses are critical to the Montana economy, providing diversity of services and income to many Montanans. However, not all of the claims made about small businesses are necessarily factual. It has been said that small businesses are insulated from recessionary impacts, that they drive employment growth, and that they are hotbeds for entrepreneurialism. These claims can influence public officials and economic developers to target their energies towards small business, but the fortunes of large businesses also impact Montana communities. Separating fact from myth about business size is essential to better understand how to target economic development efforts.

> **FACT OR MYTH?**
>
> Most Montana businesses are small businesses.
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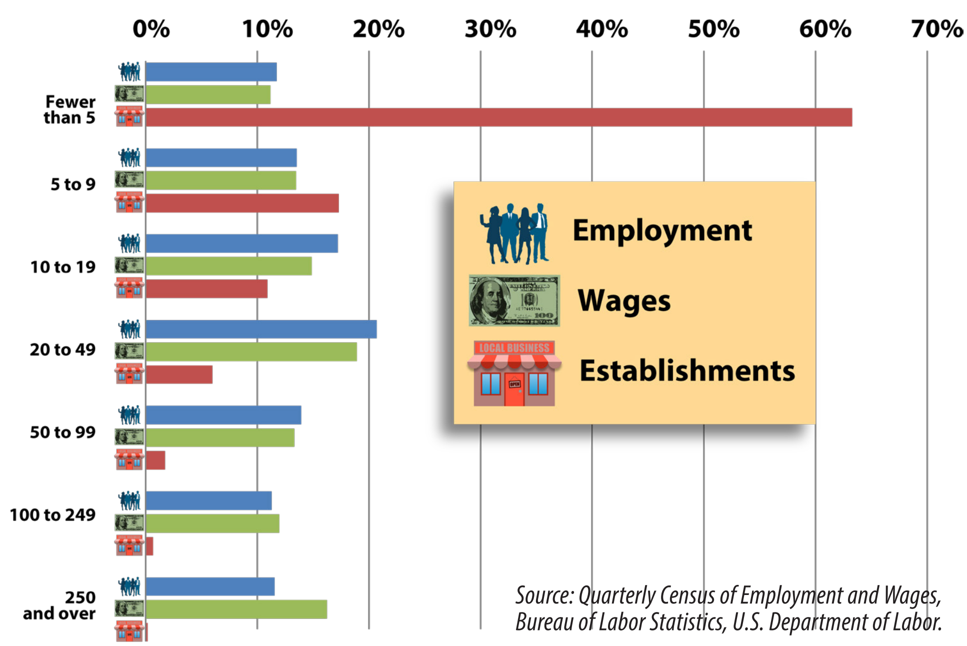
Different organizations define "small business" differently, but regardless of the definition, most Montana businesses are small. According to the federal Small Business Administration, a small business has less than 500 employees, putting nearly all of Montana's private businesses into the small business category. Other federal programs define small business as one with less than 50 employees, which would include 97.4% of Montana's private employers.

Figure 1: Montana Private Employment, Wages, & Establishments by Size Class, 2012



Source: Quarterly Census of Employment and Wages, Bureau of Labor Statistics, U.S. Department of Labor.

Using these broad definitions, the term "small business" includes nearly all Montana businesses.

However, most Montanans think of small business as mom and pop shops with a few employees or the hometown hardware store that hires one or two sales clerks. A more restrictive definition of small business (such as less than 20 employees or less than five employees) is more appropriate in Montana. The term small business would then include most of Montana's employers, as shown in Figure 1. Over 60% of Montana employers hire less than five employees, and 91% of employers hire less than 20 employees. Montana's employers tend to be fairly small. Figure 1 sorts businesses into size groups based on their establishment employment levels, meaning that all Walmarts in the state are considered separate businesses.

In addition to the employers shown in Figure 1, Montana also has about 83,600 nonemployer businesses that are active in our economy. Nonemployer firms include many self-employed individuals or family-owned firms where the owners provide all of the necessary labor. Although nonemployer firms can be an important source of income for owners and can provide goods and services to Montana consumers, this article is focused primarily on employers.

