

Kauffman Foundation Research Series: Firm Formation and Economic Growth

The Return of Business Creation

July 2013

Ian Hathaway,

Economic Advisor to Engine

Jordan Bell-Masterson,

Analyst, Research and Policy

Ewing Marion Kauffman Foundation

Dane Stangler,

Director of Research

Ewing Marion Kauffman Foundation



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Summary

Freshly released government data show that new business formation rebounded in 2011, after four years of decline, from the depths of the Great Recession. This is a welcome development—new businesses are the engine of job creation in the United States economy and an important source of innovation and productivity. Perhaps most importantly, the rise in new business formation between 2010 and 2011 was geographically dispersed throughout the United States.

While the rise of new business creation in 2011 is a significant development—it is the first annual gain in five years and the largest percentage annual increase in nearly a decade—the bulk of this paper examines two classes of new businesses that most closely resemble entrepreneurship: companies less than one year old with one to four employees and those with five to nine. This analysis finds that the smallest of these new firms represent most of the increase in firm formation in 2011:

- New companies with one to four employees comprise the vast majority of new businesses formed each year, accounting for, on average, 86 percent of new firms since the late 1970s in the BDS data.
- Job creation at new businesses of all sizes increased by 4.3 percent, and rose by 5.4 percent in new companies with one to four employees, reversing four consecutive years of decline for those smallest companies.
- Companies less than one year old with one to four employees have created, on average, more than 1 million jobs per year over the past three decades; those with five to nine employees have added, on average, half a million jobs per year.
- With a promise of more detailed analysis in future reports, this paper presents maps that illustrate the increased share of new business formation in most states and metro areas across the nation.

Encouraging Recovery in Business Creation

During the Great Recession of 2008 and 2009, the American economy went into a tailspin—the labor market bled jobs, consumer spending fell sharply, and corporate earnings tumbled off a cliff. Even after the recession officially ended in mid-2009, the economic recovery was slow and unstable. Some indicators bounced back sharply and some experienced modest improvement, while others—such as employment and overall economic output—continued to stall.

New business creation, which for many years had been a steady force in the U.S. economy, was no exception. From a thirty-year peak of more than 560,000 new businesses created in 2006, new firm formation fell 31 percent over the next few years to a nadir of fewer than 390,000 new firms started in 2010—the lowest point in the three decades covered by Census Bureau data.¹ Because the population continued to grow, the per capita pace of business creation looked even worse, falling by one-third from 2006 to 2010. Likewise, job creation at new firms fell nearly 32 percent over the same period. (See Table 1.)

Previous research has established the importance of entrepreneurship (new firm formation) to job creation and productivity growth—it is *new and young* businesses, rather than small businesses generally, that have been the primary drivers of net job creation over the last few decades.² The

Table 1

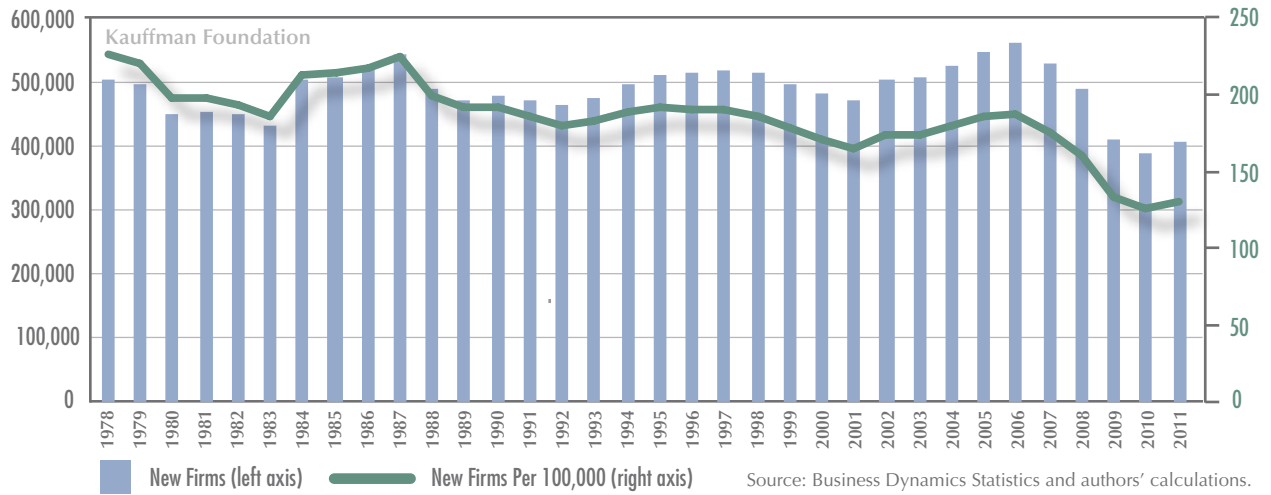
New Firms, All Sizes	Percent Change, 2006–2010
Number	-30.6
Per 100,000 People	-32.9
Job Creation	-31.7

