"Struggling to Grow: Assessing the Challenges for Small Businesses in Rural America"

Testimony before
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Committee on Small Business
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Chairman Huelskamp, Ranking Member Chu, and members of the Subcommittee, thank you for the invitation to testify today. The views I'll share with you today are my own.

The Subcommittee's focus on economic growth, and, in particular, the obstacles to faster growth in rural areas, is not only timely and important – it is, in my opinion, the most important domestic policy challenge currently confronting the nation.

The Beatles Were Only Half Right – Love is Important, but You Need Growth Too

Since emerging from the Great Recession more than seven years ago, the U.S. economy has grown at an average annual rate of just 2.2 percent – more than a percentage point slower than the post-WWII average of 3.4 percent. Indeed, the U.S. economy has not grown at 3 percent or better, on an annual basis, since 2005.

Alarmingly, the Congressional Budget Office (CBO) has projected that the economy will grow over the medium- to longer-term at a subpar pace of just 2-2.5 percent, "well below the average seen over the past several decades."[1] Recent Obama Administration budget proposals have also forecast growth of just 2.3 percent, "markedly slower than the average growth rate of real GDP since 1947."

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[1] Testimony of Douglas Elmendorf, Director, Congressional Budget Office, before the Senate Budget Committee, February 11, 2014.

Many private sector economists agree. A survey earlier this year by the National Association for Business Economics found that respondents had lowered their growth outlook to just 2.2 percent this year and 2.4 percent next year.[2] That forecast now appears to have been overly optimistic. Growth in the first half of this year was an anemic 1 percent.[3] Former Treasury Secretary Larry Summers has referred to the U.S. economy's sub-par post-recession performance as "secular stagnation."[4]

The rate at which the U.S. economy expands isn't just another dry statistic. It is the best overall gauge of the opportunity our nation provides its citizens. An economy that grows at a healthy pace of 3.5 to 4 percent on a sustained basis provides ample opportunity for the American people to pursue their dreams and achieve their potential. Slower growth, particularly over an extended period, fails our nation's citizens.

Indeed, weak economic growth experienced since 2005 is the principal cause of America's most serious, politically difficult, and, in some ways, mutually reinforcing challenges, including:

- persistently high unemployment and underemployment;[5]
- high and rising long-term debt;
- stagnant middle-class wages;
- wide and worsening income, wealth, and opportunity inequality;
- the highest poverty rates since the mid-1960s; and,
- record numbers of Americans reliant on government programs like food stamps and disability insurance.

To meaningfully address these challenges – and the anger, cynicism, and populism they inspire – we must accelerate economic growth back to the historical average of 3.5 percent *on a sustained basis*.

The difference between 2.3 percent and 3.5 percent growth may not seem significant, but in an economy the size of the U.S. economy percentage points matter. Had the economy grown at 3.5 percent since emerging from recession in 2009, GDP last year would have been more than $1 trillion greater. Over a twenty-five year period, the difference between a U.S. economy growing at 2.2 percent annually versus 3.5 percent is more than *$100 trillion* in additional economic output.

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[2] Kent Hoover, "Business Economists See Slow Growth Ahead," *The Business Journals*, March 28, 2016.

[3] "US Q2 Gross Domestic Product up 1.1% vs. 1.2% Increase Expected," *Reuters*, August 26, 2016.

[4] Josh, Boak, "U.S. Economy May Be Stuck in Slow Lane for Long Run," *Associated Press*, February 9, 2014.

[5] Nicholas Eberstadt, "The Idle Army: America's Unworking Men," *The Wall Street Journal*, September 1, 2016.

While complete solutions to the challenges listed above require progress on a number of fronts, there is little doubt that our ability to address these and other problems would be greatly enhanced by faster economic growth. Growth at or above the post-WWII rate of 3.4 percent on a sustained basis would produce the jobs necessary to end the current employment crisis, the opportunity necessary to accelerate socio-economic mobility, the rising real wages needed to narrow the income gap and reduce poverty, and the additional tax revenue necessary to narrow budget deficits and substantially reduce the nation's long-term debt.

Where Does Growth Come From?

Over most of economic history, it had been widely assumed that economic growth stems from enhancements to one or both of the two principal components of an economy – capital and labor. For an economy to grow, it was thought, either the labor market had to expand or capital intensity had to somehow increase.