Why does Montana have so many small businesses? Compared to other states, only California has a greater percentage of establishments with fewer than 20 employees. However, the distribution is not vastly different than the U.S. as a whole. Montana and the U.S. have roughly equal percentages of very small businesses with less than five employees – 63.3% compared to 62.6% respectively. However, Montana does not have as many larger employers. Over 11% of U.S. businesses have grown to 20 or more employees, while only 8.5% of Montana businesses hire 20 or more employees. The lack of larger employers may be because of industry mix or because Montana's rural nature means less-concentrated consumers.

FACT OR MYTH?

Most Montana workers are hired by small businesses

MYTH.

Businesses with more than 20 employees hire the majority of workers.

While a majority of Montana businesses have fewer than 20 employees, most employment and wages come from larger firms. Establishments hiring 20 or more employees represent only 8.5% of firms, but hire nearly 58% of all workers and pay over 60% of the wages paid in the state. The largest establishments hiring 100 or more employees make up less than one percent of businesses, but hire 23% of workers and pay out over 28% of all wages paid in Montana.

It may seem obvious that large businesses hire most of the workers – they are large because they hire many employees. But large businesses also have a disproportionate share of the total wages paid because larger establishments tend to pay higher wages than smaller ones. The average annual wage in firms of less than 20 employees is about $33,600. In comparison, the average wage paid by a business of 50 or more employees is much higher at $40,820. In every industry, the average wage increases as size increases.

In addition to paying higher wages, larger firms are also more likely to offer health insurance and other benefits. In 2011, 95% of Montana employers with 50 or more employees offered health insurance to their employees, compared to only 30% of businesses with less than 50 employees. In fact, 100% of Montana businesses with more than 1,000 employees offered health insurance to their employees.[1] While Montana-specific retirement benefit information is not available, national data suggests that larger firms are more likely to offer a retirement plan. Roughly 86% of U.S. workers in large firms hiring 500 or more workers were offered retirement benefits in 2012, compared to 79% of workers in firms with 100 to 499 workers and 50% of workers in small firms of less than 100 workers.[2]

Large businesses provide more job opportunities, generally provide higher wages, and are more likely to offer health and retirement benefits. That being said, small businesses may provide other forms of compensation and benefits that make them more attractive employers, such as holiday and vacation leave, flexible work time, better career development, or a close-knit working group.

FACT OR MYTH?

Small businesses performed better than large businesses during the recession.

MYTH.

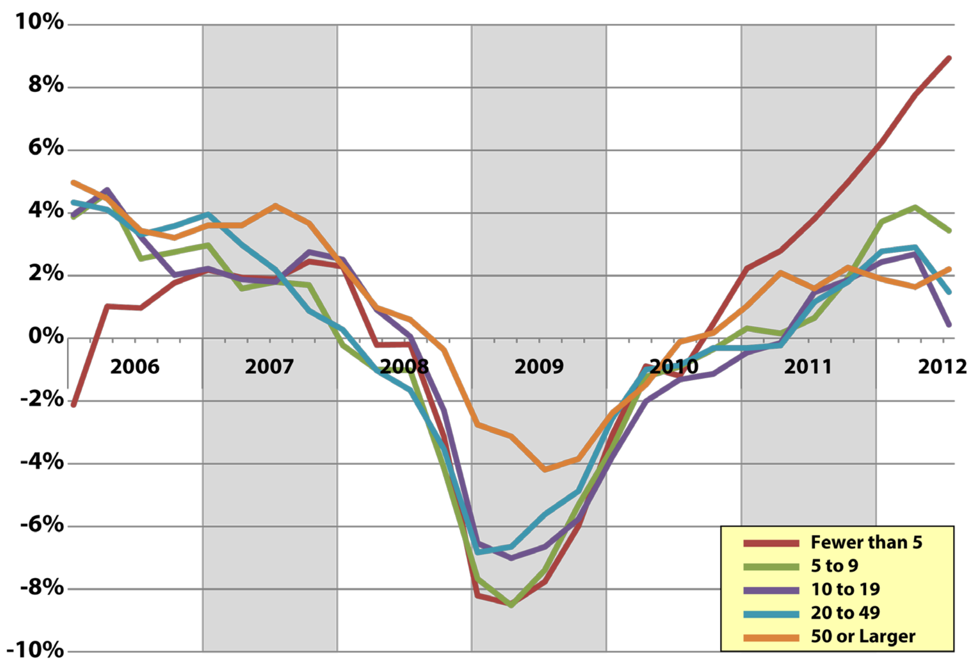
All sizes of businesses were impacted by the recession. Comparative performance depends on the metric used.

