

Where do the Jobs Come From? Strategies for Job Creation

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Table of Contents

<i>Key Points</i>	3
<i>Introduction</i>	4
<i>Do Small Businesses Really Create Jobs?</i>	5
<i>Job Creation by Young Businesses</i>	6
<i>Survival of Young Firms: An Issue of Job Quality</i>	7
<i>The Upside of Failure</i>	8
<i>Policy Implications</i>	9
<i>Conclusion</i>	11
<i>References</i>	12
<i>Appendix: Community Level Strategies for Entrepreneurship</i>	13

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Key Points

- Small businesses generate a significant portion of job growth.
- New business startups are essential to positive net job creation.
- New businesses are more volatile compared with mature firms, and account for a large share of job loss.
- It is important to have a continuous flow of new businesses in order to replenish the firms and jobs that are lost to decline and failure.
- Given the importance of new businesses to job creation, policies that support entrepreneurship may prove effective strategies for employment growth. Such policies can target:
 - Community Attitudes
 - Mentorship and Networking
 - Educational Programming
 - Available Financing
- A long-term view of economic growth is necessary to reap the job creation benefits of entrepreneurship and small business policies.

Where do the jobs come from?

Strategies for job creation

Introduction

Job loss during the Great Recession was unprecedented. The U.S. lost more than eight million jobs in just over two years. The recovery from the Great Recession has been particularly slow compared with past recessions. Regaining the jobs lost between December 2007 and early 2010 took nearly four years. In Wisconsin where the recovery has been among the slowest compared with other states, it took nearly five years to reach prerecession employment levels.

Recovery, however, requires not just gaining back the jobs that were lost but expanding employment opportunities to keep up with population growth and the increasing number of people looking for work. Thus, even though the U.S. has erased the 8.7 million jobs deficit from the recession, the unemployment rate still remains relatively high as jobs are still needed for those people who have recently (re)entered the labor force.¹

In the midst of a slow recovery, job creation, new jobs added to the economy over and above existing employment, is still a central focus in the media and in political

discourse. Often the discussion simplifies or ignores the complexity of creating new jobs and too often narrowly focuses on which industries are growing, declining, or stagnant. Net new jobs in the economy result from a dynamic process that continuously creates and destroys jobs across all industries. Each year millions of jobs are gained (created) in the U.S. as businesses open and expand. A nearly equally large number of jobs are lost as businesses close or decline. The job “churn” is a signal of a healthy dynamic economy. The relatively small net effect that results from these business processes (job creation and job loss) is employment growth. Thus understanding employment growth requires consideration of business dynamics and their associated effect on jobs.

In the U.S., the discussion of employment growth has long been centered on small businesses and their essential role as job creators. While they do create jobs, the emphasis on small businesses is, perhaps, an oversimplification. Many small business owners can be referred to as Julien-type entrepreneurs. These are small business owners, often with a small handful of employees, with no interest in expanding beyond their current size. As a business grows the owner moves from “working the business” to “managing the business” which takes them away from why they started the business. Consider a cabinet

¹ The unemployment rate in Wisconsin has been consistently below the national rate throughout the Great Recession and the recovery period. The disparity between Wisconsin job growth and the unemployment rate is attributable to slower population growth rates.

maker who started her business in order to pursue a passion of wood working. As the business grows the owner finds herself spending more time managing the business and less time pursuing their passion that is at the heart of being an entrepreneur. While Julien-type businesses are important to the entrepreneurial spirit of any given community, they are less important in terms of long-term job creation.

New data that carefully tracks business dynamics and related changes in employment has helped improve our understanding of job creation, particularly with regard to small businesses. The data show that job creation is closely tied not only to business size, but also to business age. In particular, recent research suggests that newly opened (i.e., business start-ups) and young businesses, account for a disproportionately large share of job creation. Yet with their young age comes volatility as businesses are especially vulnerable to decline and closure during their early years. The high rate of failure makes jobs in new firms less secure. Such risky employment raises the issue of job quality. Ideally, new jobs would also be stable, offer benefits, and pay livable wages.

Do Small Businesses Really Create Jobs?

