

**Congress of the United States**  
**U.S. House of Representatives**  
**Committee on Small Business**  
2361 Rayburn House Office Building  
Washington, DC 20515-0515

To: Members, Subcommittee on Contracting and Workforce, Committee on Small Business  
From: Committee Staff  
Date: September 5, 2014  
Re: Subcommittee Hearing: *“The Decline in Business Formation: Implications for Entrepreneurship and the Economy”*

---

## **I. Hearing Overview**

On Thursday, September 11, 2014, at 10:00 am in Room 2360 of the Rayburn House Office Building, the Subcommittee on Contracting and Workforce will meet for the purpose of receiving testimony on the decline in the rate of new business creation. The hearing will examine the causes and implications of this trend and discuss various ideas to reinvigorate entrepreneurship in the United States.

## **II. The Importance of Business Dynamism to the Economy**

According to economists, the United States experienced an economic recession from December 2007 through June 2009.<sup>1</sup> This event, often referred to as the “Great Recession,” lasted 18 months and was the longest economic downturn experienced in the United States since World War II.<sup>2</sup> Since that time, America has experienced significant economic challenges including high unemployment levels<sup>3</sup> and a stagnant economy that has yet to rebound in a truly meaningful way especially the reduction in so-called “business dynamism.”<sup>4</sup>

In a flexible, non-stagnant economy there are “opportunities for businesses to enter the market or expand, but it also allows businesses to fail or contract.”<sup>5</sup> However, the rate of new business creation has dropped by nearly fifty percent from 1978.<sup>6</sup>

---

<sup>1</sup> NATIONAL BUREAU OF ECONOMIC RESEARCH, BUSINESS CYCLE DATING COMMITTEE REPORT 1 (2010) *available at* <http://www.nber.org/cycles/sept2010.pdf>. It is important to note this organization is not affiliated with the federal government.

<sup>2</sup> *Id.*

<sup>3</sup> The unemployment rate topped 10 percent in October 2009. It remained above 9 percent for 30 months. BUREAU OF LABOR AND STATISTICS, LABOR FORCE STATISTICS FROM THE CURRENT POPULATION SURVEY (Aug. 2014), *available at* <http://data.bls.gov/timeseries/LNS1400000>.

<sup>4</sup> Binyamin Appelbaum, *U.S. Economic Recovery Looks Distant as Growth Stalls*, N.Y. TIMES, June 11, 2014, *available at* [http://www.nytimes.com/2014/06/12/business/economy/us-economic-recovery-looks-distant-as-growth-lingers.html?hp&\\_r=1](http://www.nytimes.com/2014/06/12/business/economy/us-economic-recovery-looks-distant-as-growth-lingers.html?hp&_r=1); accord INTERNATIONAL MONETARY FUND, WORLD ECONOMIC OUTLOOK: CRISIS AND RECOVERY 110-111 (2009), *available at* <https://www.imf.org/external/pubs/ft/weo/2009/01/pdf/c3.pdf> (noting that on average recessions last for a year and the economy typically recovers to peak outfit in less than a year).

<sup>5</sup> Rob Grunewald, *A Dynamic Economy Means Churning Employment*, FEDGAZETTE, Mar. 1, 2005, *available at* [https://www.minneapolisfed.org/publications\\_papers/pub\\_display.cfm?id=1532&](https://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=1532&).

Business dynamism – where “firms continually are born, fail, expand, and contract,”<sup>7</sup> – is an “inherently disruptive”<sup>8</sup> process that is critical to long-term economic growth and the health of the economy.<sup>9</sup> Frequently, business dynamism also is referred to as creative destruction.<sup>10</sup> In a dynamic economy, newer, more efficient processes and technologies supplant older, less efficient processes and technologies. Often, these technological developments are spearheaded by new firms competing with older established firms utilizing older technologies. Overtime, the new firms gain market share from the older firms who either must invest in the new technology to stay competitive or eventually exit the market. One result of this process is a shift in employment from older firms to newer firms.<sup>11</sup>

The data on new firm creations already cited in this memorandum shows a decline in business dynamism during the past three decades but with significant drop off since 2006.<sup>12</sup> Notably, for the first time in over 30 years, the number of business deaths exceeds the number of business births.<sup>13</sup> As the United States fails to engage in this dynamic cycle of business birth and death, there is a significant reduction in job creation which perforce contributes to a weakened economy.

