Encouraging Entrepreneurship: Growing Business, Not Bureaucracy[1]

Tim Kane

Testimony before the Joint Economic Committee
U.S. House of Representatives
July 12, 2016

Chair Coats, Vice Chair Tiberi, Ranking Minority Member Maloney, and members of the Joint Economic Committee, thank you for inviting me to testify at this hearing on "Encouraging Entrepreneurship: Growing Business, Not Bureaucracy."

I am Tim Kane. I am a Research Fellow of the Hoover Institution, a nonpartisan research institute at Stanford University. I represent my own views only.

The topic you have assembled to consider is the single most important issue that is holding back potential growth in gross domestic product, jobs, and real wages. It is a bipartisan concern, so allow me to express my respect for your joint work on improving the entrepreneurial climate in the U.S., despite the incentives you have in an election year to fight instead.

Entrepreneurship – the birth of new firms – remains poorly understood by economic theory which often oversimplifies it out of existence in macroeconomic models, but it is well understood by farmers, struggling small business owners, and idle workers with big dreams. What I'd like to do with my time is set theory aside, and to connect three points using empirical data.

Point number one is that the U.S. economy has been experiencing what I call a Great Deceleration for half a century. Each period of recovery has been slower than the past – a trend that transcends political terms of Presidents and partisan majorities, not to mention economic fads on campus. In the first figure in my written testimony, I showed the average annualized growth rate of GDP as well as the percentile contribution of its components. I only counted data for expansionary periods, yielding five expansions that include the current expansion, as well as expansionary periods in the late 1970s, the 1980s, the 1990s, and the 2000s.

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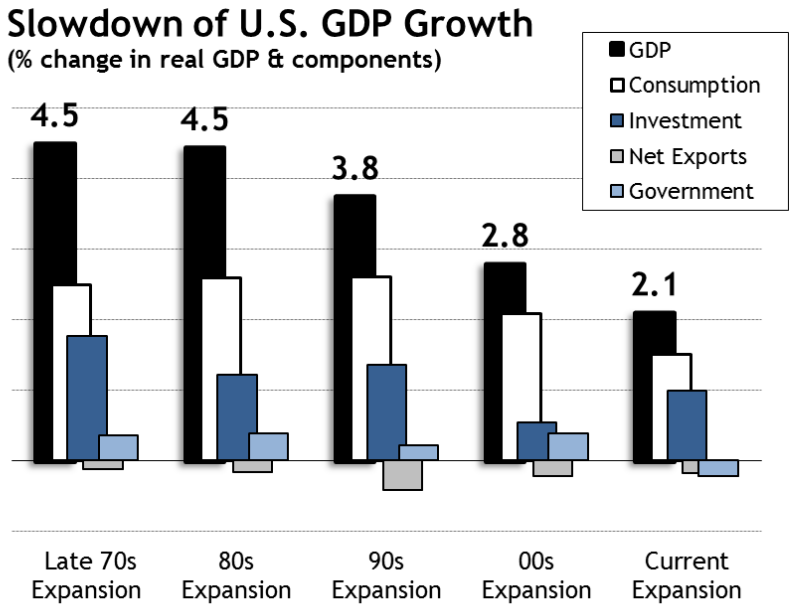
[1] Dr. Kane is an economist and Research Fellow at Stanford's Hoover Institution, a veteran Air Force intelligence officer, and former senior economist at the Joint Economic Committee.

Figure 1



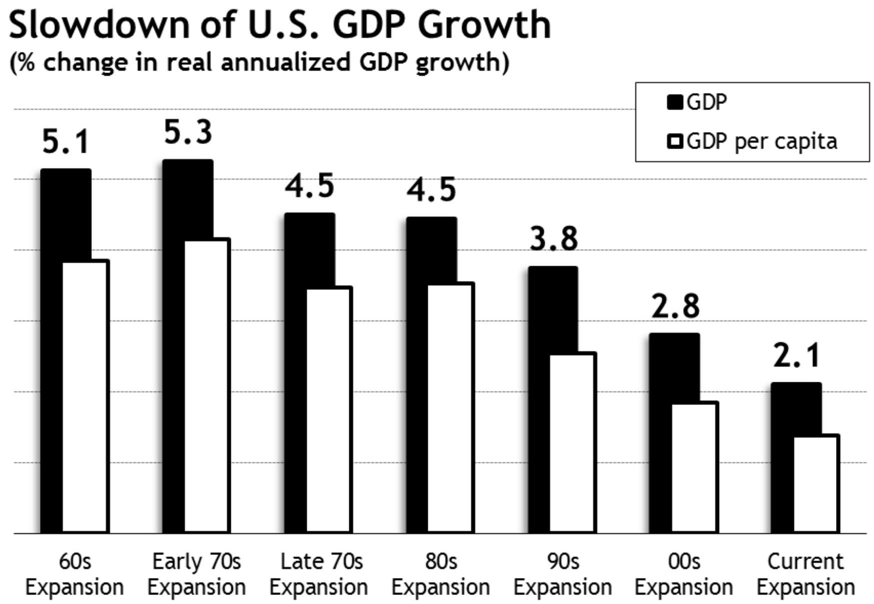
SOURCE: Author calculations, U.S. Bureau of Economic Analysis