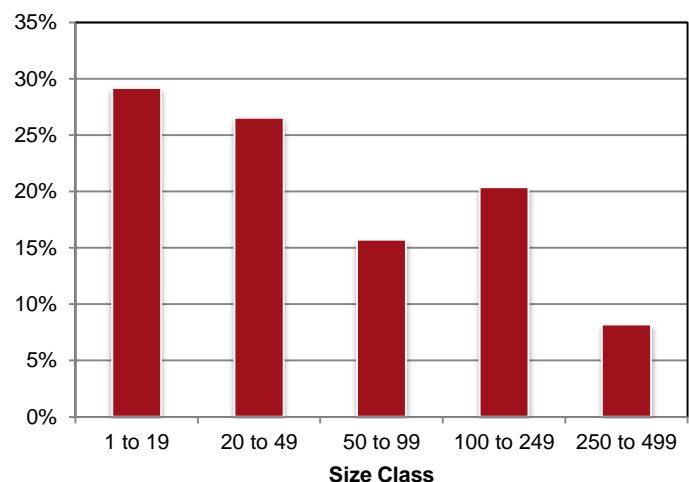
The importance of small businesses has long been emphasized in the U.S. As early as 1953, Congress passed the Small Business Act, which among other measures, established the Small Business Administration to protect and advocate

small business interests. The role of the SBA now includes ensuring that small businesses get a fair share of government contracts as well as offering direct loans and loan guarantee programs.

Nearly 25 years after the Small Business Act, MIT economist, David Birch (1979, 1981, 1989), studying employment patterns in the early 1970s, found that two-thirds of net new jobs came from businesses with fewer than 20 employees and 80% of net new jobs came from businesses with fewer than 100 employees. Indeed, recent analysis of net job creation (creation minus loss) echoes Birch's early findings (Figure 1). Over half of net job growth (55.7%) came from businesses with less than 50 employees and 29.2% came from businesses with less than 20 employees.

Since Birch published his findings, state and local economic growth and development policy makers and practitioners started to rethink the role of small businesses. Today their importance is generally taken as given by the public and elected officials. This was

Figure 1: Share of Net Job Creation by Size for Wisconsin 2012



not always the case; as recently as 30 years ago, large companies (e.g., Fortune 500-type companies) were perceived as the key to community job growth. From a local policy perspective nearly all attention was paid to the largest firms and that translated into recruiting big business. It was not until Birch's work that the focus of community-level economic growth and development strategies shifted from large to small businesses. The lasting influence of Birch's work is evident as it is often cited to substantiate small business advocacy and favorable policies. Such policies include tax regimes and government regulation that benefit small businesses, as well as other support such as loan guarantee programs.

The early research linking small business to job creation has since fallen to serious critique. More recent research, suggests that the perception of small businesses as job creators results from misleading interpretations of the data. Those who followed Birch's effort to understand employment growth have exposed a number of data and methodological shortcomings (e.g., Davis et al. 1996). The statistical techniques in past studies exaggerated the role of small businesses and missing detail about other business characteristics, such as age, left the analysis incomplete. While simple analysis, such as Figure 1, will generally show that small businesses create a large share of jobs, it is an incomplete understanding. In essence, the conclusion that small businesses drive job growth is an oversimplification and ignores the large number of Julien-type businesses that have no desire to grow above a certain size.

The data and methodology have improved considerably in recent years. The new

research has resulted in a more precise, if nuanced, understanding of employment growth. In general, basic analysis by business size does still support an inverse relationship between size and employment growth (i.e., most job growth comes from smaller businesses), however, more detailed data and better methods show that we can refine our insights and our policies.

Job Creation by Young Businesses

Emphasis on business size misses an important aspect of job creation, business age. Analysis by age shows that new and young businesses may be the key determinant of employment growth patterns. In fact, once controlling for age, there is no statistical evidence of a relationship between size and net growth rates (Haltiwanger et al. 2013). Importantly, because most new businesses also happen to be small, the evidence that net employment growth is higher in small rather than larger businesses is entirely due to most startups falling into small size categories. That is, it is the newness of startups, more than their small size, which drives job creation.

