

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, Committee on Small Business
From: Committee Staff
Date: November 15, 2013
Re: Full Committee Hearing: “*The Startup Movement*”

I. Introduction

On Wednesday, November 20, 2013, at 1:00 pm in Room 2360 of the Rayburn House Office Building, the Committee on Small Business will meet to examine the importance of startups to the economy. The hearing will focus on whether distinctions between startups and small businesses necessitate different policies.

Across the United States, a trend is rapidly emerging. Various local communities, cities, and states are competing to host startup businesses. This memorandum will explore what is meant by the term “startup,” what the startup movement indicates about the evolution of the business morphology in the United States, and the changing approaches to entrepreneurship.

II. Challenges in Defining A Startup

While the terms small business and startup are sometimes used interchangeably, startups have unique characteristics that distinguish them from the vast majority of small businesses. Startups are a unique subset of small businesses, and as such, have different concerns than traditional small businesses and grow in different ways. One notable entrepreneur observed that what “startups have lacked is a definition of who they were. For years we’ve treated startups like they are just smaller versions of a large company.”¹ As this hearing will show this treatment is inappropriate. Distinctions exist between startups and small businesses in terms of the age, the rates of job creation, and the business model.

The most basic definition of a startup company is “less than one year old.”² While the United States Census Bureau’s Business Dynamics Statistics defines startups as firms “with the

¹ <http://steveblank.com/2012/03/05/search-versus-execute/>

² BENJAMIN ZYCHER, PACIFIC RESEARCH INSTITUTE, STARTUP BUSINESSES AND THE GROWTH OF REAL STATE GROSS PRODUCT 4 (2013), available at http://www.pacificresearch.org/fileadmin/templates/pri/images/Studies/PDFs/2013-2015/StartUp_Zycher_r2.pdf [hereinafter ZYCHER]; see also TIM KANE, EWING MARION KAUFFMAN FOUNDATION, THE IMPORTANCE OF STARTUPS IN JOB CREATION AND JOB DESTRUCTION 5 (2010), available at http://www.kauffman.org/~media/kauffman_org/archive/researchreport/2010/9/firm_formation_importance_of_startups.pdf.

age of 0,”³ recent congressional action has clouded that definition. For example, recent legislation meant to bolster the growth of startups by reducing regulatory burdens in obtaining equity capital, defined “emerging growth companies” as new issuers of stock that have less than one billion dollars in revenue.⁴ Given the action of Congress, it is not enough to simply look at the age of the entity to determine whether it is a startup.

While economic statistics often are cited for the fact that 64 percent of net new jobs are created by small businesses,⁵ successful startups are truly leading the way in job creation.⁶ Startups “generat[e] revenues equal to an estimated 21 percent of [United States] GDP and creat[e] roughly 11 percent of all [United States] private sector jobs.”⁷ Specifically, research has touted “the importance of new and young businesses – as opposed to small business generally – to job creation in the United States.”⁸ In its research series on firm formation and economic growth, the Kauffman Foundation found that, “on average, fast-growing young companies create about twenty-seven jobs per year, with most growing to a size of about twenty to ninety-nine employees.”⁹ Further, this research 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.”¹⁰ Thus, rapid job creation is one difference between startups and the wider universe of small businesses.

Further evidence of this distinction is found in startup businesses’ focus on mass delivery of goods and services. Paul Graham, one of the founders of Y-Combinator, which is an accelerator program geared towards aiding startups, defines the difference this way:

A company has to be more than small and newly founded to be a startup. There are millions of small businesses in America, but only a few thousand are startups. To be a startup, a company has to be a product business, not a service business. By which I mean not that it has to make something physical, but that it has to have one thing it sells to many people, rather than doing custom work for individual clients. Custom work doesn’t scale. To be a startup you need to be the band that sells a million copies of a song, not

³ <http://www.census.gov/ces/dataproducts/bds/definitions.html>.

⁴ The Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 101(a), (b)(2) (2012) (codified at 15 U.S.C. § 77 b(a)(19) and 15 U.S.C. § 78c(a)(80) respectively).