### III. Business Dynamism, New Firms, and Job Creators

The ability of new firms to spur job creation is well-established. “Since 1977, newly-born companies usually create a net 3 million jobs per year,”<sup>14</sup> but in 2010 this number fell to 2.34 million.<sup>15</sup> Given the importance of new firms to overall job creation, particularly following

---

<sup>6</sup> IAN HATHAWAY, MARK E. SCHWEITZER, AND SCOTT SHANE, FEDERAL RESERVE BANK OF CLEVELAND, THE SHIFTING SOURCE OF NEW BUSINESS ESTABLISHMENTS AND NEW JOBS 2 (2014), *available at* <http://www.clevelandfed.org/research/commentary/2014/2014-15.pdf>. In 1978, there were 12 new businesses created for each existing business while in 2011 there were only 6.2 new firms created for each established business. *Id.*

<sup>7</sup> IAN HATHAWAY & ROBERT E. LITAN, BROOKINGS INSTITUTION, DECLINING BUSINESS DYNAMISM IN THE UNITED STATES: A LOOK AT STATES AND METROS Abstract (2014), *available at* [http://www.brookings.edu/~media/research/files/papers/2014/05/declining%20business%20dynamism%20litan/declining\\_business\\_dynamism\\_hathaway\\_litan.pdf](http://www.brookings.edu/~media/research/files/papers/2014/05/declining%20business%20dynamism%20litan/declining_business_dynamism_hathaway_litan.pdf).

<sup>8</sup> *Id.* at 1-2.

<sup>9</sup> *Id.* at 1-2.

<sup>10</sup> *Id.* at 2.

<sup>11</sup> The primary economic benefit of business dynamism is “a more efficient allocation of goods and services relative to demand the resources required to produce them.” Grunewald, *supra* note 5. Further, this process allows “productivity gains by which more productive firms drive out less productive ones, new entrants disrupt incumbents, and workers are better matched with firms.” HATHAWAY AND LITAN, *supra* note 7, at 2. As a result of productivity gains, businesses may become more profitable, increase output, and have the capacity to hire new workers at increased wages. Thus, business dynamism leads to productivity gains which leads to increased employment at higher wages resulting in economic expansion.

<sup>12</sup> HATHAWAY AND LITAN, *supra* note 7, at 2.

<sup>13</sup> *Id.* (latest available data is from 2011).

<sup>14</sup> TIM KANE, HUDSON INSTITUTE, THE COLLAPSE OF STARTUPS IN JOB CREATION 2 (2012), *available at* <http://www.hudson.org/content/researchattachments/attachment/1067/kane--thecollapseofstartupsinjobcreation0912web.pdf>.

<sup>15</sup> *Id.* Traditionally small businesses are viewed as driving private sector job creation and account for approximately 63 percent of net new job creation. OFFICE OF ADVOCACY, UNITED STATES SMALL BUSINESS ADMINISTRATION, FREQUENTLY ASKED QUESTIONS (Mar. 2014 ) *available at*

recessions, “even modest slowdowns in the creation of new businesses could significantly reduce overall employment growth.”<sup>16</sup>

Typically, new firms remain small and engage in the process of creative destruction by exiting the market within their first ten years.<sup>17</sup> However, recent studies demonstrate that “a small fraction of young firms exhibit very high growth and contribute substantially to job creation.”<sup>18</sup> Research by the Kauffman Foundation found that “fast-growing young firms, comprising less than 1 percent of all companies, generate roughly 10 percent of new jobs in any given year.”<sup>19</sup> These firms generally “create about twenty-seven jobs per year, with most growing to a size of about twenty to ninety-nine employees.”<sup>20</sup>

The foregoing demonstrates the importance of business dynamism; the process enables the creation of high-growth new firms and spurs job creation. The decline in entrepreneurial job creation to 7.8 percent under the current Administration should be cause for concern of whether appropriate policies are in place to catalyze the dynamism needed by the American economy.<sup>21</sup>

#### IV. Potential Reasons and Solutions to Combat A Decline in New Firms

The consequences of this trend include less entrepreneurial activity, fewer net new jobs, and a decline in productivity. Each of these is essential to improving living standards and the overall competitiveness of the United States economy. Experts are divided on the cause of the decline in business dynamism. During the 113<sup>th</sup> Congress, the Committee on Small Business has held hearings examining several potential causes and ideas for solutions, a few of which will now be discussed.<sup>22</sup>

##### *a. Lack of a Skilled Workforce*

---

[http://www.sba.gov/sites/default/files/advocacy/FAQ\\_March\\_2014\\_0.pdf](http://www.sba.gov/sites/default/files/advocacy/FAQ_March_2014_0.pdf). However, as most newly-born firms start out small there is substantial and overlapping link between the small firms and new firms for job creation.

<sup>16</sup> LIZ LADERMAN & SYLVAIN LEDUC, FEDERAL RESERVE BANK OF SAN FRANCISCO, ECONOMIC LETTER, SLOW BUSINESS START-UPS AND THE JOB RECOVERY (July 2014), available at <http://www.frbsf.org/economic-research/publications/economic-letter/2014/july/startups-job-growth-recovery-housing-prices/>.