To demonstrate the importance of startups, one study of the period from 1980 to 2005 finds that without the job creation from new ventures, the annual net employment growth in the U.S. would have been negative (Haltiwanger et al. 2009). There is some variation by industry, of course. In manufacturing, for example, which generally features larger firms, there is relatively more job creation among older firms (Davis et al. 1996).

In Wisconsin, small businesses did contribute positively to net job creation (Figure 1), and depending on the way sizes are grouped together, small businesses contributed more than larger businesses. But grouping businesses by age we find that all net job growth is from new businesses (Figure 2). Startups contribute more than 100% of net job creation, offsetting the negative job creation by other age groups. Taken together, the Wisconsin analysis also suggest that positive job creation across age classes is likely driven by the new business in each size category, but especially in the smallest size categories where they tend to be concentrated (Figure 3). Thus age, more so than size, drives positive net job creation.

Survival of Young Firms: An Issue of Job Quality

Relying on new and young firms for job creation does have some potential disadvantages. Young firms tend to be especially vulnerable to decline and failure. In Wisconsin, roughly half (51.6%) of new start-ups close before the end of five years (Figure 4). Indeed, many small business advisors suggest that if the business is not sustainable (i.e., profitable) at the end of the third year of operation, the owner should seriously reconsider the viability of the business.

The loss of businesses to failure is compounded by the consequences for employment as many jobs are lost when businesses exit the market. Reasonably, workers might be concerned whether the place where they work will still exist in five years. One estimate suggests that after five years, 40% of the jobs initially created

Figure 2: Share of Net Job Creation By Age Wisconsin, 2012

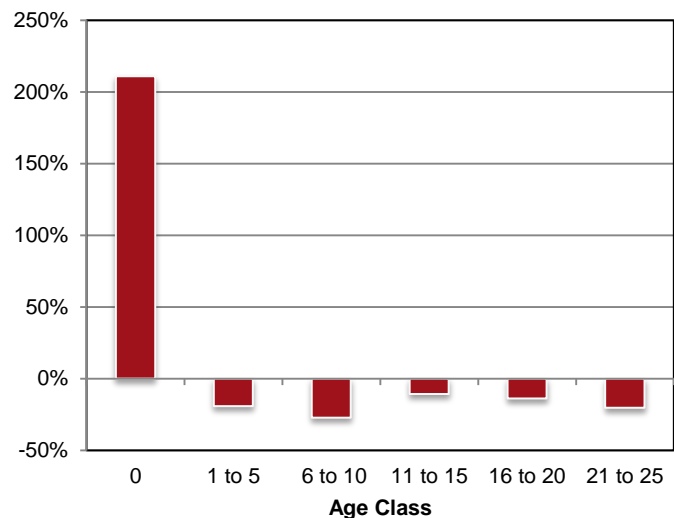
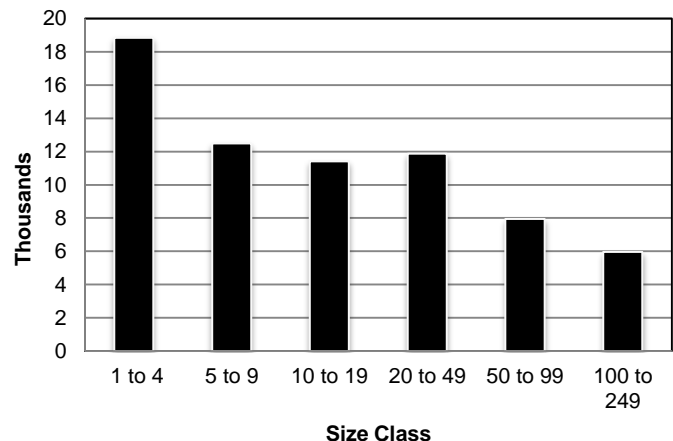