But in 1957, American economist Robert Solow demonstrated that most of economic growth cannot be attributed to increases in capital and labor, but only to gains in productivity – more output per unit of input – driven by innovation. As businesses and workers become more efficient, costs fall, profits and incomes rise, demand expands, and economic growth and job creation accelerate.[6]

Solow's identification of innovation-driven productivity gains as the driver of economic growth has been echoed by economists ever since. As Nobel Laureate economist Paul Krugman has observed: "Productivity isn't everything, but in the long run it's almost everything."

> A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker...Compared with the problem of slow productivity growth, all our other long-term economic concerns – foreign competition, the industrial base, lagging technology, deteriorating infrastructure, and so on – are minor issues.[7]

Solow's growth model is one of the great economic insights of all time – the economic equivalent of E=MC(sq). Solow was awarded the Nobel Prize in economics in 1987, the National Medal of Science in 1999, and the Presidential Medal of Freedom in 2014.

New Businesses As the Engine of Innovation, Productivity Gains, and Growth

The great significance of Solow's work is that it not only defined the *nature* of economic growth, it also identified its principal *source*. That's because economists have long understood that innovation – particularly major or "disruptive" innovation – comes disproportionately from new businesses, or "start-ups."

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[6] Robert M. Solow, "Technical Change and the Aggregate Production Function," *Review of Economics and Statistics* (The MIT Press) 39, no. 3, 1957: 312–320.

[7] Paul Krugman, *The Age of Diminished Expectations*, The Washington Post Company, 1990, pp. 9–13.

Economists Robert Litan and Carl Schramm emphasized this reality in their 2012 book *Better Capitalism*:

> [E]ntrepreneurs throughout modern economic history, in this country and others, have been disproportionately responsible for truly radical innovations — the airplane, the railroad, the automobile, electric service, the telegraph and telephone, the computer, air conditioning, and so on— that not only fundamentally transformed consumers' lives, but also became platforms for many other industries that, in combination, have fundamentally changed entire economies...
>
> Large companies, with their large fixed costs of plant, equipment, and to some extent personnel, have perfected the economic arts of economies of scale production and incremental innovation. But...most large companies are less eager to pursue radical innovations — those that disrupt current business models in which the firms are heavily invested.[8]

In addition to innovation, research conducted in 2009 by John Haltiwanger, Ron Jarmin, and Javier Miranda, followed by further analysis by scholars at the Kauffman Foundation, has shown that start-ups also account for virtually all net new job creation.[9]

From the standpoint of innovation, economic growth, and job creation – arguably the three most important metrics of economic health and vitality – thriving entrepreneurship is the beating heart, the very soul, of any economy.

The Engine of Innovation and Growth is Breaking Down

Unfortunately, as scholars at the Kauffman Foundation, the Brookings Institution, and elsewhere have documented, entrepreneurship in America is in trouble. Not everywhere, of course; in places like Silicon Valley, Austin, TX, Boulder, CO, and Cambridge, MA entrepreneurship is thriving. But in broad terms, entrepreneurship in America is struggling.

After remaining remarkably consistent for decades, the number of new businesses launched in the United States peaked in 2006 and then began a precipitous decline – a decline accelerated by the Great Recession. Research by the Kauffman Foundation indicates a rebound in start-ups in the last two years, but the recovery is from a very low level and the number of new businesses remains well below pre-recession levels.[10]

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[8] Robert E. Litan and Carl J. Schramm, *Better Capitalism: Renewing the Entrepreneurial Strength of the American Economy*, Yale University Press, 2012.

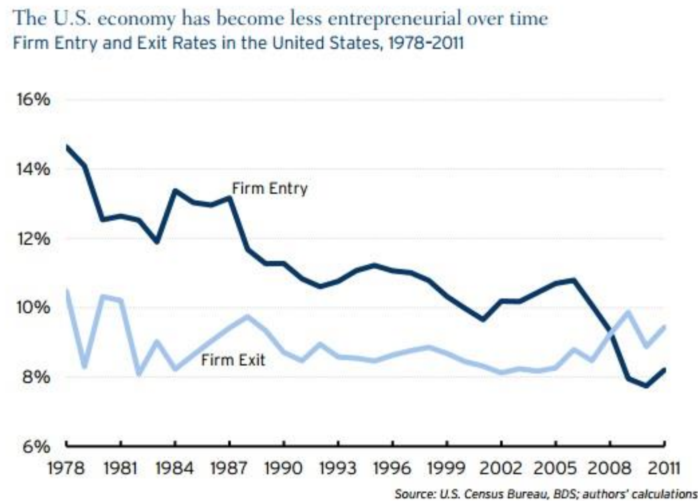
[9] John Haltiwanger, Ron Jarmin, and Javier Miranda, "Business Dynamics Statistics Briefing: Jobs Created from Business Start-Ups in the United States," Ewing Marion Kauffman Foundation, 2009; Dane Stangler and Robert Litan, "Where Will the Jobs Come From?" Ewing Marion Kauffman Foundation, November 2009; Tim Kane, "The Importance of Start-Ups in Job Creation and Job Destruction," Ewing Marion Kauffman Foundation, July 2010.