Some have argued that small businesses are more agile and better able to adapt to changing business conditions. Therefore, small businesses should be able to mitigate recession periods more successfully than large business by quickly adapting to changing circumstances. On the other hand, others argue that large businesses have a larger asset base that sustains the company during difficult periods. In Montana during the 2007 recession, all sizes of business were impacted by the recession. Which size class performed best depends on whether you consider the percentage loss or the number of jobs lost during the recession. Figures 2 and 3 illustrate the performance of Montana firms of different size from the fourth quarter of 2006 to the third quarter of 2012, or the last six years of available data, with Figure 2 comparing the size classes in percentage terms while Figure 3 illustrates the job levels. Firms are categorized by their largest statewide employment during the six years, and only private employers are included.

Figure 2 illustrates that larger firms of 50 or more employees performed better during the recession than did smaller size classes, losing only 4% of their employment level over the year in the worst quarter compared to 6% for the medium size class businesses and 8% for businesses with less than 10 employees. Cumulatively from peak to trough, businesses with 50 or more employees lost only 8% of their employment compared to 17% to 19% for the other size classes.

Because large businesses are bigger, losing 8% of their employment adds up to more job losses than a 19% loss in the smaller business groups.

Figure 2: Over the Year Employment Difference by Size Class (Percent Growth)



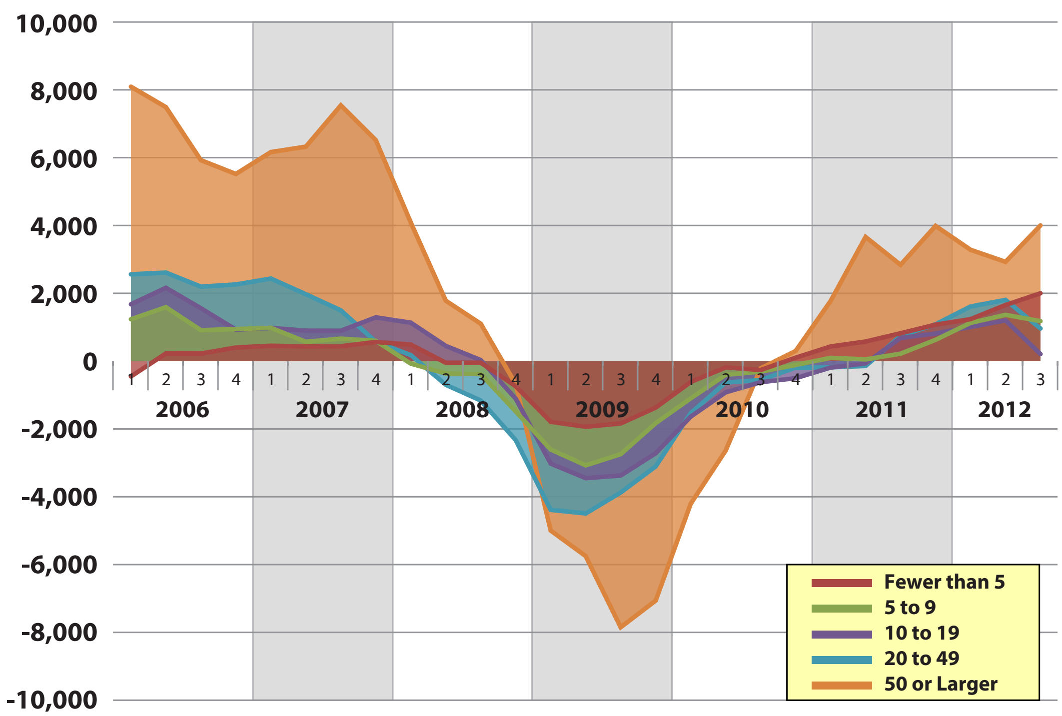
Source: Research and Analysis Bureau, Montana Department of Labor and Industry, using microdata from the Quarterly Census of Employment and Wages and predecessor/successor files from the Local Employment Household Dynamics Program of the U.S. Census Bureau