Each expansion trough and peak is determined by the business cycle dating committee at the National Bureau of Economic Research, and of course those expansions are different lengths of time. For example, the 80s expansion started in the first quarter (Q1) of 1983 and lasted until Q2 of 1990, for a total of 30 quarters. The Late 1970s expansion lasted only 19 quarters, whereas the 90s expansions was 39 quarters long. Currently, the U.S. is in the 27th quarter of expansion.

What surprised me when I assembled this data is how clear the deceleration in average growth rates has been. Each expansion is slower than the one before, by just under 1 percentage point per period. The growth rate was 4.5 percent during the 1980s expansion (note this is not the same as the 1980s decade, nor the Reagan years). The 1990s expansion saw slightly slower growth at 3.8 percent per year. Then 2.8 percent during the 23 months of expansion from 2002-2007. Which brings us to our current era with an average GDP growth rate of 2.1 percent.

Americans can feel this slowdown and are looking to us with questions, and I wish I had easy answers for you. These growth rates count only real GDP, meaning after correcting for price inflation. These past 50 years have been marked by a technological boom like nothing in human history. International trade has boomed. Patents have boomed. Food is cheaper and safer. Mortality is lower. Material quality of life is better in every – almost every – way. Yet growth is slowing.

Figure 2



SOURCE: Author calculations, U.S. Bureau of Economic Analysis, U.S. Census

A common reaction among my fellow economists is that the current slowdown is an illusion of demographics. This is incorrect. My second figure merges government GDP data with government population data over the past 50 years. The average yearly growth rate of GDP per capita peaked at 4.15 percent during the Early 1970s expansion. Then the deceleration hit: 3.5 percent in the next two expansions, then 2.5, then 1.9, and for the past 27 quarters the growth of GDP per capita is at a low 1.4 percent per year. If this trend continues, the U.S. economy will stop growing around 2030.

I believe this trend can be reversed. A rebirth of the American economy should be the government's top priority. And I believe that can happen if the government does less regulating rather than more.

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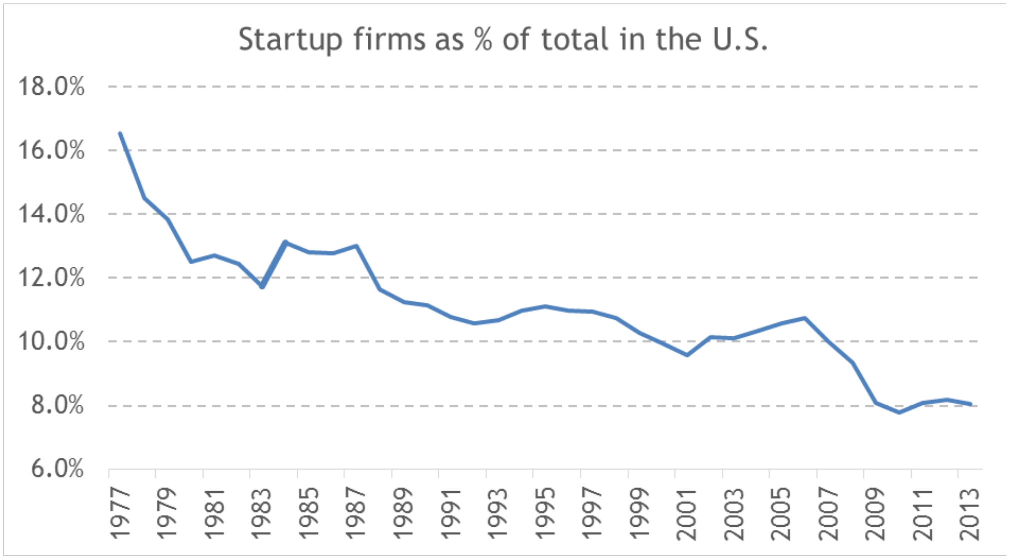
Figure 3



SOURCE: Author calculations based on Business Dynamics Statistics (firm age)

Point number two is that the dynamism of the U.S. economy has been slowing for decades. Dynamism is a term I learned from Glenn Hubbard, dean of Columbia Business School and co-author of my book, BALANCE. In recent decades, there have been declines in the number of new startups, in gross job creation, and worker mobility. It is a trend appearing in a variety of data sources including the Job Openings and Labor Turnover data, the Bureau of labor Statistics' Business Employment Dynamics data, and business dynamics measures from the Census Bureau's Business Dynamics Statistics.

