TESTIMONY BEFORE THE U.S. SENATE COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP

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"Small Business and the American Worker"

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Chairman Rubio, Ranking Member Cardin, and members of the committee, thank you for inviting me to testify today.

My name is John Lettieri. I am the President and Chief Executive Officer of the Economic Innovation Group (EIG). EIG is a research and advocacy organization focused on the decline of economic dynamism and the geography of economic growth and opportunity.

My testimony today will focus on one simple message: the well-being of American workers depends upon entrepreneurs, and entrepreneurs are facing serious challenges in today's economy. Unless policymakers take action, the future of American entrepreneurship will remain under threat from structural and policy forces that have already combined to diminish the dynamism of the U.S. economy across every sector and region.

How does entrepreneurship benefit American workers?

The creation of new businesses unleashes chain reactions throughout the U.S. economy that help ensure the labor market works for working people. New businesses are a critical source of demand for workers and a driving force behind net job creation. Startups reliably add 2.5 million to 3.5 million jobs to the national economy that either offset the losses or build upon the gains of older firms each and every year.[1]

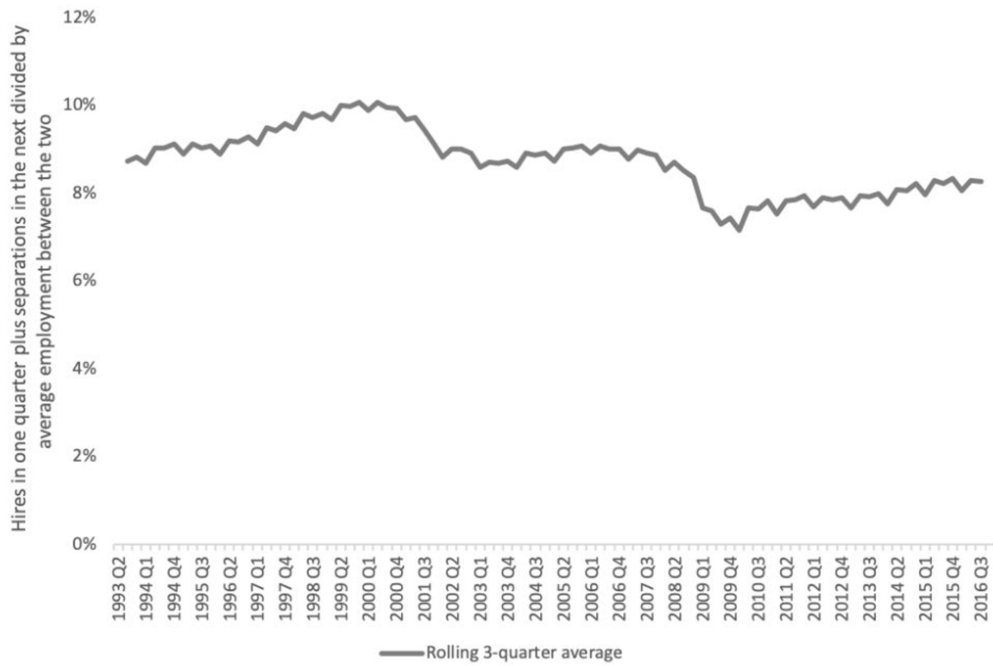
The entry of new firms also enhances competition, driving unproductive firms out of business and clearing the way for more innovative, efficient, and productive ones to

[1] EIG analysis of U.S. Census Bureau's Business Dynamics Statistics data.

thrive.[2] Through this process, American workers reallocate to companies that enable them to be more productive and earn higher wages, too.[3] Thus, in a dynamic economy, American workers benefit from churn among companies.

Before going further, let's address a common misconception about the labor market. The idea that, until somewhat recently, workers stayed attached to one job or one company throughout their careers is simply incorrect. Likewise, the idea that workers today experience greater churn in the labor market than ever before is also incorrect. Even after a long economic expansion, turnover rates only barely now match those from the depths of the prior recession.[4]

Figure 1. Workforce turnover rates



Far from a threat to workers, churn is in fact vital to their labor market success. Canonical studies show that one-third of early career wage growth for American workers comes from job-hopping, and that those early gains are critical to establishing

[2] Ryan Decker, John Haltiwanger, Ron Jarmin, and Javier Miranda, "The Role of Entrepreneurship in US Job Creation and Economic Dynamism," *Journal of Economic Perspectives* 28 (3) (2014): 3-24.
[3] Michael Strain, "The Link Between Wages and Productivity Is Strong," *Expanding Economic Opportunity for More Americans*, Aspen Institute Economic Strategy Group, February 2019.
[4] U.S. Census Bureau Quarterly Workforce Indicators, data through Q4 2016.

