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The State of Entrepreneurship

"Entrepreneurship drives economic growth, propels job creation, and creates opportunities for upward economic mobility," as stated by Dane Stangler, Vice President of the Ewing Marion Kauffman Foundation (Kauffman Foundation).[1] Societies grow richer over time with the benefit of new, less expensive, and improved products and services, conceived of by entrepreneurs and produced by the businesses they establish. In turn, business dynamism is the process by which firms are created, expand, fail, and contract, a process that has slowed compared to previous decades. Today, entrepreneurs face exceptional challenges, including lack of financing, regulation from all levels of government, and a culture that emphasizes risk-aversion over the rewards of risk-taking. Consider the following issues that the United States faces as well as the difficulties facing American entrepreneurs:

- **New business creation fell by nearly a third during the recession and has been slow to recover.** In addition, job churn—or the net change in jobs created and destroyed—has also witnessed a decline, as has job market "fluidity," which measures the ease and speed in the ability to find a job.
- **Expansive regulation inhibits private resourcefulness that stems from entrepreneurship and, in turn, economic growth.** The World Bank ranks the United States 49th out of 189 countries on the ease of starting a business. According to the Economic Freedom of the World Index, economic freedom in the United States has dramatically worsened since 2000, precipitating a decline within the overall Economic Freedom rankings from 2nd to 16th.
- **Entrepreneurship can neither be taken for granted nor instilled by decree.** One thing is clear: creative personal energy and risk-taking drive entrepreneurship and require freedom to experiment, the right to compete, and the right to reap the rewards from economic success—that is as true for opening a new restaurant as it is for introducing a new way to drill for oil and natural gas.

Policymakers can reduce barriers to entrepreneurship and help renew startup growth by: (1) addressing and reforming regulations that negatively affect startups and impede their growth; (2) highlight impediments like state occupational licensing laws that often only serve to protect incumbent advantages; (3) keep innovation "permissionless" with few barriers; and (4) encourage risk-taking that is the hallmark of productive entrepreneurs.

What Is Entrepreneurship?

Economist Israel Kirzner stated that entrepreneurship is a process of discovery. It occurs whenever a person realizes that "doing something a little different from what is currently being done may more accurately anticipate the opportunities available."[2] Put simply, entrepreneurs *notice* profit opportunities or something otherwise missing from the market. Economist Joseph Schumpeter defined entrepreneurs in the more commonly known sense, as those who *introduce* innovations, new processes to produce either new products or old products in new ways, thereby "disturbing" the usual flow of production.[3] For Schumpeter, entrepreneurship is the seed of "creative destruction"—the abrupt disruption of an industry through innovation, typically creating positive externalities and making the economic pie bigger for everyone.[4] Schumpeter originally coined "creative destruction" to describe the dynamic evolution of the economy as markets change, industries rise and fall, businesses open and close, and workers gain and lose jobs. He argued that it is an essential fact of capitalism:

> *The opening up of new markets, foreign or domestic, and the organizational development from the craft shop... illustrate the same process of industrial mutation—if I may use that biological term—that*

incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism.[5]

Recent literature argues that the similarities between these different definitions of entrepreneurship can extend to social, political, and ideological spheres, broadly conceiving of entrepreneurs as "social change agents."[6]

Societies grow richer over time with the benefit of new and improved products at lower cost.[7] In many ways, both measurable and immeasurable, Americans are better off than generations before them, as their living standards have increased over time. Smart phones, internet access, personal computers, flat screen televisions are common in households across income groups, the number of vehicles per household has risen, and the average dwelling has grown larger in square footage over time even as the number of people per household has declined.

