

Declining Business Dynamism: It's For Real

Ian Hathaway and Robert Litan

Two weeks ago, we wrote a paper for Economic Studies at Brookings that documented the decline in business dynamism in the United States during the last few decades. We of course feel that this is an important issue, but it would be an understatement to say that we have been surprised at the level of interest our work has received.

While we're happy to have invoked a spirited debate, we also don't agree with some of the analysis we've seen of the research. We'd like to use this opportunity to respond to some of it.

What We Found

To recap, our report showed a persistent decline in the rate of new firm formations and in the job reallocation rate—a broad measure of labor market churn that results from firm formations, expansions, contractions, and failures (what we and other economists call “business dynamics”). We also showed that these declines were nearly universal across the U.S. states and metros during the 30 year period between 1978 and 2011, as well as across a broad range of industries and firm sizes.

In short, the decline in dynamism and entrepreneurship doesn't appear to be isolated to any one segment of the economy or region, but instead has been a widely shared experience.

What we did not advance was a cause. Getting at why individuals are choosing not to launch their own companies and instead opt for employment at incumbent firms is an inherently tricky proposition. But we, and others, are making advances at getting to an answer, and hope to have some new findings to report in the future. For now, it is important to document what's happening—the response from our report seems to confirm that.

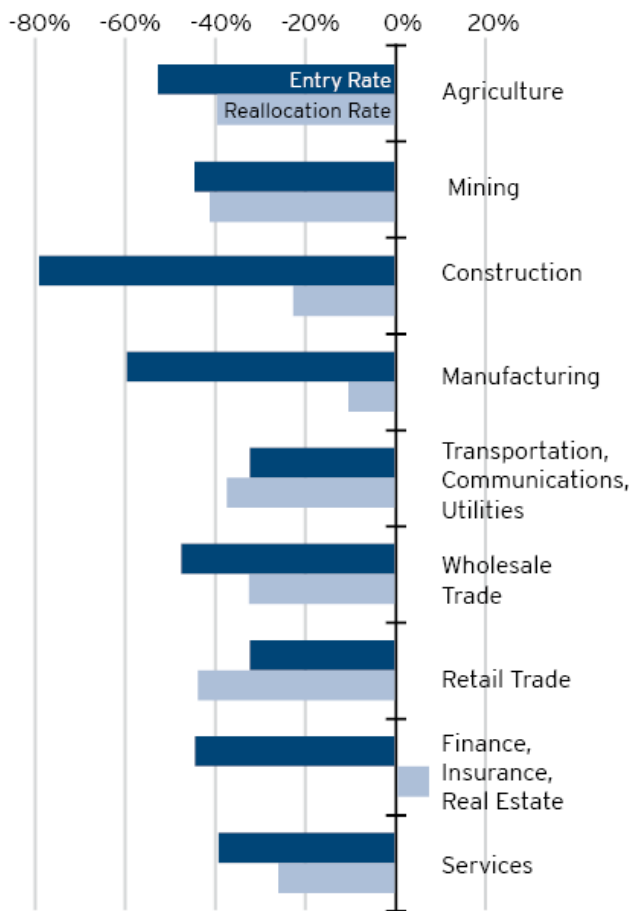
Unfortunately, not advancing a cause also left the door open for a lot of speculation as to what is driving the decline in business dynamism—some entirely valid, some without merit in our view, and some in-between. We address in the next sections several of the more important questions or critiques.

Retail and Services

One criticism is that the decline in dynamism has a lot to do with the combined effects of (i) a shift of economic activity and employment into retail and services, and (ii) the well-known consolidation of firms in those sectors. In other words: our report simply reflected already well-known declines in firm formation and job reallocation in the sectors of the economy that have experienced the most growth. So why worry?

This critique oversimplifies. For one thing, it ignores the fact business dynamism and firm entry are both down across each of the broad industry groups, as shown in Figure A2 from our report (and reprinted here as Figure 1). Put differently, the decline we documented is not limited to retail and services.

Figure 1: Percentage Change in Business Dynamism Measures by Sector (1978–2011)