<sup>17</sup> Ryan Decker, John Haltiwanger, Ron Jarmin, and Javier Miranda, *The Role of Entrepreneurship in US Job Creation and Economic Dynamism*, 28 J. OF ECON. PERSPECTIVES 3, 4 (Summer 2014), available at <http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.28.3.3>.

<sup>18</sup> *Id.*

<sup>19</sup> DANE STANGLER, EWING MARION KAUFFMAN FOUNDATION, HIGH-GROWTH FIRMS AND THE FUTURE OF THE AMERICAN ECONOMY 2 (2010), available at <http://www.kauffman.org/uploadedfiles/high-growth-firms-study.pdf>.

<sup>20</sup> *Id.* at 6.

<sup>21</sup> KANE, *supra* note 14, at 2-3. In contrast, “the average rate for entrepreneurial job creation under the previous three presidents was 11.3, 11.2, and 10.8 respectively.” *Id.* at 2.

<sup>22</sup> The examples discussed in the text are not the sole or exclusive causative agents of the decline in business dynamism. Other topics considered by the Committee such as limitations on small business access to capital also contribute to flattening of the business dynamic cycle.

A skilled workforce is an essential foundation for economic growth and a key input to the knowledge economy.<sup>23</sup> However, existing small businesses report difficulty in finding and recruiting employees with the requisite skills for the positions they have available.<sup>24</sup> This workforce shortage is especially acute in the science, technology, engineering and mathematics (STEM) fields, where a good number of students earning advanced STEM degrees at United States universities are aliens in the United States on a temporary visa.<sup>25</sup> On April 25, 2013, the Subcommittee on Contracting and Workforce held a hearing on STEM workforce shortages and immigration reform.<sup>26</sup> While the solutions to this problem vary and may include immigration reform, the clear message is that a shortage of skilled workers contributes to the decline in new firm creation.<sup>27</sup>

### *b. Complexity and Unpredictability of the Tax Code*

The complexity of the tax code has always been problematic for small firms. This has now been compounded with the temporal nature of the code; tax relief often being extended for one year, for months at a time or even retroactively. Taxpayers, and particularly small business owners, complain that this uncertainty exacerbates the difficulty in their ability to plan for future personnel and capital investments. On April 10, 2013, the Committee held a hearing on small business tax reform,<sup>28</sup> and on April 9, 2014, the Committee held a hearing examining the biggest tax challenges facing small firms.<sup>29</sup> The solutions to easing tax complexity as discussed in the aforementioned hearings vary but the key appears to be certainty so that entrepreneurs can effectively plan.

### *c. Increased Regulatory Burdens*

Further, the Committee has frequently heard of the ramifications of various regulations on small businesses. By virtue of their size and resources, small businesses are disproportionately burdened by the cost of regulations in comparison to their larger counterparts. Recently, the Committee has held several hearings on proposed various regulations such as the

---

<sup>23</sup> NEIL RUIZ, JILL WATSON & SHYAMALI CHOUDHURY, THE SEARCH FOR SKILLS: DEMAND FOR H-1B IMMIGRANT WORKERS IN U.S. METROPOLITAN AREAS 2 (2012), available at <http://www.brookings.edu/~media/research/files/reports/2012/7/18%20h1b%20visas%20labor%20immigration/18%20h1b%20visas%20labor%20immigration.pdf>.

<sup>24</sup> NATIONAL FEDERATION OF BUSINESS, SMALL BUSINESS ECONOMIC TRENDS 1 (Aug.2014), available at <http://www.nfib.com/Portals/0/PDF/sbet/sbet201408.pdf>.

<sup>25</sup> INFORMATION TECHNOLOGY INDUSTRY COUNCIL, PARTNERSHIP FOR A NEW AMERICAN ECONOMY & U.S. CHAMBER OF COMMERCE, HELP WANTED: THE ROLE OF FOREIGN WORKERS IN THE INNOVATION ECONOMY 17 (2012), available at <http://www.uschamber.com/sites/default/files/reports/STEM%20Report%20901.pdf>.

<sup>26</sup> *STEM Workforce and Immigration Reform: Hearing Before the Subcommittee on Contracting and Workforce of the House Comm. on Small Business*, 113<sup>th</sup> Cong. (2013), available at <http://smallbusiness.house.gov/calendar/eventsingle.aspx?EventID=325620>.

<sup>27</sup> JOHN DEARIE & COURTNEY GEDULDIG, WHERE THE JOBS ARE: ENTREPRENEURSHIP AND THE SOUL OF THE AMERICAN ECONOMY 31-72 (2013).