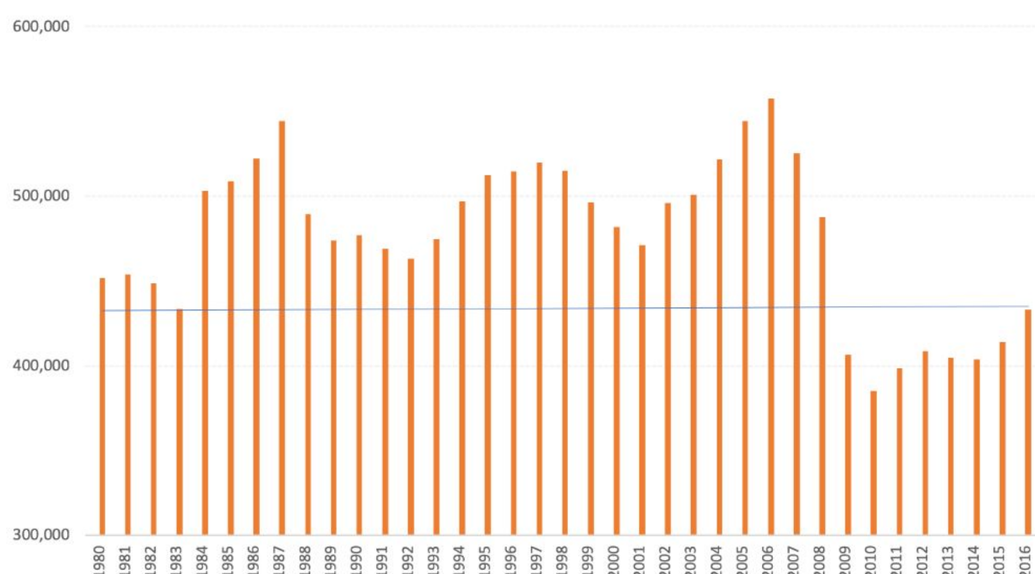
stable lifetime employment trajectories.[5] The latest data from the Atlanta Fed showed that job switchers enjoyed at least one full percentage point higher wage growth through 2017 and 2018 than job stayers.[6] Slowing churn is therefore likely permanently impacting the labor market trajectories of American workers.

What is the state of American entrepreneurship today?

Over the past several decades, the startup rate, defined as the percent of all firms in the economy that started in the past year, has declined across virtually all regions and sectors of the economy. It fell steadily through the 1980s and 1990s before collapsing with the Great Recession.[7] Troublingly, the national economic recovery has done little to improve the rate of business formation. Startup activity finally picked up in 2016, as the rate of new business creation improved to 8.4 percent. Yet even that post-recession high left the startup rate 2 percentage points below its long-run average.

How does this translate for American workers? It means that each and every year since the Great Recession, 100,000 fewer new companies have come online to compete for their labor.