Source: Authors' calculations from Business Dynamics Statistics.

1. See United States Census Bureau, Center for Economic Studies, Business Dynamics Statistics, at <http://www.census.gov/ces/dataproducts/bds/>.

2. See, e.g., John Haltiwanger, "Job Creation and Firm Dynamics in the U.S.," in *Innovation Policy and the Economy*, vol. 12 (National Bureau of Economic Research, 2011); John Haltiwanger, Ron Jarmin, and Javier Miranda, "Who Creates Jobs? Small vs. Large vs. Young," NBER Working Paper 16300 (2010); Dane Stangler and Robert E. Litan, "Where Will the Jobs Come From?" Kauffman Foundation (2009).

Figure 1: New Firm Formation



continuous creation of new businesses each year is vital to economic prosperity.

The latest round of Business Dynamics Statistics (BDS) data from the Census Bureau, updated through 2011, is thus quite heartening: they show that new business creation rose in 2011, the first annual gain in five years and the largest percentage annual increase in nearly a decade. (See Figure 1 and Table 2.) The volume and rate of new firm formation remain, however, at historically low levels.

Table 2

New Firms, All Sizes	Percent Change, 2010–2011
Number	5.0
Per 100,000 People	4.0
Job Creation	4.3

Source: Authors' calculations from BDS.

Encouragingly, job creation at new firms rose by 4 percent, also reversing four years of falling business creation from new companies. This perhaps marks the reversal of several years—even predating the recession—of falling new business job creation.³

For context, new firms represented about 8.2 percent of all firms in the U.S. private sector in 2011, up from 7.8 percent in 2010. Employment at new firms accounted for 2.21 percent of total private sector employment in 2011, a slight rise from 2010 (2.16 percent) but still down relative to a recent peak of nearly 3 percent in 2006. Average employment at new firms was 6.1 in 2011, which essentially was unchanged from 2010—meaning that the higher number of new businesses, rather than larger new companies, drove higher job creation in 2011.

Teasing out the Startups

The BDS data are the gold standard for information on business creation by age, size, employment, and geography. These data are

3. See, e.g., E.J. Reedy and Robert E. Litan, "Starting Smaller, Staying Smaller: America's Slow Leak in Job Creation," Kauffman Foundation (2011); Robert Fairlie, "Kauffman Index of Entrepreneurial Activity," Kauffman Foundation (2013).