Figure 3 illustrates the recession performance by size class in terms of the level of jobs lost and gained over the year. The 8% loss by large businesses of 50 or more employees translates into a job loss of over 8,000 jobs in one year at the worst of the recession, and a total job loss of nearly 15,000 jobs peak to trough. In comparison, the smaller size class of 10 to 19 workers had an overall loss of only 9,300 jobs, even though their loss was much worse in percentage terms (peak to trough loss of 18%).

Exiting the recession, smaller firms have grown more quickly than larger firms, with a growth rate of nearly 9% over the year for the smallest businesses with less than 5 employees (Figure 2). Growth rates for businesses with five to nine employees are also very high, peaking at 4.2% growth over the year in the second quarter of 2012. Yet this high rate of growth does not add many jobs because the businesses are small, adding about 1,500 to 2,000 jobs over the year. Comparatively, large business are growing at a slower rate of about 2% exiting the recession, but the slower growth rate translates into a large number of added jobs, adding about 3,000 to 4,000 jobs over the year in 2012. In the last two years from the third quarter of 2010 to the third quarter of 2012, businesses with 50 or more employees have added roughly 6,850 jobs – more than all the other size classes combined.

In summary, both small and large businesses were impacted by the recession, and all size classes are now in recovery. The comparative performance depends on which metric is used for the comparison. In terms of growth rates, small business had the most volatile growth rates, with dramatic losses during the recession and extraordinary growth during recovery. Larger businesses growth rates were more stable, with lower percentage losses during the recession and slower growth exiting the recession. These stable percentages translate into large job losses in the recession and large job gains exiting the recession, while the dramatic growth rates of smaller businesses don't translate to big changes in job levels.

Figure 3: Over the Year Employment Difference by Size Class (Levels)



Source: Research and Analysis Bureau, Montana Department of Labor and Industry, using microdata from the Quarterly Census of Employment and Wages and predecessor/successor files from the Local Employment Household Dynamics Program of the U.S. Census Bureau

FACT OR MYTH?

New job creation comes from startups, which are all small businesses.

BOTH FACT AND MYTH.

