

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2501 Rayburn House Office Building
Washington, DC 20515-6515

Memorandum

To: Members, Committee on Small Business
From: Committee Staff
Date: July 17, 2017
Re: Hearing: "Reversing the Entrepreneurship Decline"

On Wednesday, July 19, 2017 at 11:00 A.M., the Committee on Small Business will meet in Room 2360 of the Rayburn House Office Building for the purpose of examining the decline of entrepreneurship in the United States. The hearing will provide the Committee with an opportunity to understand the entrepreneurship trends, challenges, and opportunities that exist in the United States. This hearing will also examine how entrepreneurship influences leading economic indicators and potential solutions to promote new and existing small businesses.

I. Recent Entrepreneurship Trends

In 2015, 679,072 new businesses were established in the United States.¹ These businesses created 3 million jobs.² Because the average new business created in 2015 had roughly 4.5 employees, almost all new businesses fit the criteria to be considered a small business.³

Entrepreneurship and the formation of new businesses has declined by almost 50 percent since 1978.⁴ The rate of the decline accelerated during and immediately after the Great Recession, and in 2010, there were more business deaths than births.⁵ The businesses created

¹ U.S. DEP'T OF LABOR, BUREAU OF LABOR STATISTICS, ENTREPRENEURSHIP AND THE UNITED STATES ECONOMY, NUMBER OF ESTABLISHMENTS LESS THAN 1 YEAR OLD, MARCH 1994–MARCH 2015 (2016) [hereinafter Startup Statistics], available at https://www.bls.gov/bdm/entrepreneurship/bdm_chart1.htm.

² UNITED STATES DEP'T OF LABOR, BUREAU OF LABOR STATISTICS, ENTREPRENEURSHIP AND THE UNITED STATES ECONOMY, BUSINESS ESTABLISHMENT AGE (2016), available at <https://www.bls.gov/bdm/entrepreneurship/entrepreneurship.htm>.

³ *Id.* There are numerous ways the Federal government defines "small business." For the purposes of this memorandum, we will use the Small Business Office of Advocacy definition of a small business as an independent business having fewer than 500 employees. SMALL BUSINESS ADMINISTRATION, OFFICE OF THE CHIEF COUNSEL FOR ADVOCACY, FREQUENTLY ASKED QUESTIONS 1 (2016) [hereinafter Advocacy FAQ], available at https://www.sba.gov/sites/default/files/advocacy/SB-FAQ-2016_WEB.pdf.

⁴ 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. 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 <https://www.clevelandfed.org/newsroom-and-events/publications/economic-commentary/2014-economic-commentaries/ec-201415-the-shifting-source-of-new-business-establishments-and-new-jobs.aspx>.

⁵ According to the Federal Reserve, the Great Recession lasted from December 2007 until June 2009. https://www.federalreservehistory.org/essays/great_recession_of_200709. 1 UNITED STATES DEP'T OF LABOR, BUREAU OF LABOR STATISTICS, ENTREPRENEURSHIP AND THE UNITED STATES ECONOMY, QUARTERLY ESTABLISHMENTS BIRTHS AND DEATHS, 1993-2015 (2016), available at https://www.bls.gov/bdm/entrepreneurship/bdm_chart5.htm.

just after the Great Recession were also concentrated in a select few metropolitan areas. From 2010-2014, there were only 166,460 net new startups created; half of which were located in 20 counties.⁶ On the contrary, from 1992 to 1996, there were approximately 420,850 net new startups created; half of which were located across 125 counties in the United States. Additionally, the population in 1992 was only 83 percent of the United States population in 2010, meaning the business formation rate per capita has fallen considerably.⁷

Although the general entrepreneurship landscape may appear bleak, recent trends indicate that entrepreneurship and business formation are slowly improving. According to the 2016 Kauffman Index of Entrepreneurship Series, startup activity, local small business activity, and the growth of entrepreneurship have all recovered since the Great Recession.⁸ Also, the survival rate of new businesses after their first five years in operation fully recovered by 2014.⁹ While these are positive indicators toward improved entrepreneurship, these recent statistics still exist within the previously mentioned long-term decline in entrepreneurship.¹⁰ Therefore, it is important to further understand how depressed entrepreneurship can affect broader issues in the United States economy.

