The True Failure Rate of Small Businesses



Understanding how and why businesses fail can help prepare you for success.

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Have you heard that 90 percent of new businesses fail? Or that 50 percent of new businesses fail? Stick around in the entrepreneurial community long enough and you'll likely hear a wide spectrum of claims, mostly falling between these two extremes.

But what is the true failure rate of small businesses? And should it influence your decisions as an entrepreneur?

What we know about the failure rate of small businesses

According to data from the Bureau of Labor Statistics, as reported by Fundera, approximately 20 percent of small businesses fail within the first year. By the end of the second year, 30 percent of businesses will have failed. By the end of the fifth year, about half will have failed. And by the end of the decade, only 30 percent of businesses will remain — a 70 percent failure rate.

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Of course, we have to accept several caveats in these data. Here are some common variables.

- **Definition of failure.** This study relies on a fixed number of reported businesses. If a business no longer exists a year later, it's counted as a "failure." But there may be entirely valid reasons for the business no longer existing. The owner may be interested in retiring, for example, and chooses to close the business rather than try to sell it or transition ownership; it's hardly fair to count this as the failure of the business.
- **Annual variance.** As you might expect, there's some variance from year to year, based on economic conditions. The data reported above applied to businesses studied from around 2007 to 2017. It does seem like many of these percentages remain relatively consistent; we might see the failure rate for a single year vary between 15 and 25 percent, but it's not likely to spike or plummet. There are a few exceptions to this, which brings us to our next point.
- **Outlier events.** Major outlier events can significantly change the failure rate for businesses, for better or for worse. For example, the Covid-19 pandemic has

created harsh economic conditions for many industries, including bars, restaurants, nightclubs, and other niches dependent on close physical interaction. Failure rates are exceptionally high for 2020, though we don't have all the figures yet.

- **Industry variance.** Unsurprisingly, the failure rate varies significantly from industry to industry. Health-care businesses and organizations tend to have a failure rate that's lower than average since the demand for health-care services is high, consistent and steadily increasing. At the other end of the spectrum, failure rates for warehousing and transportation businesses are high; presumably, this is because of high start-up costs and a competitive marketplace. In the middle are businesses such as SEO companies and other marketing firms; they offer low start-up costs, but demand may vary due to market conditions or high competition.
- **Reporting.** We also need to be wary of errors in reporting. Some small businesses may not be counted in these metrics due to operating in secret or because of clerical oversights. Other businesses may be counted but may not operate like typical businesses.
- **Business health.** Businesses may survive even when performing suboptimally. Many "successful" businesses in this report may be dangling by a thread.

Why the failure rate matters

Some people wield small-business failure statistics as a tool for discouragement; they want to warn would-be entrepreneurs about the dangers of starting a business. But there's a more useful way to study and learn from statistics like these.

For starters, the failure rate gives you an idea of how and when businesses tend to fail. Only 20 percent fail within the first year but 50 percent fail within the first five years. In other words, an additional 30 percent of businesses will fail

between years 2 and 5, or about 7.5 percent of the initial amount per year. If we assume a kind of “death by natural causes” and take that 7.5 percent figure as a predictable rate of failure, we can assume about 12.5 percent of businesses in the first year fail due to lack of preparation in one way or another. If you’re better prepared than the bottom eighth of business owners, you’re in good shape.

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This is also useful for calculating risk, especially if you apply this risk to your personal life. We tend to be optimistic when evaluating our own endeavors due to the overconfidence effect, but statistics can keep us realistic and pragmatic. If we assume a 20 percent failure possibility for our business in year 1, we should be distributing our investments and our time accordingly; we need to balance our risk profile to protect us in the event of failure.

Why people overestimate the failure rate

I also want to acknowledge that whenever failure statistics are misrepresented, they’re usually inflated. In other words, people have a tendency to exaggerate the failure rate of small businesses. Why? It might be a conservative way to taper expectations, or it might play into the desire to discourage would-be entrepreneurs. Either way, we need to be cautious of people who confidently assert a trivial “truth” about business ownership.

Small businesses do fail somewhat often, to the point where you basically have a 50/50 shot of surviving past year 5. But it’s important to take statistics for what they are, to understand their context and to not allow them to unfairly discourage you from pursuing the development of your business.

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