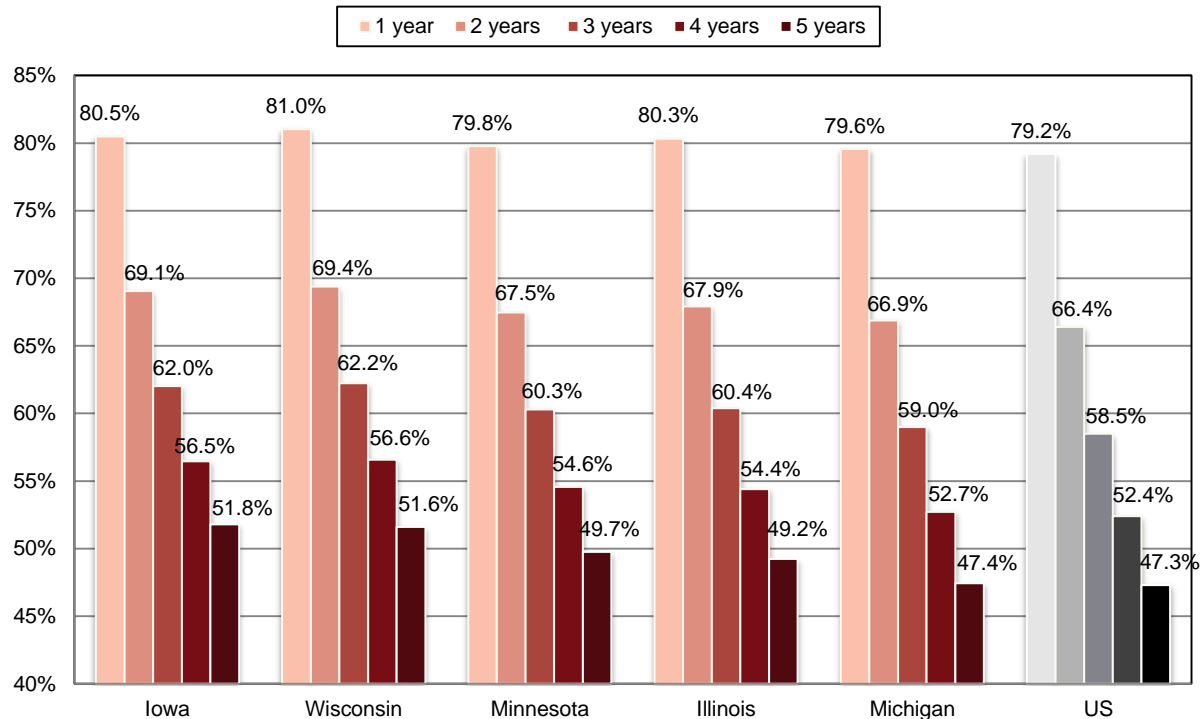
Figure 3: Job Creation from Establishment Births By Size Class Wisconsin, 2012



by start-ups have been eliminated by closures (Haltiwanger et al. 2013).

Due to risk of failure and the associated job loss, jobs in new firms can be perceived as relatively low quality. They are less secure and offer workers limited financial and economic stability for the future. Young firms are also far less likely to offer their

**Figure 4: New Business Survival Rate
1998-2007**



employees basic benefits in the form of health insurance and retirement programs (Litwin and Phan, 2013). Generally, the likelihood of offering benefits increases little during the first five years. Comparatively, mature firms offer job security and stability, but their stagnant growth trajectory provides few new employment opportunities.

The Upside of Failure

While business decline and failure incur a direct cost in the form of jobs, there are at least two positive economic results associated with failure. First, at the firm level there is a clear up-or-out pattern (Haltiwanger et al. 2013). Young firms that do survive grow more rapidly than their mature counterparts. Most high-growth firms called “gazelles,” which are particularly important for job creation, are relatively young and small. Conditional on

survival, it is their young age rather than their small size that determines their exceptional growth (Henrekson, 2009).

Second, at the community level, a high rate of failure can also be indicative of a dynamic and healthy economy. David Birch writes, “The reality is that our most successful areas are those with the highest rates of innovation and failure” (1981, p. 5). A high capacity for risk-taking, innovation, and even business failure can be an economic strength that leads to vibrant, entrepreneurial communities, new market niches, and long-term job creation. In a sense, the lessons learned from failed businesses can help inform future decisions. In fact, establishment deaths have been linked to future employment growth across the U.S. (Bunten et al. 2015). In the simplest sense, churn is healthy for the economy.