Figure 2. Total number of startups

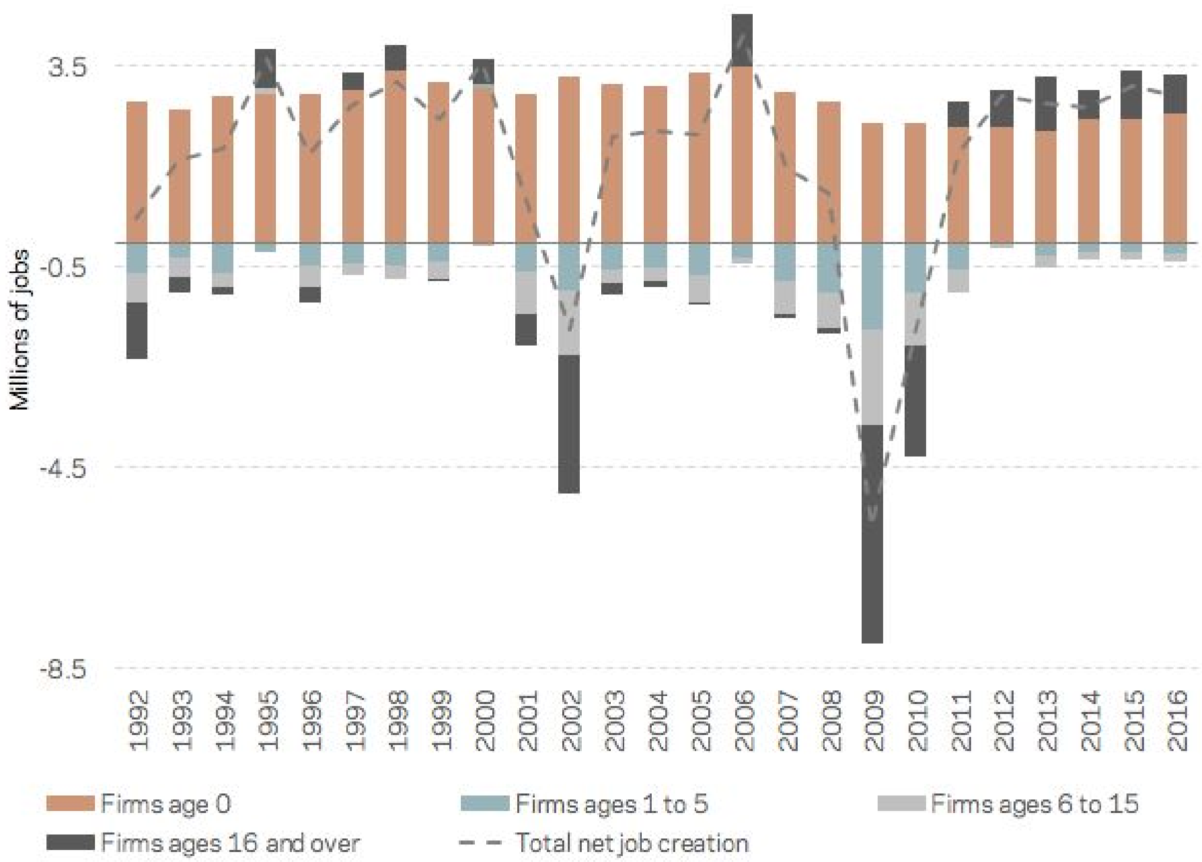


[5] Robert Topel and Michael Ward, "Job Mobility and the Careers of Young Men," *Quarterly Journal of Economics* 107 (2) (1992): 439-479. The study defines early career as the first 10 years in the labor market.
[6] Federal Reserve Bank of Atlanta's Wage Growth Tracker.
[7] This and all startup and small business related statistics in this section comes from our analysis of U.S. Census Bureau's Business Dynamics Statistics data.

This deficit helps explain why, since 2010, new firms have created only 2.4 million jobs each year on average -- 600,000 short of their 3.0 million average in the 1990s and 800,000 short of their 3.2 million average in the 2000s (through 2007).

Even in 2016, the post-recession era's high-point, 125,000 fewer firms launched than in 2006, creating 1 million fewer jobs. Small businesses, for their part, have struggled similarly and relinquished their traditional role as the driving force behind national rebounds. Large, old companies have grown to dominate the U.S. economy at the expense of small, new ones. The unsatisfying nature, pace, and geography of the protracted recovery from the Great Recession may be directly related to these business dynamics of recovery.

Figure 3. Net annual job creation by firm age



Older incumbent companies have stepped into the void left by missing startups and now consistently account for a greater share of net job creation than in the past. Yet, while American workers are clearly better off being hired by an established company than not being hired at all, this development raises a red flag. To generalize, incumbent firms have a fundamentally different relationship vis-a-vis labor than do entrepreneurs. The former, with mature business models, technologies, and market shares, generally prioritize reducing labor costs. Entrepreneurs, on the other hand, deploy workers in new and creative ways in order to unlock value where there was none before. American entrepreneurs find new ways for American workers to thrive. As we've seen, a recovery unfriendly to one is unfriendly to both.

The Shrinking Geography of Economic Dynamism

We are understandably fixated on national aggregates when it comes to understanding the economy. However, this can lead us to overlook how component parts of the economy -- communities -- are faring. The diminished rate of business formation is related to and driving a deeply uneven, and shrinking, geography of economic dynamism.

First, let me be clear: The U.S. economy is less dynamic across all regions today than even a short while ago. At EIG, we evaluated state-level dynamism across seven different metrics from 1992 to 2014 and found that the most dynamic state today (Nevada) scores like one of the least dynamic states two decades ago.[8] This is a trend that leaves no corner of the country untouched.