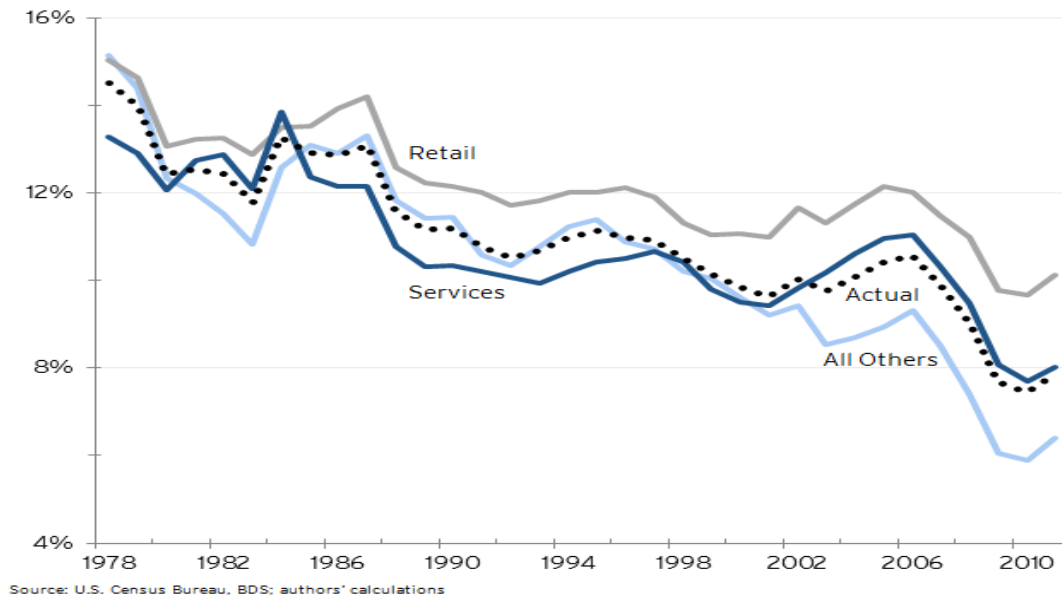
Source: U.S. Census Bureau, BDS; authors' calculations

To amplify our point, consider some additional data from the same Census Bureau series that we used in our initial report, which allow us to calculate firm entry and job reallocation rates for the retail and services sectors versus the rates for the remaining sectors as a group.

As shown below in Figure 2, the firm entry data tell two stories. First, excluding the retail and services sectors pushes the firm entry rate *lower*, not higher as the critique seemingly would imply. This is especially true when retail firm entrants are excluded, since the entry rate in this sector is above average throughout the three-decade period we examined. In contrast, the entry rate for services largely tracks or slightly underperforms the overall rate until around 2001, after which it increases as the non-Retail and non-Services sectors display linear declines (in fact, this decline starts in the mid-1990s).

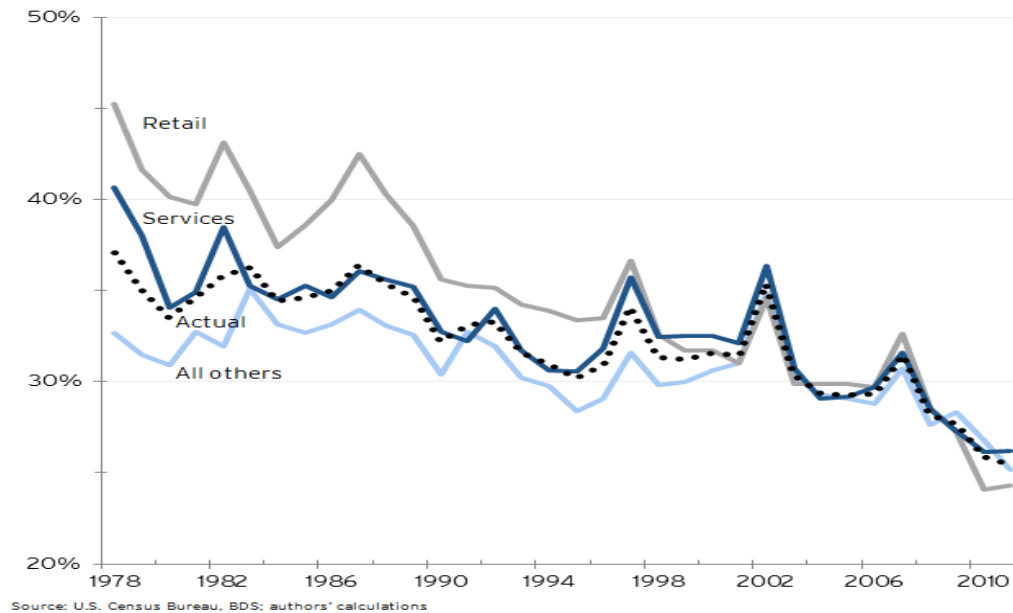
Figure 2

Firm entry has been higher because of the retail and services sectors
 Firm Entry Rate: Retail and Services versus All Others



The patterns for job reallocation rates are slightly different. As shown in Figure 3 below, the drop in the job reallocation rate (partially a function of firm entry), is significantly more pronounced for Retail relative to Services (before the late-1990s) and relative the rest of the economy prior to the early 2000's. From there, all trends move down in a similar manner.

Figure 3:
Retail and Services tell a different story when it comes to job reallocation
Job Reallocation Rate, 1978-2011: Retail and Services versus All Others



Services on the other hand, perform about the same as the job reallocation rate overall. The pattern in this part of the economy suggests that the decline in dynamism in Services is less driven by firm entry than is the case for other sectors.

So, we're back largely where started and initially reported. It is true that retail and services constitute a greater share of the economy than in the past, which means any decline in dynamism in these sectors would drive down the overall rates of dynamism and firm entry disproportionately. But the evidence is more complicated. Both Retail and Services pushed up the firm entry rate, while for job reallocation, Retail pushed it down significantly while Services was about average.