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How can one measure entrepreneurship more directly, and what can one discern about its trend? Stangler states, "The core elements of dynamism and entrepreneurial growth are the entrants of new firms, the rapid growth of young firms, the shifting of jobs from less productive to more productive businesses, and the movement of workers into and out of jobs."[8]

In an effort to shed further light on the trends in entrepreneurship, this summer, the Census Bureau anticipates the release of the inaugural Annual Survey of Entrepreneurs, a public-private partnership with the Kauffman Foundation and the Minority Business Development Agency.[9]

Entrepreneurial Activity

Currently, the Kauffman Foundation measures entrepreneurial activity with three main indexes. The first is the Growth Entrepreneurship Index, which rose for the third straight year in 2015, albeit at a slower pace than in the 1980s and '90s, and relies on three factors: (1) the rate of startup growth, (2) share of scale-ups from small businesses, and (3) high-growth company density, defined as annualized revenue growth of 20 percent over a three-year period.[10] Similarly, the Startup Activity Index (which measures new business creation) increased for the first time in five years in 2015.[11] Finally, the Main Street Entrepreneurship Index (which measures the number of firms over five years old with fewer than 50 employees per population) also rose in 2015, though still below pre-recession levels.[12]

Demographics may also factor into rates of entrepreneurship. As detailed in the JEC Republican staff analysis, "Not Your Mother's Labor Market," employment in America is undergoing incredible shifts.[13] The population is getting older, as is the workforce. Additional research found that in 2013, the rate of new entrepreneurial activity has fallen to new lows for Americans age 20-34 (today, the millennial generation largely occupies this age group). In other words, millennials are not starting companies at the same pace as baby boomers did.[14] However, the "peak age" for business creation appears to be late thirties and early forties, which suggests that millennials have yet to reach their entrepreneurial potential.[15]

Business Dynamism

New business creation fell by more than 30 percent during the recession and has been slow to recover.[16] The slower pace of startup creation has significantly affected business dynamism, or the process by which firms are created, expand, fail, and contract.[17] The Kauffman Foundation finds that three general factors have contributed to the "startup deficit" the economy is currently experiencing: (1) the recent recession sped up the longer-term decline in overall business creation since the 1980s; (2) the recession created a generation of "missing" or "lost" firms that were never created; and (3) new firms that started during the recession are smaller in size and will grow more slowly due to the scars left by the recession and slow recovery. Indeed, one study found that, had the current startup rate matched its 1980s rate, the U.S. economy would have returned to pre-recession employment levels two years ahead of the current recovery.[18]

Even absent the recession, research by economist John Haltiwanger has shown a longer-term decline in business dynamism, including within technology industries.[19] Since 2000, growth of high-tech firms has slowed significantly, particularly in "superstar" high-growth firms.[20] Studies by economists at the Brookings Institution found that the share of startups (firms less than one year old) had fallen from 15 percent of all businesses in 1978 to 8 percent in 2011. By contrast, the share of older firms (older than 16 years) jumped from under a quarter to more than a third of all businesses.[21]

In addition to declining rates of entrepreneurship and business dynamism, job churn—or the net change in jobs created and destroyed—has also witnessed decline, as has job market "fluidity," which measures the ease and speed in the ability to find a job. This remains concerning particularly for the most vulnerable workers, including young entrants and low-skill workers, and in a broader sense, contributes to general pessimism about the American economy as slower growth in productivity, job creation, and wages reflect these trends.[22]

Entrepreneurship's Role in Technological Advancement

However, some would argue that in recent years all the "low-hanging fruit" in technological gains may have been plucked, at least for now.[23] Some would argue that technological innovation still occurs, but rather than making economic gains by leaps and bounds, recent improvements have been incremental and less valuable. Just think, from an economic standpoint, of how much value harnessing electricity and inventing the telephone created, versus what the innovations of social media have done for society. However, given the potential of developments in areas like nanotechnology and 3-D printing, large gains may return, as technological capabilities in these areas become affordable realities, dramatically improving industries like healthcare and medicine.

There is hope that the slowing trends mentioned above might reverse. Technology today may give entrepreneurs a marketing reach that only established businesses had in the past. Technology also may broaden consumer options, particularly in light of the growing prevalence of the "sharing economy" and its association with technological innovations in the way we transact and communicate. Indeed, there is some evidence that entrepreneurship is thriving in certain areas, including in health care and financial technology, which has increasingly enabled entrepreneurship to fill roles held by traditional banks, including mobile payments and transfers, third-party lending and fundraising, and even asset management.