Figure 3 shows that the percentage of U.S. firms that are startups, a term I use to define a newly founded company in its first year of existence. During the Carter administration, roughly 14 percent of U.S. companies were startups. That rate declined by one percentage point during the Reagan years, two points during the recession of the George H.W. Bush presidency, held steady under Bill Clinton, dropped a percentage point under George W. Bush, and then dropped two full points during the first term of President Obama. The most recent data available are for 2013, yet this startup ratio has held steady at 8.0 percent, down slightly from 2011.

New companies create roughly 3 million jobs every year, while existing companies tend to shed 1 million jobs net. A study I published back in 2010 found that in most years startups create 100 percent of all net new jobs. Older firms create fewer jobs in gross terms, and tend to be net job destroyers. The bottom line is that net job creation is literally nothing without startups. Even in gross terms, start-ups punch above their weight, with 16 percent of all new jobs created by start-ups. And with the decline in startups, there has been a decline in gross job creation and destruction, documented in many papers by many economists. The decline is associated with reductions in productivity, real wages and employment.

I should emphasize that immigrants are a vital source of entrepreneurial talent. Research shows that immigrants to the United States are significantly more likely to create new startups than native-born workers are.

Twenty percent of the workforce was employed by young small and medium enterprises in the early 1980s according to data collected by professor John Haltiwanger, but today fewer than ten percent are. Perhaps the growing concentration of larger firms isn't a threat to GDP growth if it represents a process of merely weeding out unproductive mom and pop shops. Silicon Valley tech firms are booming, no? No. In March of this year, Haltiwanger and three other economists published a report showing the overall decline in entrepreneurial activity since the 1980s has spread to high-growth young firms since 2000, even in technology sectors. This is not a false alarm.

Weak startup dynamism highlights a labor market problem: government is discouraging entrepreneurship. It's passive, maybe even unintentional, but the institutional hostility to entrepreneurs is very real.

This is point number three. Taxes are more complex. Regulations are thicker. Employment law is more dangerous. The instinct for elected leaders to protect voters from the consequences of economic change and economic fluctuations may well be counterproductive. Mandatory benefits cost a typical employer half of total wages and salaries. This burden raises costs and depresses wages. For example, employer-provided health insurance was initially sparked as an optional perk by favorable tax treatment during the 1940s, but is now mandatory under the Affordable Care Act. Today, workers are less willing to leave current jobs for alternatives (including entrepreneurship), known as "job lock."

The negative relationship between regulation and entrepreneurial activity seems obvious, but I must warn you that scholars have not settled the issue. George Mason University economists Alex Tabarrok and Nathan Goldschlag combined data on dynamism with a novel industry-level measure of regulation that combs the Code of Federal Regulations (CFR) for restrictive terms and found, counterintuitively, that more regulated industries had slightly more startup activity. I disagree with their finding, and caution that their regulation variable is new and superficial, but highlight their research to show that root causes remain unresolved.

I would suggest that a better measure of regulatory burden on startups is occupational licensing. When an individual chooses between working for an established firm or as an entrepreneur, they must weight the extra costs and risks of starting their own company. Incorporation is daunting. Even establishing an LLC requires paperwork and a fee. Perhaps the biggest (and growing) burden is occupational licensing. More than one-in-three workers today need a government license to work, compared to one-in-twenty in the 1950s. Occupational licensing not only hinders employment levels, but hinders occupational mobility, and has been criticized by liberals and conservatives alike, including the Obama administration.

It is tempting to believe that regulations are well-intentioned and save lives. Surely some do, but this is a naïve rule of thumb. Adam Smith himself noted the tendency of older firms to conspire for regulatory protections from the government against new competitors. Horse buggy makers were the greatest supporters of car safety regulations. As a general rule, without any government guidance or regulation, the market itself exerts the greatest discipline for safety as one of the many desirable features of a product. I would urge the members to support efforts to trim federal regulations, to put sunset clauses into new regulatory legislation, and to provide more oversight of anti-competitive state and local licensing.

Tim Kane Biography

Dr. Tim Kane is an economist at the Hoover Institution at Stanford University. Kane has served twice as a senior economist on the Joint Economic Committee of the U.S. Congress. Kane has appeared on ABC, CBS, CNN, C-SPAN, FOX, NPR,CNBC, and Bloomberg. He is a veteran US Air Force officer who founded two software companies after serving overseas.

Kane graduated from the United States Air Force Academy with a degree in economics. He earned a Ph.D. in economics from the University of California, San Diego.

Kane’s most recent book is *Balance: The Economics of Great Powers from Ancient Rome to Modern America*, coauthored with Glenn Hubbard. In 2012, Kane authored *Bleeding Talent: How the U.S. Military Mismanages Great Leaders and Why It’s Time for a Revolution.*