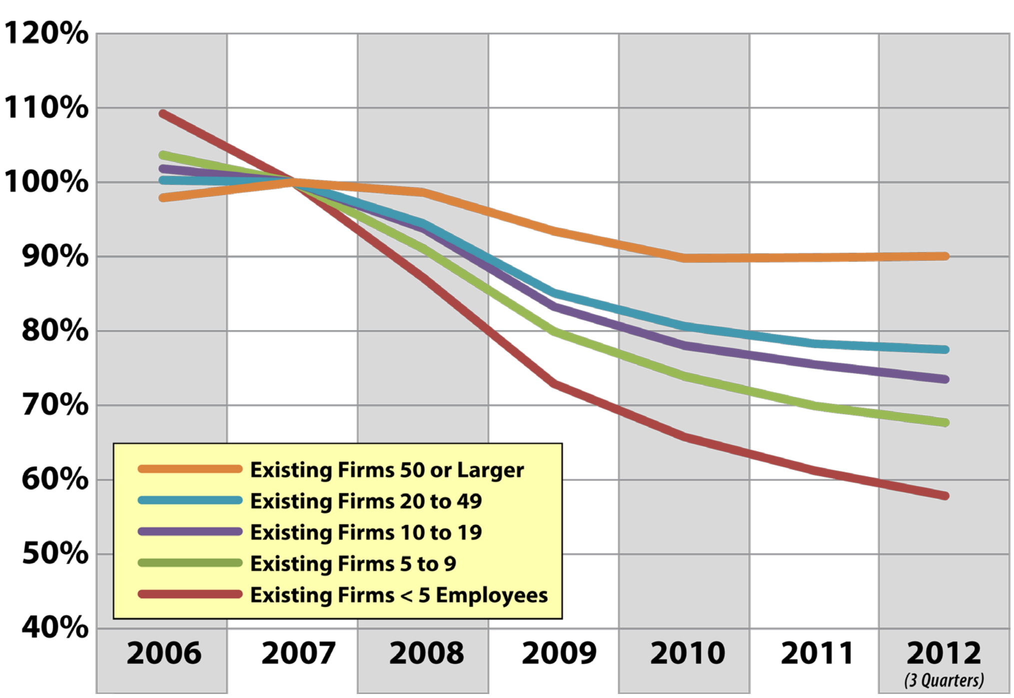
New business start-ups have added nearly 70,000 jobs to the Montana economy in the last six years, but these jobs come from new businesses of every size.

Based on growth figures during the recession, the start date of the business appears to be more important to job creation than the size class of the business, as firms that were in existence prior to the recession have lost jobs while new firms have gained jobs. Figure 4 illustrates the performance of Montana private businesses by size class including only firms that were in existence in 2006. The chart is indexed to illustrate the current employment as a percentage of the employment level in 2007. Firms that were in business prior to the recession have lost employment throughout the recession and recovery, with the smallest employers of less than five employees having only about 60% of their 2007 employment levels by 2012. Existing larger firms of 50 or more employees lost about 25% of their 2007 employment by 2012, and firms smaller than 50 workers lost 20% or more of their pre-recession employment levels.

Existing firms losing employment over time is not a surprising phenomenon. Businesses often go out of business, which can account for a portion of the declining employment. Economist Joseph Schumpeter, famous for his work on business cycles and firm dynamics, argued that firms cannot exist forever. Firms die either because they were never financially feasible, because of mismanagement or the retirement of the owner, or because the firm is unable to keep up with the changing economy and becomes obsolete. Firm deaths accelerate during recessions because of a rapidly changing environment. Roughly 64% of the firms in existence in 2006 continued to have employment in 2011, while the rest were unable to make it through the recession.

Even firms that successfully manage the changing economic environment reduce their workforce during the recession because of reduced demand for