Policy Implications

The traditional policy focus on small businesses for employment growth is at least somewhat misguided. Focusing on size alone ignores the importance of business dynamics that relate to firm age. One study concludes, “[t]o the extent that policy intervention aimed at small businesses ignore the important role of firm age, we should not expect much impact on the pace of job creation” (Haltiwanger et al. 2013). Instead of small businesses, it is the youngest businesses that generate substantial job creation as they open and grow. They also terminate a large share of jobs, because they are more likely to close in their early years. Consequently, effective policies must consider both business age and size in the context of the complex processes of firm formation, growth, decline, and closure.

There are a number of potential policy levers that will affect job creation via business dynamics. Given the disproportionately large share of job creation from new business start-ups, supporting entrepreneurs may be one of

the most effective. Support for new business owners, even those that do not yet have employees, could lead to higher gross and net job creation. As pointed out above, much of the job creation generated by new businesses is offset by the job loss from decline and failure. Generally, only half of firms survive to five years (Figure 4).

A note on Business Migration: The Effect on Employment

As previously stated, firm behavior is key to understanding employment growth. The opening, closing, expansion, and decline of businesses largely explain changes employment. In addition, the number of local jobs can increase when businesses in-migrate and decrease when businesses out-migrate. The employment effects of migration, however, are trivial. One early study concluded, “Virtually none of the employment change in an area is due to firms moving” (Birch 1981, p 5). More recent work has corroborated the negligible effect of relocation on employment over different time periods, areas, and industries (i.e. Conroy and Deller 2014a, 2014b; and Conroy, Deller, and Tsvetkova 2015).

In some sense, the high rate of failure makes a high start-up rate all the more vital to employment growth. As the market is constantly pushing less successful ventures out, it is necessary to have new businesses continuously replenishing the largest source of job creation.

Support programs that aid businesses especially during their first five years would complement strategies targeting start-up. Though volatility and the high rate of failure are consistent with healthy business dynamics and strong economy, the particular challenges that face young

businesses may warrant policy intervention. For example, credit constraints that choke small business growth may best be remedied through loan guarantee programs.

Specific strategies vary at the state and local levels due to institutional differences (e.g., ability to alter prevailing laws) and available resources. In essence, the state is

in a better position to implement some strategies while individual communities are better positioned to pursue other strategies. Providing educational opportunities for people interested in starting a new business or expanding a relatively young business, for example, can vary significantly at the state and local levels. The state has the resources of the UW System and Technical Colleges to steer formal programs, the types of which local communities cannot offer. Yet, community-level efforts through local institutions, such as chambers of commerce and business associations, can offer more informal educational workshops and seminars to help local small and new businesses. Ideally state and local resources are complementary and supportive of each other. The University of Wisconsin-Extension Cooperative Extension county offices, for example, can provide a bridge between state and local educational efforts.

The state also has the authority and resources to create and fund small business start-up financing programs such as loan guarantee programs. Local institutions, again such as community development corporations and chambers of commerce, among others, can help inform local entrepreneurs about the availability and appropriateness of such financing programs.

Local communities can also tap into state resources, including but not limited to the University of Wisconsin, to help conduct local economic analyses for the benefit of potential entrepreneurs. Such information can help identify economic strengths, and weaknesses of the local/regional community as well as the local/regional

comparative advantages, or economic clusters, that local entrepreneurs can use to build business opportunities.

At the community level local, resources can be used to provide technical, and moral support, to young businesses and more importantly people who are interested in starting a new business. Many communities have recruited their local business experts, such as loan officers, accountants, and even information technology experts, to provide free counseling opportunities. Counseling and mentorship can take place in formal and informal workshops or in local business incubators. Networking opportunities where new business owners can learn from each other and more established local business owners are best achieved at the local level.

Communities that network existing business owners with those within the community who are interested in starting a business can help sustain existing businesses. In their research, Ayres, Leistriz and Stone (1992) find that many local Julien-type business owners elect to retire and close the business rather than sell it. Ayres and her colleagues found that in more "successful" communities, existing business owners are networked with those in the community who are interested in going into business for themselves and may be potential buyers. The message of the research was simple, do not close your business, rather, sell your business.