In a University of Maryland [working paper](#), economists there and from the Census Bureau took a closer look at the decline across sectors. While they make stronger comments about the decline in Retail and Services than we do, even they conclude:

"But we note that even in those sectors, we cannot account for most of the decline by taking into account simultaneously the interaction of firm age, firm size, detailed industry, geographic location and indicators of the firm operating in multiple locations. Ultimately, most of the decline in these sectors is in the "unexplained" within component."

In other words, declining dynamism is real and the causes may be difficult to detect, but the spread of large retail chains like Walmart, Starbucks, Costco, and Walgreens does not contradict our basic finding.

High-Growth Firms

A second criticism has been that by focusing on entrepreneurship in all sectors, we aren't separating the one's that "matter" from those that "don't." In other words, by including the mom-and-pop shops (predominantly in retail and services, but also in areas like professional services and construction) along with high-growth potential firms, we are masking the true amount of entrepreneur-driven innovation occurring in the economy—the type of entrepreneurship that will lead to income growth and job creation.

While we disagree with normative judgments about which types of entrepreneurs matter and which ones don't, there is evidence about the importance of high-growth firms. In fact, a very small percentage of firms account for the substantial majority of new jobs created in a given year.

The problem is that it is very difficult, if not impossible, to know at the time of founding whether or not firms are likely to survive and/or grow. This is true even with venture-capital backed firms, which are presumably the ones some of our critics believe that matter, but which in fact are a tiny fraction of all firms launched in any year. Conversely, research conducted at the Kauffman Foundation (where one of us used to work) has shown that the large majority of firms that do grow rapidly – making it to the *Inc 500* list of fast-growing firms in any given year – never received VC money.

The key point about the entrepreneurship rate is that it represents the commercial equivalent of hockey's "shots on goal." The more firms started, the more rapidly growing firms are likely to emerge. For that matter, and to use another sports analogy, the more at bats we get the more doubles and triples will be produced –not just the home runs. That is a major reason why the secular decline in the new firm rate is so worrisome.

Policy and Politics

We also want to caution against those who might use or have used our findings to advance a particular partisan political agenda.

First, we have seen a number of comments in the conventional media and social media that somehow the fact that firm exits now exceed firm births, or that the decline in firm entry generally, is President Obama's fault. We understand in this highly partisan environment, the temptation to advance such claims, but we do not believe they have merit. For one thing, it is doubtful that Presidents have much to do with the rate of firm entry. But even if they did, our data span a period of *30 years*, and include periods when Presidents from both political parties have governed. And yet dynamism has continued to decline over the entire period.

Second, it is difficult to pin the blame for the secular decline in dynamism on high personal income tax rates (which matter for many startups, which increasingly are pass-through entities), either at the federal or state level. At the federal level, the top marginal tax rate has *fallen* since the Reagan tax cut of 1981 (the beginning year of

our three decade span), and yet business dynamics have declined. Meanwhile, at the state and local levels, it is difficult to detect from the data we looked at that differences in state and local taxes have accounted for declining dynamism, since the decline has occurred *in every state and virtually every metro area*.

Third, we have speculated in comments since our report that mounting regulation – from all levels of government – could be one factor frustrating job reallocation while tilting against entrepreneurship. [Younger, smaller firms do not have the resources](#) that larger, more established firms do to hire full-time attorneys or compliance officers, which should put them at a progressively larger competitive disadvantage as regulations continue to grow in number and complexity. In other words, we think a more relevant conversation isn't a generic one about regulation per se, but one that considers if our regulations systematically disadvantage entrepreneurs vis-à-vis incumbents and larger firms. We want to stress that this “cause” for declining dynamism is only a hypothesis at this stage, and awaits confirmation by future researchers, but it seems to be a plausible contributing factor.

Fourth, notwithstanding the *possibility* that mounting regulation in general may be one factor driving the decline in dynamism, it is also *possible* that the much-criticized Affordable Care Act could eventually help to begin reversing the secular decline in firm formation. This is because “guaranteed issue” of health insurance without discrimination on the basis of preexisting conditions, in principle, could loosen [“job lock”](#) that can inhibit employees with ideas for new businesses from leaving more established firms to take the entrepreneurial plunge. It will take several years, however, to see whether the data confirm or refute this plausible hypothesis. In addition, any benefits the ACA may entail in this regard say nothing about other critiques of the Act and proposals for how it may be improved.

Finally, as we noted in our initial report, the lowest hanging “fruit” for reversing the decline in startups is to increase the numbers of permanent work visas for immigrants coming here to earn advanced degrees in STEM fields and to establish businesses in the United States. Such measures would build on the well-established fact that immigrants generally are more likely to establish businesses than native-born Americans. Importing more individuals with technical knowledge, in particular, should help ensure that many of the new businesses that immigrants launch here introduce the kinds of new scientifically advanced products, services, and methods of production that are especially likely to enhance productivity growth, and thus faster growth in U.S. living standards.