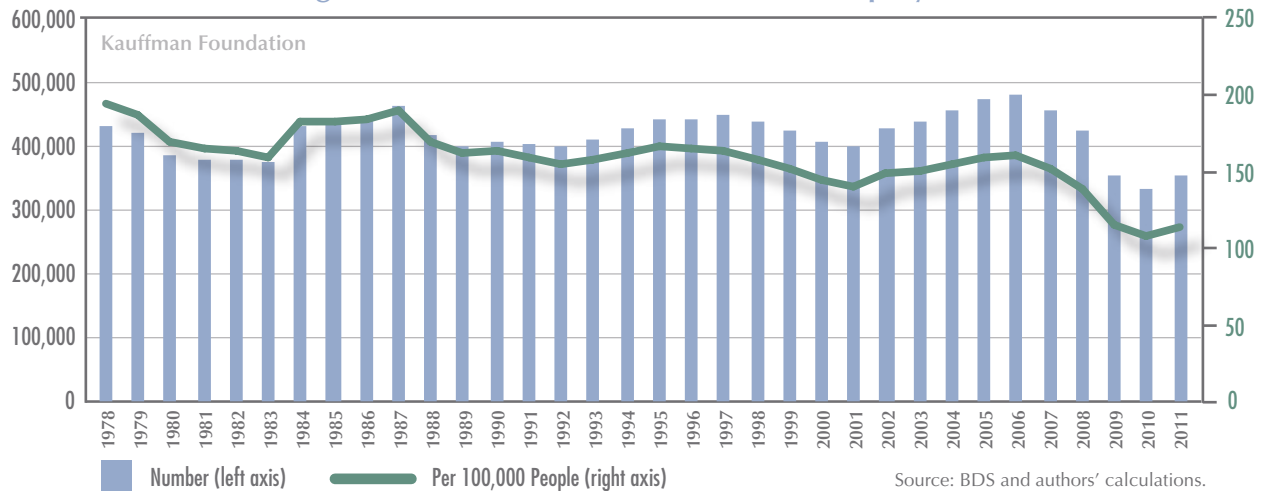
different from other government sources in two important ways. First, business and employment dynamics at the establishment level (physical business locations) are tied back to the parent firm (in the case of multi-establishment businesses). This makes sense because business decisions to expand, contract, close doors, or open up new ones are made at the enterprise-level. For example, much as it would be incorrect to classify a new McDonald's location as a "small business," it also would be a misnomer to call it a "new business." The BDS would correctly classify that as a new business establishment of a very large and very old firm. This difference is critical in the study of entrepreneurship.

Second, and in contrast with many other data that measure entrepreneurship using self-employment figures, the BDS only includes employer firms: companies that have employees.⁴ Yet even the data displayed in Figure 1 include information on "new" businesses that few people would classify under entrepreneurship: large temporary employment agencies and new locations established by foreign multinationals, for example.⁵

To try to get a clearer picture of what might be closer to "real" founders and business owners, we also looked at new firms (those aged less than one year in the BDS) that came into existence with one to four employees.⁶ These represent many of the companies that most closely match the conventional notion of entrepreneurship. Yet we recognize that this subset of new firms necessarily excludes many types of businesses that must come into existence with a minimum number of employees. Certain kinds of restaurants, for example, may need to begin with a few dozen employees to cover various shifts. Since restaurants comprise a substantial portion of new businesses started each year, looking only at firms with one to four employees excludes many of them.

But, looking only at firms with fewer than five employees does capture a very large share of new job creation, and subsequent analysis (see Figures 3 and 4) includes firms with five to nine employees. These small companies are a major source of jobs among new firms in any given year, which means they also are a leading source of new jobs for the entire economy. Accordingly, Figure 2 displays

Figure 2: New Firms with One to Four Employees



4. The dataset includes all types of business entities as well: C Corporations, S Corporations, partnerships, and sole proprietorships. Note as well that, because a self-employed individual who has an incorporated business technically is an employee of their own business, there is some small number of self-employed included in the data. Self-employment often is used by economists as a statistical proxy for entrepreneurship, but it is less useful as an economic proxy.

5. Private correspondence with Census Bureau researchers.

6. Because the BDS tabulates firm size as the average of the current and prior years' employment for statistical purposes, in the case of new firms, the true firm size is twice that listed in the BDS data for all sizes larger than one employee. For example, new firms classified as one to four employees are actually one to eight employees; those classified as five to nine employees are actually ten to eighteen employees, and so on. Here, we stick with the definitions used in the BDS to avoid confusion with researchers using these data.

Table 3

New Firms, One to Four Employees	Percent Change, 2006–2010
Number	-30.7
Per 100,000 People	-33.0
Job Creation	-31.8

Source: Authors' calculations from BDS.