The issue of job quality may be partly addressed by policies that increase the survivability of young firms, but in addition to stability there must be attention to benefits. In the U.S. a relatively small

number of businesses are providing benefits to a disproportionately large share of the workforce. Only about 30% percent of businesses have employees, of those about 60% offer their employees some form of health care coverage, and just

under half offer their full time workers any form of retirement plan (Litwin and Phan 2013, p 836). The implication for workers is that those in jobs that do not offer benefits suffer from a lower standard of living compared to those in jobs with benefits.

Conclusion

Designing and implementing effective policies for job creation requires a careful, nuanced understanding of business dynamics. Supporting new businesses through entrepreneurship may be an especially important aspect of job creation. At the community-level there are countless ways to support would-be entrepreneurs ranging from changing community attitudes, facilitating mentorship and networks, providing education, and making financing available. *Several specific community actions are discussed in detail in the appendix.*

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Appendix

Community Level Strategies for Entrepreneurship

State government can and does play an important role in fostering the creation of new start-up businesses through policies such as simplified tax regimes, streamlined regulatory processes, and investment in entrepreneurship training opportunities through the UW System, Technical Schools, and programs at the high school level. Stability and simplicity of tax code and regulation are more important than the overall tax burden and regulation rigor. Well-implemented and consistent regulator policies actually improve the entrepreneurial environment because it removes levels of risk and uncertainty: the “rules of the game” are established, understandable, and consistent. State government has the resources and comparative advantage to offer financial programs such as low interest and guaranteed loan programs. The state also has the resources to offer planning support and grants to communities seeking a stronger entrepreneurial environment along with the technical resources to help communities move forward with implementation. But much of the real work of creating an environment that is conducive to entrepreneurial activity occurs at the community level. A sampling of strategies those successful entrepreneurial communities have pursued follows.

Community Attitudes

A precondition to assessing the entrepreneurial environment of the community is to determine the attitudes of residents toward small business start-ups and activities. Is the community open to new ideas, including ideas that may not be successful? Many new business ideas do

not meet expectations and many small business owners stumble along the way before their business becomes sustainable. For Wisconsin 51.6% of new start-ups survive through their 5th year meaning that nearly half of new businesses fail. While the trail and error of business start-ups is a valuable learning experience for the business owner, it can sometimes be viewed as a “failure” and in some communities “failure” is akin to “losing” which is frowned upon. A positive **community attitude** toward experimentation, innovation, and risk-taking in business is vital to successful entrepreneurial communities.

- Local government is responsive to the needs of those starting a new business.
- The whole of the community (local government, business associations, development organizations, etc.) is responsible for fostering an entrepreneurial environment: responsibility does not fall to a small group of people or organizations.
- All members of the business community feel comfortable voicing their opinion and are listened to by others, particularly community leaders.
- The community deliberately fosters the growth of leadership amongst new or existing small businesses.
- Local ordinances are conducive to home-based businesses.
- Local media regularly features stories on local businesses.

- The communities maintain an up-to-date inventory of all the businesses by type and size within the community.
- The community at large is willing to experiment with new ideas and learn from their mistakes.
- The community's activities focus on entrepreneurship over business.
- Members of the business community trust each other and have strong relationships.
- The community rejects the "entrepreneurs are born not made" attitude.
- The community thinks "regionally" and actively partners with neighboring communities to foster entrepreneurship and business start-ups.
- There is an ombudsman or mentor who can help guide the new business through the necessary steps of obtaining local permits and licenses.
- The community actively seeks out "outside help" (e.g., UW, WEDC, EDA, etc.) in moving the communities toward being more entrepreneurial.
- People and businesses in the community support locally owned businesses by choosing to spend money with them whenever possible.
- The community continually re-evaluates the services and mentoring programs offered to new businesses.
- Community support systems are geared for all phases of the business life cycle (birth, growth, maturity, spin-off, succession).

- There is a mechanism in place for community leaders, including business leaders, elected officials and concerned citizens, for learning about and acting upon emerging needs of the community's small business owners.

Networking, Mentorship, and Role Modeling

One of the most fundamental strategies in fostering entrepreneurial activity within communities is the facilitation of **networking** opportunities. Many new business owners work in isolation and do not have an adequate support network. These networking opportunities can provide not only "moral support" but also open up learning opportunities and potential business connections.