As detailed in the JEC Republican Staff Analysis, "Dōmo arigatō, Mr. Roboto: The Transformative Impact of Automation," automation is a form of technological advancement that has witnessed massive growth in recent decades, though this has led to a rise in the longstanding fear that robots will replace humans in the workplace.[24] Some suggest that the advent of affordable robots capable of replacing all or parts of human labor may actually boost entrepreneurship.[25] Technological improvements in automation and robotics are frequently associated with negative effects today, such as replacing middle-skill workers, a phenomenon known as "job polarization" between high-skill and low-skill occupations. As longer-term technological trends continue, job polarization[26] will continue to affect the types of jobs demanded in the economy as middle-skill jobs are automated. This is an example of the disruptive effects entrepreneurship and innovation can have, and it is essential to continued progress that government responses to these changes does not inadvertently hinder entrepreneurship.

The Kauffman Foundation has listed some alternative possibilities that may play into slower job churn and slower business growth. For example, if entrepreneurial quality has risen over time, as some studies suggest, then even if the quantity of startups has declined, this does not necessarily indicate that slower business growth is all-negative. Also, many established firms may be taking better advantage of entrepreneurial talent among their employees, leading innovations to occur within the business rather than as a separate entity.[27]

Policies Thwarting Innovative, Entrepreneurial Efforts Are Ripe for Reform

One can neither take entrepreneurship for granted nor instill it by decree. Efforts by government to find the formula by which to activate, accelerate, and direct entrepreneurship never cease. The concept of innovation hubs has been in vogue for some time by which government, academia, and the private sector interact in close proximity trying to emulate developments like Silicon Valley and The Triangle in North Carolina. However, what determines the forms and the rates of successful entrepreneurship is not fully understood.

As discussed in the JEC hearing entitled, "Encouraging Entrepreneurship: Growing Business, Not Bureaucracy,"[28] one thing is clear: creative personal energy and risk-taking drive entrepreneurship and require freedom to experiment, the right to compete, and the right to reap the rewards from economic success—that is as true for opening a new restaurant as it is for introducing a new way to drill for oil and natural gas. Entrepreneurship will drive economic progress the most when it permeates the economy, which is why restrictive regulation, mandates and taxes can be so detrimental to it.

For many people, owning a business is the American dream. However, would-be entrepreneurs generally consider the risks and rewards, or the costs and benefits, of their endeavor prior to pursuing that dream. In the 21st century, the quantity and complexity of government regulations are so overwhelming that they likely prevent many businesses from getting started and, consequently, from serving society through the introduction of goods and services and productive job creation. With the growing number of government-created obstacles, the risks and costs of business creation are rising. Once those obstacles surpass the rewards and benefits of business creation, the business will not be started and society loses, bereft of new jobs and new products. On several occasions Bernie Marcus, cofounder of Home Depot, stated that he would not be able to start Home Depot today because of the regulatory environment.[29] While his comments are in reference to the more recent regulations on the financial side of business (including elements of *Dodd-Frank* and *Sarbanes-Oxley*) there are many other regulations that cover all facets of starting and running a business that discourage entrepreneurship. Echoing a similar sentiment, witness Jamie Richardson noted in the JEC hearing on entrepreneurship, "White Castle's growth has halted. In 2012, when I testified before the House Oversight & Government Reform Committee on the Affordable Care Act, we had 408 White Castle restaurants. Today, we have 390."[30]

The World Bank ranks the United States 49th out of 189 countries on the ease of starting a business, losing out to Canada, France, and even Russia.[31] Administrative and bureaucratic compliance costs borne by firms have increased significantly. The annual costs of federally imposed rules is nearly $1.9 trillion in compliance according to the Competitive Enterprise Institute.[32] As measured by the Economic Freedom of the World Index, economic freedom in the United States has dramatically worsened since 2000, precipitating a decline within the overall Economic Freedom rankings from 2nd to 16th.[33]

As Kauffman Foundation's Stangler emphasizes:

> *...above all, policymakers must focus on identifying ways to, as economists put it, lower the costs of entrepreneurial experimentation or reduce the 'frictions on experimentation'... Direct support or subsidization of entrepreneurs (the sufficiency approach) may be less effective than an approach that aims at preserving entrepreneurial entry and competition, and holding the line against incumbent bias.*[34]