⁵ http://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf.

⁶ DANE STANGLER, EWING MARION KAUFFMAN FOUNDATION, HIGH-GROWTH FIRMS AND THE FUTURE OF THE AMERICAN ECONOMY 2 (2010), available at http://www.kauffman.org/~media/kauffman_org/archive/researchreport/2010/04/highgrowthfirmsstudy.pdf [hereinafter STANGLER].

⁷ SILICON VALLEY BANK, STARTUP OUTLOOK 2013 REPORT 10 (2013), available at <http://www.svb.com/pdf/startup-outlook-2013-full-report/> [hereinafter STARTUP OUTLOOK].

⁸ IAN HATHAWAY, EWING MARION KAUFFMAN FOUNDATION, TECH STARTS: HIGH-TECHNOLOGY BUSINESS FORMATION AND JOB CREATION IN THE UNITED STATES 2 (2013), available at http://www.kauffman.org/~media/kauffman_org/archive/newsrelease/2013/8/bdstechstartsreport.pdf [hereinafter HATHAWAY].

⁹ STANGLER, *supra* note 6, at 6.

¹⁰ *Id.* at 2.

the band that makes money by playing at individual weddings and bar mitzvahs.¹¹

The conflation of the terms “startup” and “small business” occurs primarily because the “distinction... has been underrepresented in research on business dynamics and in small business policy.”¹² A reason for this failure to distinguish startups from small firms may be that policymakers and researchers are incapable of defining the term “startup.” Their difficulty is exacerbated by the fact that individuals within the startup community have no consistent definition.

For example, notable entrepreneur Steve Blank defines a startup as “a temporary organization designed to search for a repeatable and scalable business model. Within this definition, a startup can be a new venture or it can be a new division or business unit in an existing company.”¹³ Another well-known entrepreneur, Paul Graham, defines a startup as “a company designed to grow fast. Being newly founded does not in itself make a company a startup. Nor is it necessary for a startup to work on technology, or take venture funding, or have some sort of ‘exit.’ The only essential thing is growth. Everything else we associate with startups follows from growth.”¹⁴ On the other hand, another entrepreneur, Eric Ries, defines a startup as “a human institution designed to create a new product or service under conditions of extreme uncertainty.”¹⁵

Arguably, one could surmise from this definitional gallimaufry that all startups are small businesses, but not all small businesses are startups. This conclusion is often most notable when discerning what is needed and how to plan for a startup, which differs from a traditional small business. Entrepreneur Scott Allison notes, “[it is] possible and entirely sensible to plan a traditional business before you launch, but with a startup you [cannot]. You [do not] know what you [do not] know, and [do not] know what the market wants until you build something and show it to them. Consequently, it might take a few months or a few years before you get a scalable and repeatable business model.”¹⁶

III. Startups and the Changing Business Landscape

The startup movement appears to be reflective of a changing landscape within the United States economy and a desire for entrepreneurs to do more than merely own their business; instead, they want to create the next titan of industry with an innovative and rapidly growing product.¹⁷ In order to attain the high-growth frequently synonymous with startups, “these companies need to make significant investments for an extended period of time.”¹⁸ Due to this, “whether one looks by sector or revenue level, most startups [do not] earn a profit – even when

¹¹ <http://paulgraham.com/startupfunding.html>

¹² HATHAWAY, *supra* note 8, at 2.

¹³ <http://steveblank.com/2012/03/05/search-versus-execute/>.

¹⁴ <http://www.paulgraham.com/growth.html>.

¹⁵ ERIC RIES, *THE LEAN STARTUP* 27 (Crown Business, 1st ed. 2011).

¹⁶ <http://www.forbes.com/sites/scottallison/2012/04/10/startup-success-throw-away-your-business-books/>.

¹⁷ That is every entrepreneur wants to be the next Steve Jobs, Bill Gates, Sergey Brin, or Mark Zuckerberg.