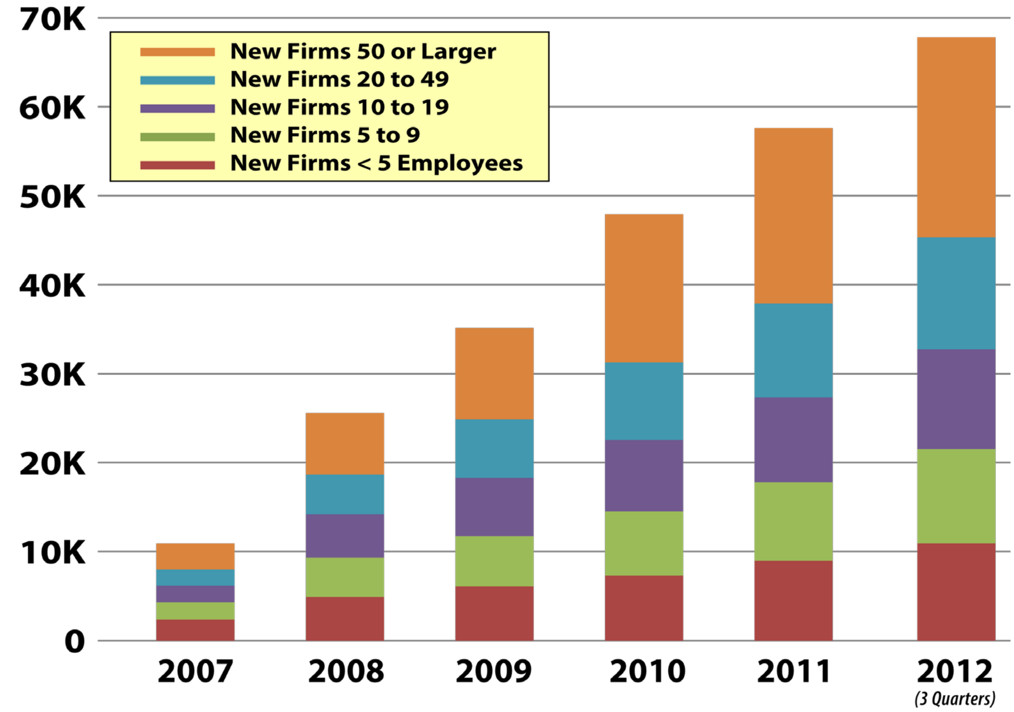
Figure 4: Performance of Existing 2006 Firms by Size Class (Indexed to 2007)



Source: Research and Analysis Bureau, Montana Department of Labor and Industry, using microdata from the Quarterly Census of Employment and Wages and predecessor/successor files from the Local Employment Household Dynamics Program of the U.S. Census Bureau

goods and services. Although most jobs return with the economic recovery, keeping up with a changing economic environment also requires firms to reduce costs and to find more efficient production processes. More efficient production usually requires fewer workers to produce the same amount of goods and services, thus reducing the number of jobs needed by existing firms. Although it may reduce labor needs, increased productivity ultimately benefits the efficiency of the economy, increases wages for retained workers, and allows Montana businesses to survive in a competitive environment.

Figure 5: Jobs Added by New Firms Started Since 2007 by Size Class



Source: Research and Analysis Bureau, Montana Department of Labor and Industry, using microdata from the Quarterly Census of Employment and Wages and predecessor/successor files from the Local Employment Household Dynamics Program of the U.S. Census Bureau

With existing firms losing employment, job gains must then be coming from new businesses. Figure 5 illustrates the number of jobs added by size class for firms that started in 2007 or later. New businesses started in the last six years have added nearly 70,000 jobs to the Montana economy, making up for the job losses in existing firms. New businesses added jobs regardless of size class, with the largest firms with 50 or more employees adding the most jobs (22,474 in 2012), and the two smallest size classes of fewer than five employees and five to ten employees adding over 10,600 each. The large job growth in new firms suggests that new businesses are the drivers of our economy, not necessarily small businesses.

The facts are that both small business and large business are critical to the Montana economy, both adding something different to the dynamics of our economy. While small business makes up the majority of businesses in the state, large business provides the majority of jobs and wages to our workforce. Small business growth during the recession and recovery was a roller-coaster ride. Large business growth rates were more stable, but still lost and gained a large number of jobs.

Separating the performance of existing versus startup firms suggests that age, not size, is an important characteristic for job growth. Schumpeter, a forefather of modern business cycle theory, once argued that new industries and new businesses were more profitable than old ones, and existing businesses must either adapt to keep up with their new competitors or cease to be in business. Although recession periods are the exception, not the rule, Montana job growth figures over the few years suggest that Schumpeter's focus on emerging and new businesses was valid. Entrepreneurs and business startups look to be more important for Montana's job growth than business size.

[1]Agency for Healthcare Research and Quality, Center for Financing, Access and Cost Trends. 2011 Medical Expenditure Panel Survey-Insurance Component.

[2]Bureau of Labor Statistics, U.S. Department of Labor. National Compensation Survey, 2011.