This sentiment harkens back to something that witness Andrew McAfee noted in the JEC hearing entitled "The Transformative Impact of Robots and Automation": entrepreneurs are facing an "increasingly dense thicket of things that an employer or worker has to confront before they can start something up. And navigating your way through that becomes increasingly difficult, and it looks like more and more people are saying, 'I'm just not going to bother with it'." McAfee lauded the Silicon Valley notion of "permissionless innovation," which argues for greater ability to innovate without submitting to a bureaucracy or permitting process before proceeding.[35]

Most businesses in America start small. Some of them remain small throughout their entire existence while others grow to employ thousands and serving millions. However, the first step in any business is to establish its operations, and there are many hurdles to clear for this to happen. Some of those include learning complex laws, taking risks created by the government, hiring expensive experts to understand and meet the regulatory burden, and having all of the necessary licenses. For example, a new business must obtain permits for industry-specific regulations and state or local licensing requirements. Before a business hires workers, the owner must learn about and devote significant resources to follow the appropriate labor, healthcare, and tax laws. It may have to obtain legal help to navigate through implementing payrolls and collecting taxes, track hours of certain employees, etc. With each step, there is the potential of a problem that could upend the calculation of the potential reward from starting a business, and this list is by no means comprehensive.

Occupational licensing can too often be a clumsy, knee-jerk reaction to ensure customer health and safety. Consumer health and safety can be prioritized in other ways, such as voluntary certification, without hurting entrepreneurship and job-seekers' ability to find employment. The justification for licensing should include why certification is not enough. Many states require expensive licensing requirements that could be out of the reach of an unemployed worker.[36] However, exorbitant hour requirements do not necessarily mean better prepared workers or better consumer health outcomes. For example, California requires animal trainers to obtain 1,095 days of education/experience to be licensed, while midwives only have to have 238 days of experience.[37] States looking to encourage entrepreneurship should re-examine their occupational licensing laws to ensure that they are not serving the interests of incumbent groups in place of the consumers they are meant to protect.[38]

Rising tax burdens on small businesses may be yet another source of declining entrepreneurship, representing a significant market barrier. In many states, small businesses taxed through the federal individual income tax rate—known as "pass through" businesses, face a marginal tax rate of over 50 percent.[39] For those taxed at the corporate rate, the President's suggested tax framework for businesses would give a greater advantage to foreign competitors than already exists. In addition to a 50 percent of shareholder ownership threshold, the Administration would also tax inverted companies as U.S. corporations if the "management and control" of the company is primarily in the United States. While the Obama Administration's plan is aimed at trapping American-headquartered companies in the U.S. tax system, the proposal is likely to discourage new companies from choosing American headquarters.

Every day, entrepreneurs launch new companies and decide where to place the headquarters. Selecting a location that attempts to trap its businesses in an uncompetitive tax system indefinitely would be illogical. Like the United States, the United Kingdom underwent a period of "headquarter flight," but responded as the United States should: by lowering its corporate tax rate and moving to a competitive international tax system. As a result, companies have returned to United Kingdom and new companies are incorporating there.[40] In fact, many existing companies, like Avon, that originally established their headquarters in the United States are also moving to the United Kingdom. The best solution for stemming inversions is to treat the root of problem—an uncompetitive tax system—rather than enact punitive measures to treat the symptoms.

Furthermore, the economic benefits of deregulation in the United States and United Kingdom in the 1970s and 1980s were clear. Regulation not only stifles business creation, but also discourages investment in existing firms. As the utility, communications, and transportation industries were deregulated, investment in these sectors as a percentage of capital stock more than doubled. In stark contrast, European countries—such as Italy, France, and Germany—that did not undertake these large-scale reforms saw a five percent decline in investment.[41]

Many unintended consequences of the cumulative burden of regulation, redistribution efforts, and the current tax and welfare structures negatively affect investment and entrepreneurship. Regulatory barriers to entrepreneurship, specifically the cumulative burdensome requirements imposed at the federal level and occupational licensing laws at the state level, will continue to impede the creation and development of businesses and the jobs that come with it.[42] The following is a non-exhaustive list of more difficult barriers that entrepreneurs can face:

- **Necessary financing is difficult for new businesses to obtain.** Many smaller, community banks have closed their doors or cannot provide the loans due to onerous requirements and restrictions from *Dodd-Frank*.

