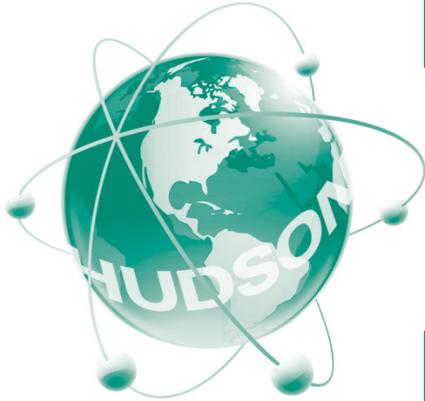


ECONOMIC POLICY BRIEFING PAPER



Hudson Institute

The Collapse of Startups in Job Creation

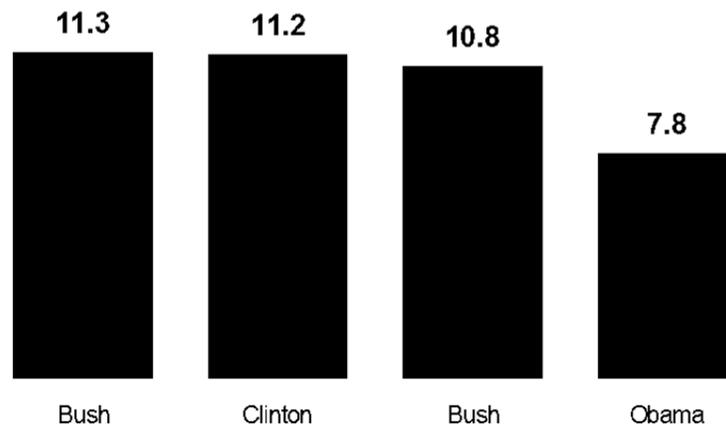
Tim Kane

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Hudson Institute
1015 15th Street, NW
6th Floor
Washington, DC 20005
www.hudson.org

The Collapse of Startups in Job Creation

Startup Jobs per 1000 Americans



Source: Tim Kane, based on Business Dynamics Statistics, U.S. Census Dept.

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The number of jobs created by establishments less than 1 year old has decreased from 4.1 million in 1994, when this series began, to 2.5 million in 2010.

That is how the Bureau of Labor Statistics (BLS) described the climate for entrepreneurship in America *after* the recent recession was over. As voters head to the polls in just a few weeks, especially with the topic of entrepreneurship recognized as vital by all parties to the recovery, it would only be fair to consider the most recent data possible. Fortunately, last month the BLS published 4th-quarter 2011 figures on job creation by startups, giving us a final annual snapshot of startup job creation during the year.

The state of entrepreneurship in the United States is, sadly, weaker than ever. There are fewer new firms being formed today than two years ago when the recession ended. As the BLS described quarterly entrepreneurship figures, “New establishments are not being formed at the same levels seen before the economic downturn began, and the number is much lower than it was during the 2001 recession.” The peak number of new establishments was 667,000 in 2006, which dropped every year until it hit 548,000 in 2009. Then in 2010 it fell to 505,000.

Job creation at new firms was at an all-time low in 2009 of 2.8 million, then fell again a year later by 250,000 jobs. As background on the issue of startup jobs, there was no good way to measure them without using a proxy of jobs created at small companies, but small companies are overwhelmingly older. I authored a study in July 2010 for the Kauffman Foundation which examined for the first time job creation by *newly formed* firms, as opposed to *small* firms, using a new data series from the Commerce Department called Business Dynamics Statistics which had annual counts of job creation and loss recorded by cohorts of firms by their age from 1977 to the present. The BLS issued an almost identical study in August 2010 which used Labor Department data (from 1994 to the present). Both studies affirmed the surprising new fact that startups create essentially all net new jobs. Existing employers, it turns out, tend to be net job losers, averaging net losses of 1 million workers per year. Entrepreneurial firms create a net 3 million jobs per year on average.

What those initial studies were not able to do was look at data after 2009. Nor did they explore jobs on a per capita basis.