- There is a viable chamber of commerce or business association that is welcoming to new businesses and members.
- New members are encouraged or mentored to assume leadership roles within the chamber or association.
- People from different parts of the business community get together to exchange information and ideas.
- The chamber of commerce or business association is/are viewed as important parts of the local community and business owners seek out active participation.
- The community has a core group of business professionals willing to provide mentoring and advice to new business owners and managers.
- The chamber of commerce or business association is viewed as a

resource to people thinking of starting a new business and not as a “social club” for existing businesses.

- There is a network for women and minorities in business within the community.
- There is a mechanism in place to help existing businesses transition to new owners-operators.

Education

Many new business owners are passionate about their business and are very adept at producing the good or service that they offer. Unfortunately, many of these new business owners lack the business savvy to manage the business from marketing to financial analysis to managing their human resources. Many new business start-ups can be called Julien-type businesses where the business owner prefers to remain small so that their time can be focused on producing the good or service that they sell and not on business management issues. Indeed, many new businesses fail because of business management errors. The community needs to be proactive in providing **educational** opportunities so that new business owners can minimize the risk of basic management errors. Many schools (UW, Technical Colleges, private colleges, etc.) offer traditional business management classes, but semester long courses are ill-suited for most new business owners. Shorter-term more focused educational seminars/workshops are necessary.

- The chamber of commerce or business association offers educational seminars/workshops for those interested in starting a new business.

- Commercial lenders provide support, such as courses or materials, in preparing for a business loan request.
- Local institutions of higher education (UW, Technical Schools, private colleges) offer short-term intensive training opportunities in basic business management skills and techniques. Examples might be a three-hour Saturday morning workshop on how to use Quicken Books to manage cash flow, billings and receipts or earmark information necessary for tax preparation, or a similar short workshop on how to use social media for marketing.
- The community offers a “quick response” team to help when a new business is struggling: when in doubt about a business decision, there is someone that can be called upon for guidance. These could be retired business owners or existing business professional who volunteer their time and expertise.
- The community has a network of business support services such as accountants, financial, marketing and management advisors that are in a position to help new businesses.
- The public library maintains a current collection of small business support materials.
- Representatives of local school systems are active members of the community small business formation and entrepreneurship team or organization.

Financing

The local small business loan officer at community banks are often the first point of entry into the world of starting a new business for entrepreneurs. Very few new entrepreneurs have sufficient “cash on hand” to fully **finance** the first few years of their new business venture. Most new entrepreneurs must borrow to start their business. Thus, these local small business loan officers are vital to an entrepreneurial community.

- Community financial institutions (banks, savings and loans, credit unions) have embraced the broader community goal of promoting entrepreneurship through business start-ups.
- Local loan officers are networked into community business support and technical assistance groups and freely make referrals.
- Local loan officers are aware of and actively use state and federal small business financing programs.
- There are financial resources available, other than commercial lenders, to invest in new and growing business.
- The community has angel investors interested in working with new businesses.
- The community offers small “planning grants” for people with new business ideas to explore business feasibility and business planning studies. A popular strategy is to hold a “business plan competition” where the winner(s) receive media attention and planning grants to refine their business plan.

These strategies range from the simplistic to the complex and no single strategies is a “magic bullet”. In addition, these are long-term strategies where investments today may not have seeable outcomes for several years. This requires the community to think long-term and not to become frustrated if immediate payoffs are not seen.

Time-Frames

The research is clear, sustainable long-term economic growth requires focusing on smaller businesses, particularly new start-up businesses. The challenge with this approach is twofold. First, although these strategies can be very successful, it can take years before any noticeable changes in the economy are present. A cultural preference for immediate results, tends to push government officials to pursue less sustainable short-term strategies. Second, the success of these types of entrepreneurial focused strategies can be subtle and easily overlooked. Consider two scenarios each where the community experiences 50 new jobs being created. The first one involves 25 new business start-ups each with two employees occurring over a year. The second is a firm moving into the community and creating 50 jobs. The research is clear, the case with more new firm start-ups, even if they are small, is more sustainable in the long-term and will make for a healthier economy. Unfortunately, the 25 new small start-ups are likely to go unnoticed yet the one larger firm moving into the community will garner significant attention. The challenge we face is being patient and thinking long-term.