- **New health care laws and regulations factor into expansion.** The *Affordable Care Act* (ACA) has mandates that employers must follow regarding: (1) the number of employees considered full-time and hours worked; (2) a mandate that an employee's share of health insurance premiums cannot exceed 9.5 percent of the employee's household income.

- **Labor requirements can cost significant resources.** The Department of Labor's overtime rule threshold increase can impose additional costs, and the Office of Labor Management Standards requires lawyers that counsel a small business on labor relations matters (despite if the business has a union or not) to disclose all work, fees, and arrangements the attorney has with that business regarding labor relations issues.

- **Workplace safety laws not always relevant or helpful.** For example, Occupational Safety and Health Administration (OSHA) rules, such as those pertaining to silica exposure, may not address an actual risk for many firms.[43]

The only way to devise appropriate rules for the economy is by analyzing suspected market problems and evaluating the costs and benefits of alternative policies to address them, including leaving the private sector to resolve them. Unfortunately, most federal regulations, by far, are never subjected to cost-benefit analysis, and this should change as should the self-serving way in which agencies often conduct them.[44] But there is an additional problem that relates to social regulation and the nature of the benefits attributed to it. Agencies claim benefits for their regulations that are essentially nonmonetary, but for purposes of cost-benefit analysis, monetize them in a way that shows the benefits far exceed the costs. Aside from the tendency of regulators to overstate the benefits of their rules, the problem is that the costs are a real and immediate burden on the economy, whereas the benefits often do little or nothing to increase economic growth. As practiced, social regulation, which concerns not price and output, but quality-of-life factors like consumer product, workplace safety, and environmental preservation, faces no budget constraint. Expansive interpretation of social regulatory benefits has led to progressive market encroachment by government that inhibits private resourcefulness and, in turn, economic growth. In theory, it could consume the nation's entire GDP on the logic that its welfare benefits are greater.[45]

The problem is not just an accumulation of poorly written rules but also a philosophy that sees market failures everywhere and government regulation as the antidote. Federal policymakers have an important role in fostering a free-market economy in which Americans enjoy many opportunities for employment, such as by protecting intellectual property and managing the patent process efficiently, but government should not and cannot be the paramount facilitator. The private sector is the true driver of economic dynamism. Specifically with respect to entrepreneurship, policymakers can reduce "frictions on experimentation" and renew startup growth:

- **Address and reform regulations that negatively affect startups and impede their growth.** This includes the aforementioned barriers to entrepreneurship, such as the ACA employer mandates, the Labor Department's new overtime rule, and calls for increases in the federal minimum wage.

- **Highlight impediments to creative destruction.** Continue to encourage state and local levels to reexamine their occupational licensing laws, ensuring that they are befitting of consumer protection and not preserving incumbent advantages.

- **Keep innovation permissionless.** Consider appropriate regulations that will provide consumer assurances while also protecting innovation occurring in the sharing economy and beyond.[46]

- **Encourage risk-taking.** Demographic changes, business consolidation and the economic disruption experienced in the 2008 financial crisis have left their mark on Americans' attitude toward risk. A 2015 Gallup survey found that one-quarter of potential entrepreneurs did not start their ventures, citing "I like the security of a steady income" as the most prominent reason. As Mark Zuckerberg reminds us, "The biggest risk is not taking any risk... In a world that is changing really quickly, the only strategy that is guaranteed to fail is not taking risks." Our society has become adept at quantifying the cost of change from the status quo, but not at quantifying the cost of the status quo in the face of change.

As stated in the 2016 Joint Economic Report: "Implementation of pro-growth policies remains important as ever in fostering a competitive business environment both here and abroad, as well as recognition of government's role in removing barriers to entry, protecting property rights and promoting the rule of law, thereby bolstering economic activity and entrepreneurship."[47]

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