<sup>28</sup> *Small Business Tax Reform: Growth Through Simplicity: Hearing Before the House Comm. on Small Business*, 113<sup>th</sup> Cong., 1<sup>st</sup> Sess. (2013), available at <http://smallbusiness.house.gov/calendar/eventsingle.aspx?EventID=325471/>.

<sup>29</sup> *The Biggest Tax Problems for Small Business: Hearing Before the House Comm. on Small Business*, 113<sup>th</sup> Cong., 2<sup>nd</sup> Sess. (2014), available at <http://smallbusiness.house.gov/calendar/eventsingle.aspx?EventID=373095>.

Waters of the United States Rule on May 29, 2014.<sup>30</sup> Additionally, as occupational licensing has become more prevalent the burden is shifting as potential entrepreneurs struggle to even obtain the necessary credentials to open a firm.<sup>31</sup> A June 2014 study even found occupational licensing was the number one regulatory burden facing small firms.<sup>32</sup> On July 16, 2014, the Committee held a hearing which examined the role that the Federal Trade Commission (FTC) plays in combatting the rise of unnecessarily restrictive occupational licensure in the states through the enforcement of federal anti-trust laws. Prior to that hearing, on March 26, 2014, the Subcommittee on Contracting and Workforce examined whether the public safety benefits and assurances of competency provided by state licensure requirements outweigh the costs borne by society due to less competition, innovation, and job creation.<sup>33</sup> As evidenced in those hearings, the rise in occupational licensing contributes to a decrease in new firm formation and solutions vary from potential federal action through anti-trust laws to state and local level policies solutions which make it easier for entrepreneurs to enter various fields and start businesses.

## V. Conclusion

As discussed above, there is a disturbing trend which demonstrates a drop in entrepreneurship and the creation of new firms. While the economic impact of this trend is significant, the exact causes and potential solutions are debated among academics, economists, entrepreneurs, policymakers, and other interested parties. Despite this, it is clear that as we seek to promote economic growth and restore America's prosperity that items under the purview of the federal government, such as onerous federal regulations and a complex tax code, do not negate and deter the entrepreneurial spirit in the United States.

---

<sup>30</sup> *Will EPA's 'Waters of the United States' Rule Drown Small Businesses?: Hearing Before the House Comm. on Small Business*, 113<sup>th</sup> Cong., 2<sup>nd</sup> Sess. (2014), available at <http://smallbusiness.house.gov/calendar/eventsingle.aspx?EventID=373099>.

<sup>31</sup> In 1950, fewer than 5 percent of all occupations were licensed at the state level; yet today, an estimated 29 percent of occupations are licensed, or approximately 1 in 3 occupations. Morris M. Kleiner and Alan B. Krueger, *The Prevalence and Effects of Occupational Licensing*, 48 BRIT. J. INDUS. REL. 651, 679 (2010), available at [http://www.hhh.umn.edu/people/mkleiner/pdf/Prevalence\\_of\\_Occupational\\_licensing.pdf](http://www.hhh.umn.edu/people/mkleiner/pdf/Prevalence_of_Occupational_licensing.pdf); accord DICK M. CARPENTER, ET. AL., THE INSTITUTE FOR JUSTICE, LICENSE TO WORK: A NATIONAL STUDY OF THE BURDENS FROM OCCUPATIONAL LICENSING 6 (2012), available at [https://www.ij.org/images/pdf\\_folder/economic\\_liberty/occupational\\_licensing/licensetowork.pdf](https://www.ij.org/images/pdf_folder/economic_liberty/occupational_licensing/licensetowork.pdf).

<sup>32</sup> <http://www.thumbtack.com/survey#/2014/1/states>; see e.g., Gabrielle Karol, *Survey: Licensing Regulations Biggest Pain for SMBs*, FOXBUSINESS, June 11, 2014, available at <http://smallbusiness.foxbusiness.com/finance-accounting/2014/06/11/survey-licensing-regulations-biggest-pain-for-smbs/>.

<sup>33</sup> *Barriers to Entrepreneurship: Examining the Anti-Trust Implications of Occupational Licensing: Hearing Before the House Comm. on Small Business*, 113<sup>th</sup> Cong., 2<sup>nd</sup> Sess. (2014), available at <http://smallbusiness.house.gov/calendar/eventsingle.aspx?EventID=384426>; *Barriers to Opportunity: Do Occupational Licensing Laws Unfairly Limit Entrepreneurship and Jobs: Hearing Before Subcomm. on Contracting and Workforce of the H. Comm. on Small Business*, 113<sup>th</sup> Cong., 2<sup>nd</sup> Sess. (2014).