Table 4

New Firms, One to Four Employees	Percent Change, 2010–2011
Number	5.9
Per 100,000 People	4.9
Job Creation	5.4

Source: Authors' calculations from BDS.

the number and the per capita rate for new firms employing one to four people.

These companies—brand new, with one to four employees—comprise the vast majority of new businesses formed each year, accounting for, on average, 86 percent of new firms since the late 1970s in the BDS data. It is, thus, not surprising that Figure 2 looks similar to Figure 1.⁷ The same is true for Table 3 compared with Table 1, which shows that the creation of these smallest new companies also fell precipitously from 2006 to 2010.

Hearteningly, these companies, as with all new companies, had a correspondingly strong rebound—and even slightly stronger. This is evident in job creation: Job creation at new businesses of all sizes increased by 4.3 percent (see Table 2), and rose by 5.4 percent (see Table 4) in new companies with one to four employees, reversing four consecutive years of decline.

Because of the essential role played in economic dynamism by the smallest of the new firms, their strong rebound in 2011 is an important development. As the Figure 3 illustrates, new

Figure 3: Job Creation in New Small Firms



7. See also Dane Stangler, "Neutrality and Entrepreneurship," Kauffman Foundation (2010).

companies that come into existence with one to four employees have created, on average, more than 1 million jobs per year over the past three decades. Those with five to nine employees also have added, on average, half a million jobs per year.

As with the other data presented here, the combined job creation by new businesses with one to nine employees rebounded from the recessionary nadir. Despite this rise, job creation in 2011 by these smallest new firms also continued a persistent trend dating back to the late 1990s—higher job contributions from *larger* new businesses.⁸ (See Figure 4.) The share of new company job creation accounted for by small, new firms was 50.2 percent in 2011, a slight decrease from 2010.

In fact, from 1998 to 2011, the smallest of the new companies (one to nine employees), on average, accounted for about 51 percent of new firm job creation. This has been considerably lower—and persistently lower—than the 56 percent average seen in the previous twenty years. Relatively speaking, this highlights the role of bigger new companies in new job creation—those that come into existence with more than ten employees. The causes of this shift likely vary, and we don't yet have

enough detailed information to know precisely. It could be due to sectoral shifts in terms of the types of businesses being started, or it could reflect the shrinking initial size of the smallest new companies, which would mean, proportionately, a larger role of big new firms. It also may reflect idiosyncrasies in the data—for example, as mentioned above, temporary employment agencies show up as very large new companies in these data.

Rebound in Firm Formation was Widely Dispersed Across the Country

As welcome as the aggregate finding about business creation is, even more heartening is the geographic dimension. As Figure 5 shows, nearly every corner of the country shared in the entrepreneurship rebound.

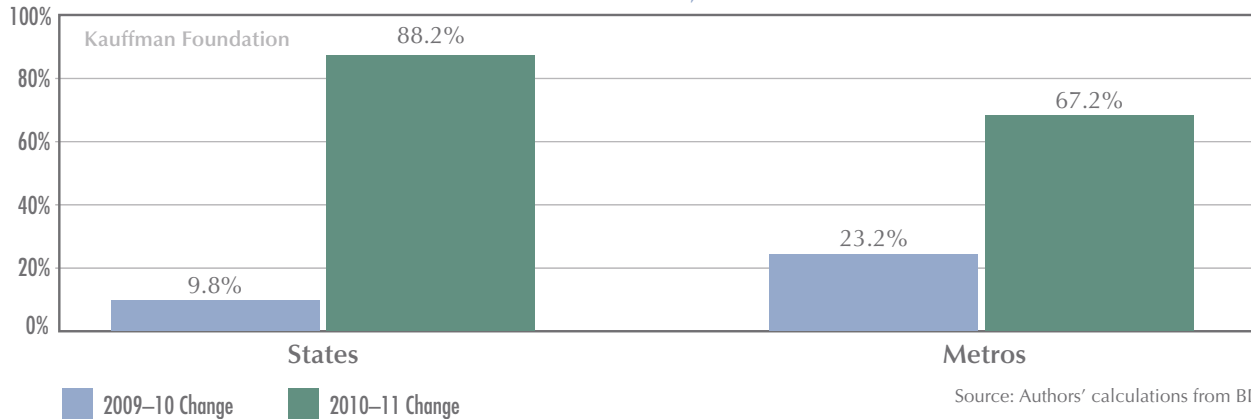
As the data show, growth in new business formation reached far more states than in 2010, when it was still falling across most of the country.