[10] Index of Start-Up Activity, Ewing Marion Kauffman Foundation, August 2016. Also see testimony by Dane Stangler, Vice President for Research & Policy, Ewing Marion Kauffman Foundation, before the Committee on Small Business and Entrepreneurship, U.S. Senate, June 29, 2016.

A recent report by the Economic Innovation Group (EIG) found that, beginning in 2009, the total number of firms in the U.S. economy actually *declined* for three consecutive years. This decline is without precedent; even during prior recessions, the U.S. economy produced tens of thousands of net new businesses.[11]

When compared to previous post-recession recovery periods, the rate of new business formation since the Great Recession is especially alarming. In the five years following the 1991 and 2001 recessions, over 400,000 net new businesses were launched, according to EIG's research. In stark contrast, between 2010 and 2014, the net increase in American businesses was just 166,500.

Even more alarming, economists Robert Litan and Ian Hathaway have shown that entrepreneurship rates have fallen near a 30-year low, and that this decline is occurring *across a broad range of industry sectors, including high-technology, and in all 50 states*.[12] The chart below, taken from Litan and Hathaway's May 2014 paper, shows that the number of new firms as a percentage of all firms has been in steady decline for more than three decades – and, since 2008, has fallen below the rate of business failure. In other words, in recent years more businesses have been failing in America than launching.



As Solow's growth model would predict, U.S. productivity has fallen along with the decline in rates of new business formation. Annual productivity gains averaged about 2.5 percent from 1948 to 2006, but have fallen to about 1.1 percent since 2011– less than half the historical rate. Growth in output per hour slowed to just 0.5 percent in 2014, and to just 0.3 percent in 2015.

[11] "A New Map of Economic Growth and Recovery," Economic Innovation Group, May 2016.

[12] "Declining Business Dynamism in the United States: A Look at States and Metros," Robert Litan and Ian Hathaway, The Brooking Institution, May 5, 2014. Also see John Haltiwanger, Ian Hathaway, and Javier Miranda, "Declining Business Dynamism in the U.S. High-Technology Sector," the Ewing Marion Kauffman Foundation, 2014.

The Conference Board has predicted that U.S. productivity growth will actually *decline* in 2016, for the first time in three decades.[13]

2004 Nobel Prize recipient Edward Prescott and his colleague Lee Ohanian from Stanford University have argued that the economy's anemic performance in recent years is due largely to the plunge in productivity growth – caused by the dramatic decline in start-ups:

> The remarkable productivity growth that has enabled the U.S. to become the wealthiest country on earth has slowed considerably in recent years.
>
> The most recent period of rapid productivity growth in the U.S. — and rapid economic growth — was in the 1980s and '90s and reflected the remarkable success of new businesses in information and communications technologies, including Microsoft, Apple, Amazon, Intel, and Google. These new companies not only created millions of jobs but transformed modern society, changing how much of the world produces, distributes and markets goods and services.
>
> Sadly, the annual rate of new business creation is about 28 percent lower today than it was in the 1980s, according to our analysis of the U.S. Census Bureau's Business Dynamics Statistics annual data series. Getting the U.S. economy back on track will require a much higher annual rate of new business start-ups.[14]

Circumstances in rural areas of America are particularly acute. The recent EIG report shows that most of the new business formation that has occurred since the Great Recession has been highly concentrated, clustered mostly in high-density urban or suburban areas. Fully half of the net increase in U.S. business establishments between 2010 and 2014 occurred in just 20 counties, and 17 of those 20 counties are in just four states – California, Florida, New York, and Texas. This pattern of concentration stands in stark contrast to previous recoveries. From 1992 to 1996, for example, 125 counties generated the same 50 percent of new businesses.

Perhaps most alarming, rural areas have not participated in even the scant amount of new business formation that has occurred since the Great Recession. In the five years following the 1991 recession, small counties – those with less than 100,000 residents – generated the highest rates of new business formation, and nearly a third of the net increase in total U.S. businesses over the period. Since 2009, small counties have experienced net negative growth in the number of business establishments.