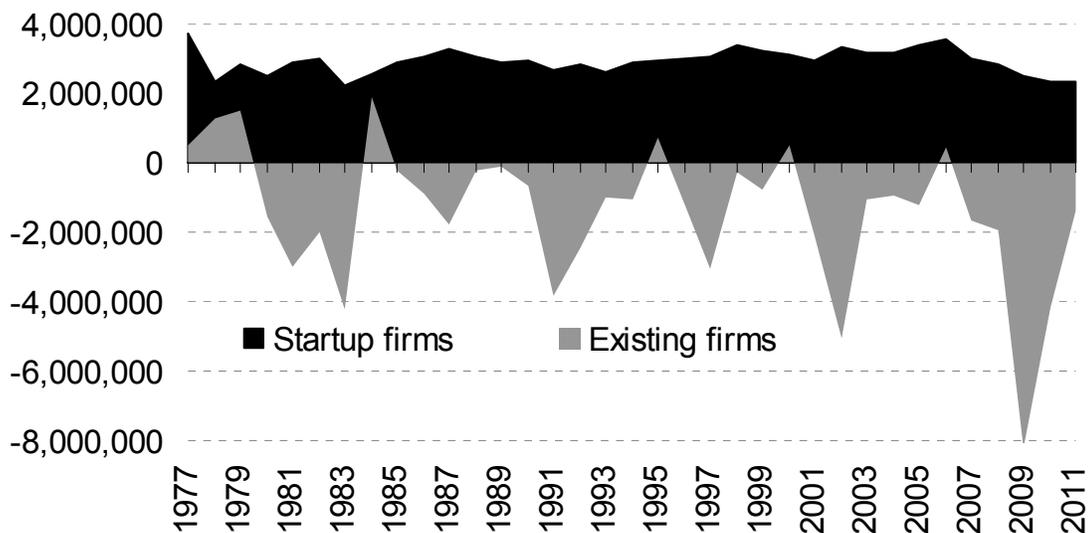
This study aims to answer two questions. First, what has been the long-term pattern of startup job creation per capita? One might expect entrepreneurship to be rising in the United States, especially with lower fixed costs for modern service-based startups, as well as other advantages, such as higher levels of human capital, higher incomes, and the rising availability of funding through bank and venture capital. Second, this study will update the data to the nearest date possible, including interpolation of data through 2011.

The Startup Jobs Rate

Based on my initial research into the importance of startups for job creation, cited by the *2011 Economic Report of the President*, this paper extends that data series by an additional two years. The following figure shows how important startups are for net job creation. Since 1977, newly born companies usually create a net 3 million jobs per year, but the most recently released data report as falling to 2.34 million in the year 2010. The Commerce Department will not release annual 2011 or 2012 data until after the election, but we can see that *quarterly* figures for startup job creation have continued to weaken. Adding the quarterly figures in 2010 yields a total of 2.932 million jobs, but in 2011 that sum total dropped to 2.928 million. I estimated *annual* 2011 figures using that as the proxy.

Job Creation: Startups vs Existing Firms

Net job creation minus loss by firm age cohorts



Source: Tim Kane, based on Business Dynamics Statistics, U.S. Census Dept.

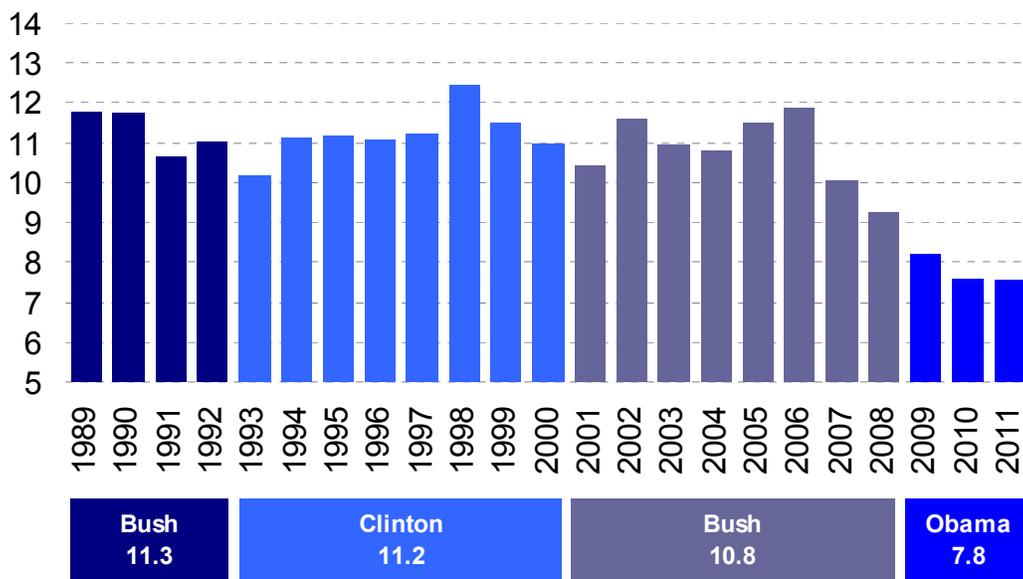
The next step is to convert that startup data into per capita metric. The national population grew from 246 million people to 311 million, according to the U.S. Census. After converting, it is clear that entrepreneurs are having a harder time starting a company today than at any time since the government began collecting data.