Figure 4: Share of New Firm Job Creation in New Small Firms



8. See, e.g., E.J. Reedy and Robert E. Litan, "Starting Smaller, Staying Smaller: America's Slow Leak in Job Creation," Kauffman Foundation (2011).

Figure 5: Share of States and Metros with Increases in Business Creation, 2010 and 2011



Sparsely populated states such as North Dakota, Wyoming, and West Virginia saw the largest percentage increases, albeit from low bases. In the case of North Dakota, this undoubtedly reflects the economic boom precipitated by the shale gas revolution centered on that state—the

unemployment rate in that state hasn't risen above 4 percent since early 2010.

At the other end, Louisiana and Mississippi experienced the largest declines. This stands in contrast to findings in the Kauffman Index of Entrepreneurial Activity (KIEA), in which these

Figure 6A: Percent Change in New Business Formations by State (2010–2011)

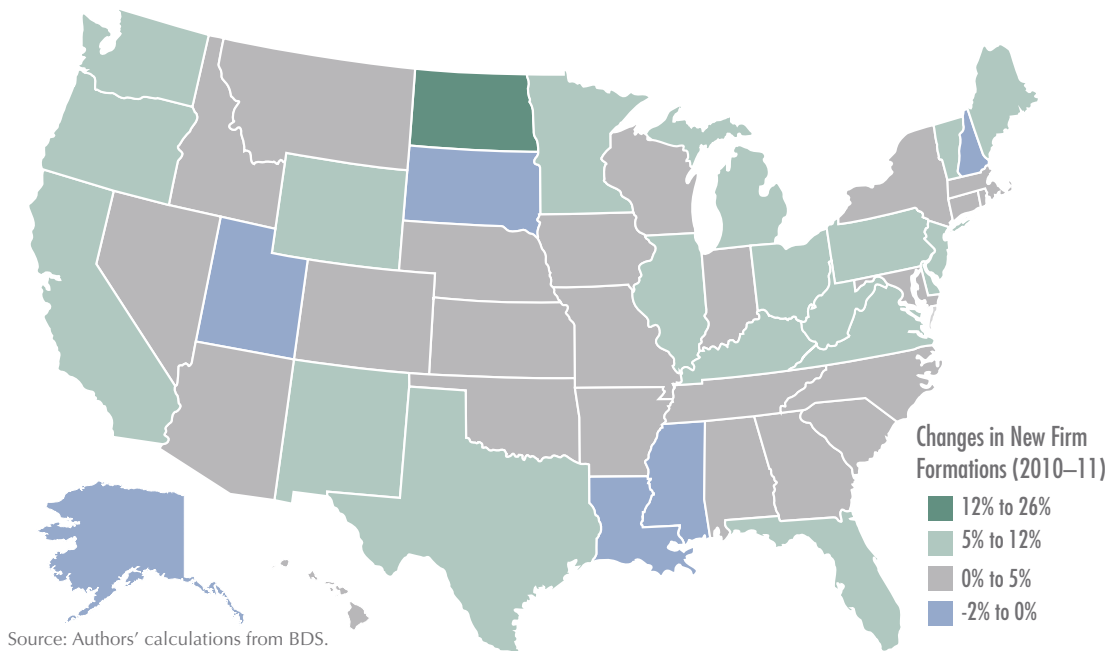
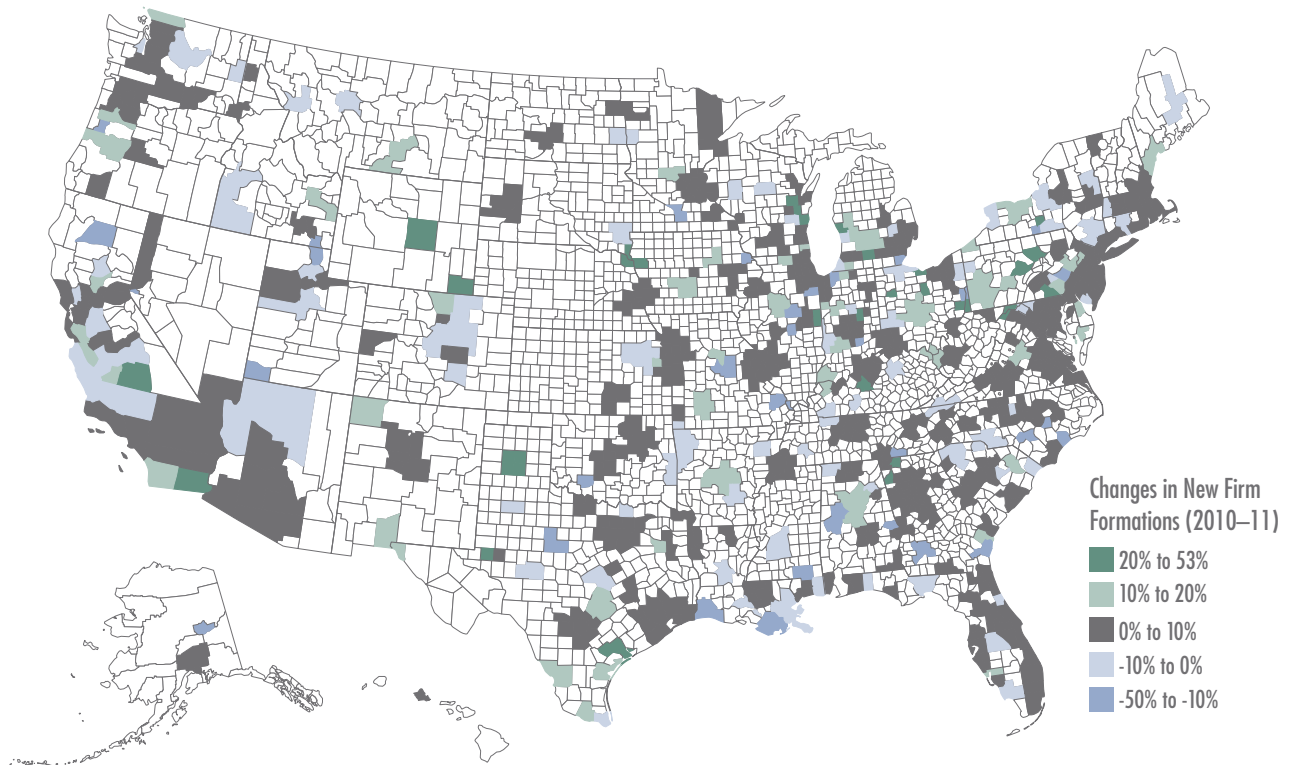


Figure 6B: Percent Change in New Business Formations by Metro (2010–2011)



Source: Authors' calculations from BDS.

two southern states had among the highest rates of entrepreneurial activity in the nation.⁹ Because the KIAE is a broader measure, based on different data collection, and captures non-employer businesses and the self-employed as well as employer companies, this discrepancy likely points to the differential nature of entrepreneurship across the country.¹⁰ What is more, given the uneven geographic character of the recession and recovery, some states may have a preponderance of “necessity” or “replicative” entrepreneurship, while other states have more “innovative” or “growth” entrepreneurship.¹¹

One notable difference between the state and metropolitan maps is that, in a state such as North Dakota, the sum of change in its metro areas doesn't necessarily equal the statewide change. While North Dakota experienced the largest change from 2010 to 2011, its three MSAs didn't see the same increases, and Fargo even saw a decline. This difference likely reflects the inclusion of rural areas in the statewide count, as well as the cross-border nature of many metropolitan areas. Forthcoming Kauffman Foundation reports will look more closely at entrepreneurship at the state and metropolitan levels, but the preceding maps illustrate the widespread rebound in business creation in 2011.