II. Entrepreneurship and Economic Indicators

Entrepreneurship has a pronounced positive effect on economic growth and other primary economic indicators. One of the first individuals to make the connection between entrepreneurship and economic growth was famed 18th century economist, Adam Smith, who said that entrepreneurship would lead to an increase in innovation, productivity, and economic growth.¹¹ Although Adam Smith's theory was published back in 1776, the correlation between entrepreneurship and economic growth can be seen in the United States today. In 1997, the number of businesses less than one year old per capita was ten percent higher than in 2015.¹² Although the GDP growth rate was an impressive 4.5 percent in 1997, the decline in business formation coincided with an anemic GDP growth rate of 2.6 percent in 2015.¹³

The connection between entrepreneurship and innovation also holds true today. According to a report issued by the Small Business Administration Office of Advocacy, in 2002 small businesses invented and managed an average of 10.01 products, and large businesses

⁶ ECONOMIC INNOVATION GROUP, THE NEW MAP OF ECONOMIC GROWTH AND RECOVERY (2016) [hereinafter EIG Map], available at <http://eig.org/recoverymap#mapBusiness>.

⁷ This number was calculated using the June 1992 population of 256 million and the June 2010 population of 309 million. <http://www.census.gov/data/datasets/2016/demo/popest/nation-total.html>, <http://www.census.gov/data/datasets/time-series/demo/popest/intercensal-1990-2000-national.html>.

⁸ EWING MARION KAUFFMAN FOUNDATION, KAUFFMAN INDEX ENTREPRENEURSHIP SERIES (2017), available at <http://www.kauffman.org/kauffman-index/profiles?loc=US&name=united-states&breakdowns=startup-activity|overall,main-street|overall,growth|overall#indicator-panel-se-index>.

⁹ *Id.*

¹⁰ *State of the Small Business Economy: Hearing Before the H. Comm. on Small Business*, 115th Cong. (2017) (testimony of Victor Hwang), available at <https://www.govinfo.gov/content/pkg/CHRG-115hhrg24071/pdf/CHRG-115hhrg24071.pdf>.

¹¹ Randall G. Holcombe, *Entrepreneurship and Economic Growth*, MISES INSTITUTE, QUARTERLY JOURNAL OF AUSTRIAN ECONOMICS (July 30, 2014), available at <https://mises.org/library/entrepreneurship-and-economic-growth>.

¹² This number was calculated by using the number of businesses established in 1997 (639,114) and in 2015 (679,072) divided by the population in the United States during that time (272,647,000 in 1997 and 322,060,000 in 2015). Startup Statistics, *supra* note 1. UNITED STATES CENSUS BUREAU, UNITED STATES POPULATION CLOCK, (2017,) available at <https://www.census.gov/popclock/>.

¹³ U.S. DEP'T OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS, NATIONAL ECONOMIC ACCOUNTS, (2017) available at <https://www.bea.gov/national/>.

invented and managed an average of 21.44 products.¹⁴ Although larger businesses invented roughly twice as many products, the products-to-employee ratio was significantly higher for small businesses than their larger counterparts. In terms of the number of patents obtained per dollar spent on research and development (R&D), small-young businesses obtained 2.41 times more patents than large-young businesses for every dollar spent on R&D, and small-young businesses obtained 2.5 more patents than small-old businesses.¹⁵ This means that larger and older businesses have to invest more in research and development to produce the same amount of innovation as smaller and younger businesses.

Entrepreneurship is also a primary contributor to job creation. Business startups account for about 20 percent of gross job creation, and high-growth businesses account for almost half of gross job creation in the United States.¹⁶ Furthermore, with small businesses accounting for 63 percent of net new job creation, it is the younger and smaller businesses that propel not only economic growth and innovation, but also job growth in the United States.¹⁷

III. Barriers to Entrepreneurship

Clearly, there are inherent benefits associated with a healthy entrepreneurship sector. Consequently, when entrepreneurship declines, economic growth, innovation, and job creation suffer. Although there are several issues limiting entrepreneurship, three of the most significant barriers on which the Committee has heard testimony are access to capital, tax burdens, and regulatory compliance costs.