Given the critical role start-ups play as the principal source of disruptive innovation, productivity growth, economic growth, and job creation, such circumstances amount to nothing short of a national emergency.

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[13] Sam Fleming and Chris Giles, "US Productivity Slips for First Time in Three Decades," *The Financial Times*, May 25, 2016.

[14] Edward C. Prescott and Lee E. Ohanian, "U.S. Productivity Growth Has Taken a Dive," *The Wall Street Journal*, February 3, 2014.

Why are Start-up Rates Declining?

Rates of new business formation have fallen near multi-decade lows, both in terms of the number of new businesses being launched and the share of all U.S. businesses that are new.

But why?

To find out, a colleague and I decided to put the question directly to America's entrepreneurs. Over the summer of 2011, we conducted roundtables with entrepreneurs in 12 cities across the United States, asking them, quite simply: "What's in your way?"

More than 200 entrepreneurs participated – from a web-based software company in Seattle to an industrial construction firm in Orlando, from a developer of bioscience technologies in Boston to a distributor of glow-in-the-dark fluorescent fish in Austin – all explaining in specific and vividly personal terms the issues, frustrations, and obstacles that are undermining their efforts to launch new businesses, expand existing young firms, and create jobs.

An astonishing take-away from our roundtables – and enormously significant from the standpoint of potential policy solutions – is that the problems and obstacles encountered by entrepreneurs across the country are remarkably consistent. Entrepreneurs from Austin to Boston and from Seattle to Orlando reported the same burdens, frustrations, and difficulties:

- "We have the jobs, and we need to fill them to survive, but we can't find enough people with the skills we need."
- "Our immigration policies don't effectively attract and retain the world's best and most innovative talent."
- "Access to start-up capital is even more difficult in the wake of the financial crisis."
- "Over-regulation is killing us."
- "Tax complexity and uncertainty is diverting too much of our time and attention away from our new businesses."
- "There's too much economic uncertainty – and it's Washington's fault. It's the endless bickering and partisanship. The fiscal cliff, the debt ceiling, the government shut-downs. The inability to achieve tax reform, immigration reform, or effectively deal with the national debt. Washington is a generator of problems not solutions, a source of anxiety and uncertainty for businesses – and it's killing the economy."

Our summer on the road revealed a number of critical insights central to any discussion about accelerating economic growth.

First, new businesses are extremely fragile – a third fail by their second year, half by their fifth. And yet, those new businesses that survive tend to grow, innovate, and create jobs at very rapid rates.

Second, the policy needs and priorities of new businesses are unique. Start-ups are different from existing businesses. The challenges they confront are different and their ability to successfully navigate those challenges is more limited.

Third, policymakers in Washington do not sufficiently understand or appreciate the unique nature, importance, vulnerability, and needs of start-ups. Focused on the priorities of either large corporations or the small business community, policymakers too often overlook the economy's true engine of growth and job creation.

Finally, policy help for America's job creators is urgently needed. Given the critical role they play in our nation's economy as the principal source of innovation, growth, and job creation, America's young businesses need and deserve a comprehensive and *preferential* policy framework designed to cultivate and nurture start-ups – an on-ramp to viability.

Fortunately, we now know what needs to be done. Our remarkable summer on the road meeting and listening to America's entrepreneurs revealed with unprecedented clarity the major obstacles undermining their ability to launch new businesses, grow those businesses, and create jobs. With those obstacles in mind, my colleague and I developed a 30-point policy plan for unleashing the growth- and job-creating capacity of the entrepreneurial economy – based on what American entrepreneurs told us they need.

See the attached Appendix for the complete list of our policy proposals.

Conclusion

Economic growth is driven by productivity gains, which are driven by innovation – which comes disproportionately from new businesses. Revitalizing American entrepreneurship, therefore, is the *essential pathway* to faster economic growth and the nation's ability to meaningfully address its most serious socio-economic challenges.

But that necessary revitalization requires changes in public policy. Fortunately, we have a good sense of what needs to be done. Research conducted in recent years, together with input from entrepreneurs by way of the roundtables mentioned above and other forums, has produced a uniquely credible pro-entrepreneurship growth agenda that, if enacted, would dramatically enhance the circumstances for new business formation, survival, and growth and, in doing so, accelerate economic growth, in aggregate and across America's many communities, to the rate necessary to generate the opportunity the American people deserve.

The only remaining question is: Do America's policymakers have the will to act?

Thank you for organizing this important hearing and for inviting me to participate.