¹⁸ *STARTUP OUTLOOK*, *supra* note 7, at 10.

they earn significant to topline revenues and even in capital-efficient sectors.”¹⁹ However, successful startups provide significant benefits to the national economy even before they are profitable through increased job creation and changes in how human capital in the United States is being deployed.

Despite the lack of profit, startups’ effect on the job creation is immense. For example, 87 percent of startups “plan to hire new employees in 2013, up from 83 percent”²⁰ in 2012, demonstrating the strong belief in upward growth in the startup world. In contrast, the National Federation of Independent Businesses reports that only nine percent of small businesses plan to hire in the next year.²¹

Startups also bolster the local economy. For example, at the state level “each net job created by startup firms is estimated to increase state gross product by almost \$1.2 million in a given year.”²² Further in the high-tech sector, for every job created “4.3 additional jobs are projected to be created in the local goods and services economy,”²³ demonstrating startups significant multiplier effect.

However, startups influence the workforce by more than simple job creation as startups have broadly changed the way Americans engage in everyday activities as new technologies enhance Americans productivity. For example, advances in mobile devices and computing have led to a thriving application (app) economy, which is expected to double from \$72 billion to \$151 billion by 2017.²⁴ More importantly though, is through the creation and development of these new apps, typically developed by startups, there has been an enhancement of business tools which are increasing productivity by allowing work to be streamlined or conducted on the go.²⁵

Startups have also become an attractive alternative to more traditional career paths for highly skilled workers. Starting high-growth young firms is increasingly a viable choice for individuals seeking both jobs and the rewards that come from a successful company. Recent graduates of colleges and graduate programs have higher-than-average unemployment rates,²⁶ but these same populations increasingly view startups as a lucrative opportunity. For example, the Wharton School of Business at the University of Pennsylvania, one of the top business schools in the country,²⁷ reports that within the last five years the percentage of Master of

¹⁹ *Id.*

²⁰ *Id.* at 16.

²¹ WILLIAM C. DUNKELBERG AND HOLLY WADE, NATIONAL FEDERATION OF INDEPENDENT BUSINESS, SMALL BUSINESS ECONOMIC TRENDS 1 (2013), available at <http://www.nfib.com/research-foundation/surveys/small-business-economic-trends>.

²² ZYCHER, *supra* note 2, at 3.

²³ *Innovative as a Catalyst for New Jobs: Hearing Before Subcomm. on Economic Growth, Tax and Capital Access, of the H. Comm. on Small Business*, 113th Cong. (2013) (statement of Michael McGeary, Co-Founder, Engine Advocacy) available at http://smallbusiness.house.gov/uploadedfiles/4-18-2013_mcgeary_testimony.pdf.

²⁴ <http://apnactionconference.com/main/research/>.

²⁵ http://www.businessweek.com/magazine/content/09_44/b4153044881892.htm.

²⁶ Thomas Luke Spreen, *Recent College Graduates in the U.S. Labor Force: Data from the Current Population Survey*, MONTHLY LAB. REV., Feb. 2013, at 3, available at <http://www.bls.gov/opub/mlr/2013/02/art1full.pdf>.

²⁷ According to U.S. News Rankings, the Wharton School is ranked third in the country for graduate business schools and ranked first for undergraduate business programs. <http://colleges.usnews.rankingsandreviews.com/best-colleges/university-of-pennsylvania-215062/overall-rankings>.

Business Administration students “starting their own businesses at graduation has nearly tripled, and the number of students working summer internships with startups is up 15 percent since last year.”²⁸

IV. Conclusion

As startups continue to propel entrepreneurship in a new direction, it is imperative that this sector of small firms be adequately understood at a federal level. This is evident from the lack of a single definition for the term “startup.” Without understanding the universe of startups policymakers cannot adopt policies that promote that subset of small businesses rather than adopting policies for the entire universe that only by fortuity assist startups. This hearing will provide a forum for that discussion.

²⁸ <http://www.businessweek.com/articles/2013-06-25/more-wharton-mbas-are-opting-for-startups>.