Access to capital is a vital component to starting and operating a business. Although total business loans have increased since 2009, small business loans at commercial banks have declined by 15 percent since before the Great Recession.¹⁸ In a 2017 report from the Federal Reserve, 67 percent of small businesses reported financing shortfalls, while only 45 percent of larger firms were confronted with the same issue.¹⁹ Although alternative methods of acquiring capital have grown in popularity in recent years, venture capital has been disproportionately concentrated in a few metropolitan areas. In 2015, 78 percent of the country's venture capital investment was centered in California, Massachusetts, and New York.²⁰ Additionally, 8 of the top 20 counties for business formation from 2010 to 2014 were in either California or New York.²¹ Addressing financing shortfalls would help to start and to keep businesses operating. Making it easier for small businesses and entrepreneurs to obtain capital from banks, venture capital, or other sources would remove a significant obstacle for businesses that are just starting or are struggling to keep up with costs.

¹⁴ JOSE PLEHN-DUJOWICH, PRODUCT INNOVATIONS BY YOUNG AND SMALL FIRMS, SBA OFFICE OF ADVOCACY 11 (2013), available at <https://www.sba.gov/sites/default/files/files/rs408tot.pdf>.

¹⁵ *Id.*

¹⁶ Ryan Decker, John Haltiwanger Ron Jarmin & Javier Miranda, *The Role of Entrepreneurship in US Job Creation and Economic Dynamism*, J. OF ECON. PERSPECTIVES 28:3 (2014), available at <http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.28.3.3>.

¹⁷ Advocacy FAQ, *supra* note 3.

¹⁸ Kelsey Reichow, *Small-Business Lending Languishes as Community Banking Weakens*, FEDERAL RESERVE BANK OF DALLAS, Economic Letter 12:3 (2017), available at <https://www.dallasfed.org/research/ecllett/>.

¹⁹ Press Release, Federal Reserve Bank of New York, Federal Reserve Banks Release First-Ever National Findings from the Small Business Credit Survey (April 11, 2017), available at https://www.newyorkfed.org/newsevents/news/regional_outreach/2017/an170411.

²⁰ National Venture Capital Association, *Yearbook 2016* (2016).

²¹ EIG Map, *supra* note 6.

Tax burdens and complexities are also an inhibitor to starting a business. In the current tax system, the smallest businesses also have the highest proportional tax burden. Businesses with more than 50 employees have a tax burden of about \$182 to \$191 per employee, but businesses with 5 employees or fewer face burdens about \$4,308 to \$4,736 per employee.²² Also, in order to start a business, many entrepreneurs run losses before eventually turning a profit.²³ However, the current system imposes a larger tax burden on businesses that take longer to turn a profit.²⁴ This discourages long term investments in favor of short term investments that turn profits faster. By allowing businesses to increase a carried-forward net operating loss deduction, losses could either be claimed immediately or in the future, which could promote more investment in projects that need more time to come to fruition.²⁵ By ensuring the tax system does not favor the size of the business or the length of time it takes to turn a profit, smaller and more innovative businesses would be more likely to thrive to research the products and ideas of tomorrow.

Regulatory burdens are yet another barrier that disproportionately affects smaller and newer businesses. In a 2017 Gallup poll, government regulation was listed as the top concern for small businesses and entrepreneurs.²⁶ Also, in a ranking of countries by how regulations affect starting a business, the United States came in 51st, with countries like Greece and Chile receiving similar scores.²⁷ Regulation harms small businesses, entrepreneurship, and dampens the inherent benefits associated with a thriving small business and entrepreneurship sector.