The rate of job creation at startup companies was steady in the 1980s and 1990s at 11 startup jobs per 1000 people (i.e. among every 1000 Americans, 11 were newly hired at a

company started that year). But the startup jobs rate has collapsed in recent years. In fact, the rate of startup jobs during 2010 and 2011, years that were technically in full recovery, are the lowest on record. The second figure shows how the rate declined during the recession years 2008-2009, but also shows that it continued to decline afterwards. The average rate for entrepreneurial job creation under the previous three presidents was 11.3, 11.2, and 10.8 respectively, but under President Obama it has been cut by one-third to 7.8.

Startup Jobs Rate

U.S. jobs in new U.S. companies per capita (1000)



Source: Tim Kane, based on Business Dynamics Statistics, U.S. Census Dept.

Economic theory suggests that the modern economy offers a better environment for even more entrepreneurship. First, there is a wider technology frontier to explore. Second, a wealthier society enables more individuals to explore rather than merely work to survive. Third, the shift to services requires less startup capital than manufacturing or agriculture. In other words, the downward trend in the rate of entrepreneurship should, in theory, have rebounded by now. According to economist Sander Wenneker, there is an empirically based U-shaped relationship between self-employment and economic development.

So why is entrepreneurship still declining in the United States?

While this report documents a disturbing weakness in startup job creation, it does not explain the cause of decline. There is anecdotal evidence that the U.S. policy

environment has become inadvertently hostile to entrepreneurial employment. At the federal level, high taxes and higher uncertainty about taxes are undoubtedly inhibiting entrepreneurship, but to what degree is unknown. The dominant factor may be new regulations on labor. The passage of the Affordable Care Act is creating a sweeping alteration of the regulatory environment that directly changes how employers engage their workforces, and it will be some time until those changes are understood by employers or scholars. Separately, there has been a federal crackdown since 2009 by the Internal Revenue Service on U.S. employers that hire U.S. workers as independent contractors rather than employees, raising the question of mandatory benefits. New firms tend to use part-time and contract staffing rather than full-time employees during the startup stage. According to Labor Department data, the typical American today only takes home 70 percent of compensation as pay, while the rest is absorbed by the spiraling cost of benefits (e.g., health insurance). The dilemma for U.S. policy is that an American entrepreneur has zero tax or regulatory burden when hiring a consultant/contractor who resides abroad. But that same employer is subject to paperwork, taxation, and possible IRS harassment if employing U.S.-based contractors. Finally, there has been a steady barrier erected to entrepreneurs at the local policy level. Brink Lindsey points out in his book *Human Capitalism* that the rise of occupational licensing is destroying startup opportunities for poor and middle class Americans.

The quantitative impact of the shifting policies on startup jobs is in need of further study. There is a widespread sense that globalization of the economy exposes companies to new challenges by leveling the playing field for trade. There is no doubt a level playing field among economic institutions as well, where service-based employment can move quickly from one jurisdiction to another. By cracking down on employing Americans part-time, and mandating higher benefits, new American policies may be pushing jobs overseas. This is an issue policymakers must consider carefully when designing rules and regulations for the 21st-century economy.

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About the Author:

Tim Kane is Chief Economist at Hudson Institute and Founder of the social networking firm, StoryPoint. Kane's research on entrepreneurship and job creation has been widely cited, notably in the 2011 Economic Report of the President. He has served in multiple executive and scholarly roles at think tanks and universities. Kane's forthcoming books are *Bleeding Talent* (Palgrave Macmillan), which will explore entrepreneurial leadership in the U.S. military, and *Balance* (Simon & Schuster, with Glenn Hubbard), which will examine the economic decline of great powers. With Glenn Hubbard, Kane maintains a blog, www.BalanceofEconomics.com.

Previously, Kane was a Senior Scholar at the Ewing Marion Kauffman Foundation, where he established the growthology.org blog and initiated the annual Economics Bloggers Forum. Kane organized a quarterly survey of top economics bloggers, which he continues to produce as a Hudson Institute report.

Kane's commentary has appeared in the *New York Times*, *USA Today*, and other outlets. He often provides analysis on CNN, CNBC, ABC, NBC, CBS, FOX, MSNBC, Bloomberg, and PBS' Nightly Business Report. With a track record of successful entrepreneurial startups, his research on job creation has been widely cited.

Kane can be reached via email at tim@hudson.org.

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