9. See the interactive data on the Kauffman Index of Entrepreneurial Activity site: <http://www.kauffman.org/research-and-policy/kiea-interactive-2012.aspx>.

10. See Paul Kedrosky, “Getting the Bug: Is Entrepreneurship Contagious?,” Kauffman Foundation (forthcoming, 2013).

11. See also Bill Aulet and Fiona Murray, “A Tale of Two Entrepreneurs: Understanding Differences in the Types of Entrepreneurs in the Economy,” Kauffman Foundation (May 2013).

Conclusion

Data that are two years old are no longer “news,” so it might perplex some readers why newly available data for 2011 is cause for a short paper of this kind. Just recently, in fact, a new report purported to find that “more Americans are becoming entrepreneurs than ever before.”¹² Any perusal of blogs or news sites will confirm this impression—it is actually difficult to avoid entrepreneurship these days. So why should we celebrate a small uptick in business creation two years ago? Look around: Entrepreneurship is everywhere!

On the other hand, there also have been recent reports that economic dynamism is dead: the “risk-taking spirit appears to be fading.”¹³ The long-term data illustrated in this paper lend support to this view—the per capita rate of business formation in the United States has been on a slow and steady downward trend since the 1990s. Indeed, what the charts above tell us is that, as entrepreneurship has grown in popularity, and as interest has spread over the past two decades, the needle hasn’t moved much in terms of actual businesses being created. Thankfully, 2011 was a move in the right direction, and we’ll look for a continuation of that trend with next year’s data release.

These conflicting narratives can only be reconciled through data, but a constant limitation in entrepreneurship research is the timely availability of accurate data. The most up-to-date data on business ownership are the Current Population Survey of the Census Bureau, from which the Kauffman Index of Entrepreneurial Activity draws its data. As noted above, that dataset does not allow us to pinpoint employer companies, the businesses most responsible for job creation. Without a more contemporary data dashboard for new business creation, researchers and observers must either wait or rely on less accurate sources of information, including surveys, anecdotes, and sporadic sources of data that cover only small spaces of the entire universe of entrepreneurship.

Perhaps, however, this necessary data delay is a boon. The tradeoff between accuracy and timeliness comes with a cost, in the form of under-informed, or misinformed, decision-making by policymakers—at all levels—and others who seek to support entrepreneurs. Everyone “knows” that entrepreneurship is important, one way or another: for creating new jobs, for innovation, for challenging established incumbents, and so on. Proving that with accurate data is another task altogether. The proliferation of entrepreneurship support of all types—accelerators, courses, training modules, university centers, etc.—is one indicator, of course, but it doesn’t tell us if the actual rate of new business creation is increasing as a result, or if those entrepreneurs who now have a plethora of resources to tap enjoy greater success.

In any case, we now know for certain that, as the overall American economy belatedly recovered in 2011, so too did business creation. Perhaps all those entrepreneurship support programs that began to spread in the wake of the recession really are having an impact. Job creation from new companies also rebounded in 2011, though the levels of firm formation and the job creation therefrom remain far below long-run averages. Nevertheless, the most encouraging finding is that this business creation recovery from the recession was spread throughout the country.

12. See Max Nisen, “More Americans are Becoming Entrepreneurs than Ever Before,” *Business Insider*, June 6, 2013, at <http://www.businessinsider.com/babson-study-finds-more-entrepreneurs-2013-6>.

13. Ben Casselman, “Risk-Averse Culture Infects U.S. Workers, Entrepreneurs,” *Wall Street Journal*, June 3, 2013, p. A1.

Ewing Marion
KAUFFMAN
Foundation

4801 ROCKHILL ROAD
KANSAS CITY, MISSOURI 64110
816-932-1000
www.kauffman.org