IV. Solutions to Improving Entrepreneurship

Although there are several barriers to entrepreneurship, there are also several potential solutions to help increase entrepreneurship. For example, improving access to broadband internet across the country could mitigate the geographic concentration of entrepreneurship. According to the 2016 progress report by the Federal Communications Commission (FCC), 10 percent of all Americans, 39 percent of rural Americans, and 66 percent of Americans living in U.S. territories lack access to adequate broadband.²⁸ With retail sales from e-commerce growing from \$36.5 billion in the second quarter of 2008 to \$105.7 billion in the first quarter of 2017, e-commerce is quickly becoming the predominant platform for how Americans purchase goods. However, if a sizable percentage of the population lacks the infrastructure to buy or sell goods online, businesses can lose out on potential customers, and some customers may not be able to transact with businesses they would like to purchase goods from. By providing adequate broadband service across the country, businesses and individuals country can better connect to buy goods, collaborate, innovate, and create the new ideas and businesses of the future.

²² *How Tax Compliance Obligations Hinder Small Business Growth: Hearing Before the H. Comm. on Small Business*, 114th Cong. 3 (2015) (testimony of J. Christopher Mihm), available at <https://www.gpo.gov/fdsys/pkg/CHRG-114hhrg95580/pdf/CHRG-114hhrg95580/pdf/CHRG-114hhrg95580.pdf>.

²³ *Start-ups Stalled? The Tax Code as a Barrier to Entrepreneurship*, 115th Cong. 4 (2017) (testimony of Kyle Pomerleau), available at <https://www.gpo.gov/fdsys/pkg/CHRG-115hhrg24070/pdf/CHRG-115hhrg24070.pdf>.

²⁴ *Id.*

²⁵ *Id.*

²⁶ GALLUP, *Optimism Among Small-Business Owners Soars* (March 13, 2017), available at http://www.gallup.com/poll/205898/optimism-among-small-business-owners-soars.aspx?g_source=SMALL_BUSINESS_INDEX&g_medium=topic&g_campaign=tiles.

²⁷ THE WORLD BANK, *DOING BUSINESS, MEASURING BUSINESS REGULATIONS, ECONOMY RANKINGS* (2017), available at <http://www.doingbusiness.org/rankings>.

²⁸ FED. COMMUNICATIONS COMMISSION, *2016 BROADBAND PROGRESS REPORT* (2016), available at <https://www.fcc.gov/reports-research/reports/broadband-progress-reports/2016-broadband-progress-report>.

New and innovative solutions to entrepreneurship education are not only changing the way entrepreneurship is taught in schools, but are reaffirming the importance of entrepreneurship to the next generation. One university that has made particularly significant strides in training the next generation of entrepreneurs is Miami University in Oxford, Ohio. For example, at Startup Weekend Miami Ohio, students participate in a 54 hour event where they pitch an idea, build a product team and brand for execution, and prepare product presentations to a panel of judges.²⁹ The Armstrong Institute for Interactive Media at Miami studies places students at internships at startups in Cincinnati, Ohio and San Francisco, California for students learn directly from top executives in startups, accelerators, and venture capital firms.³⁰ Miami University also recently launched a Cincinnati Digital Innovation Center, which provides students an opportunity to work at digitally-focused startups in the Cincinnati area and meet with startup executives and alumni who work in startups in the region. By thinking of entrepreneurship not as a specific concentration but as a lens to study other subject matter, students from all academic backgrounds can start thinking entrepreneurially to succeed in their academic and professional careers.

V. Conclusion

Entrepreneurship is a key driver of economic growth, innovation, and job creation. However, there has been a slow decline in entrepreneurship in the United States since the late 1970s that accelerated during the Great Recession. Although there are several issues contributing to the entrepreneurship decline, access to capital, tax burdens, and regulatory burdens cripple entrepreneurs and make it harder than ever to start a business in the United States. However, through solutions like reducing regulatory burdens, ensuring there is necessary broadband infrastructure to connect businesses across the country, and providing the educational tools in our nation's universities, American entrepreneurship can flourish.

²⁹ <http://communities.techstars.com/usa/muohio/startup-weekend/8392>.

³⁰ <http://miamioh.edu/cca/digital-innovation/>.