

# MEASURING THINGS: DO MOST SMALL BUSINESSES FAIL?

By Joseph W. Duncan

Do most new businesses fail early on in their existence? The common understanding is that they do—that, for example, half of all new businesses fail in their first year, two-thirds in the first three years, and nearly four out of five by the fifth year. Data from Dun & Bradstreet's market research database demonstrate, however, that these common perceptions are wrong. In fact, two-thirds of most "real" businesses that start up survive for at least several years (Figure 1).

The problem with evaluating the staying power of businesses is often related to the problem of identifying what is a start-up. There is no official register or definition of new businesses. There is a gray area between firms undertaking activities normally associated with a business and individuals merely acting to sell their own labor. Any definition of what constitutes a business must define the boundary between these two areas.

Another gray area concerns the distinction between the discontinuance of a business and an actual business failure. A business *failure* is defined as a closure where a loss to creditors is involved. A *discontinuance* is when a business closes for any other reason. Many more firms discontinue their operations (23%) than fail (10%) for a variety of reasons. A firm may not be generating a sufficient return on capital vis-a-vis other uses of resources. The firm's owner may retire, sell the business, or simply terminate operations because the firm's business plan has been fulfilled.

The usual economic and tax-related statistics, such as from IRS tax returns, are no help in either identifying new businesses or isolating discontinuances on a

timely basis. For example, often an incorporation is reported as a shell for a potential new idea, as a legal protection for a current activity, or as a subdivision of a business to restrict liability (e.g., each cul de sac in a housing development is separately incorporated to limit risks such as foundation failures). Even more typical is the individual who declares a business based on casual activity conducted from the kitchen or study (e.g., an activity to manage modest investments or rental property) with the major intent to collect expenses as tax deductions. In between are

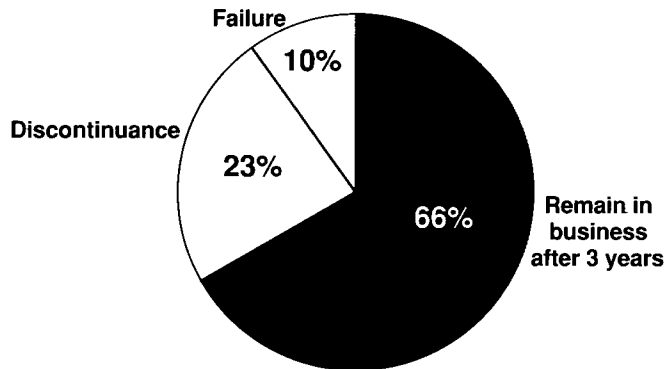
the idea was never workable. While no data exist, undoubtedly many of these casual businesses *do fail* in the first three years of life.

Dun & Bradstreet tracks *real* business organizations—that purchase supplies, sell products, or otherwise merit a review of their importance, reliability, resources, etc. The gap between the number of real businesses and casual ones is enormous. The IRS reported tax returns on about 19.5 million businesses in 1989. Dun & Bradstreet had records on about 9 million firms concurrently. The Dun & Bradstreet firms accounted for 98% of reported employment and 97% of reported assets and sales. Thus, while there are a large number of casual businesses, in aggregate they account for a negligible piece of the economy.

If one separates the real business enterprises from the casual, one gains a completely different picture about births and deaths of firms. Clearly, from the point of view of contribution to Gross Domestic Product or generation of significant employment, the real firms merit close attention. While the data are limited, it is clear that when entrepreneurs start

a real business they stick with it for a substantial period of time. The old adage that four out of five small businesses fail in their first five years may be fact for casual businesses, but for real ones, it's just plain fiction.

Figure 1  
Outcome of Business Start-ups



Source: Data provided by Dun & Bradstreet.

sole proprietorships where a carpenter may sell some personal services on a part-time basis, while being fully employed by a construction firm. Of course there are also "off the record" business activities like bartered services that are undertaken to avoid tax liability. Separating a genuinely new business from one that has metamorphosed in some manner, such as a transfer of ownership, change of name or relocation, is also exceedingly difficult.

When all of these *casual* or paper businesses are considered, the picture may be quite different because the start-up was not real, the effort was not sustained, or

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