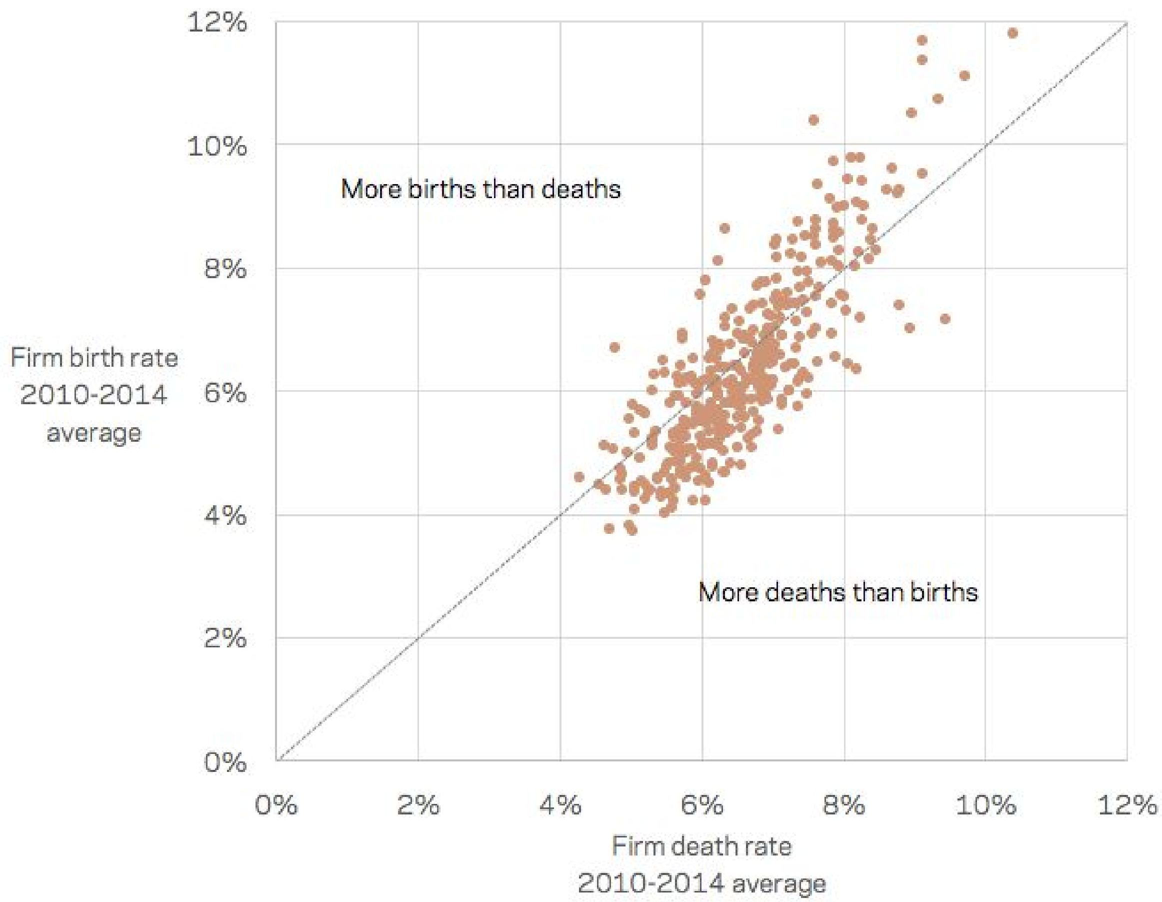
The startup rate is the signal indicator of economic dynamism, given the chain reactions it unleashes. A metro-scaled analysis illustrates the implications of the startup slowdown for people and places. As the national startup rate collapsed, the number of metro areas in which the firm closure rate (relatively constant over time) eclipsed the firm birth rate (which has been falling over time) spiked to unprecedented highs, where it has remained. Thus, even as the number of firms populating the U.S. economy continues to modestly increase, a majority of metro areas are home to a declining stock of firms. Put differently, they are contending with a shrinking number of employers competing for local workers' labor.

The United States now relies on a relatively narrow base of regional economies to drive net firm creation. In the 1970s, more than one-third of metro areas met or exceeded the national startup rate. By the late 1990s, only one in five did. Come the 2010s, that number was only one in seven. The combination of a declining national startup rate and

[8] The seven metrics are: Business churn, change in firms, jobs in new companies, jobs in incumbent companies, labor market churn, labor force participation,and net domestic migration. Economic Innovation Group, "Index of State Dynamism," May 2017.

a contracting startup geography left five major metro areas alone responsible for half the net increase in firms in the U.S. economy from 2010 to 2014. As recently as the 1990s, it took 30 metro areas to achieve a similar benchmark.

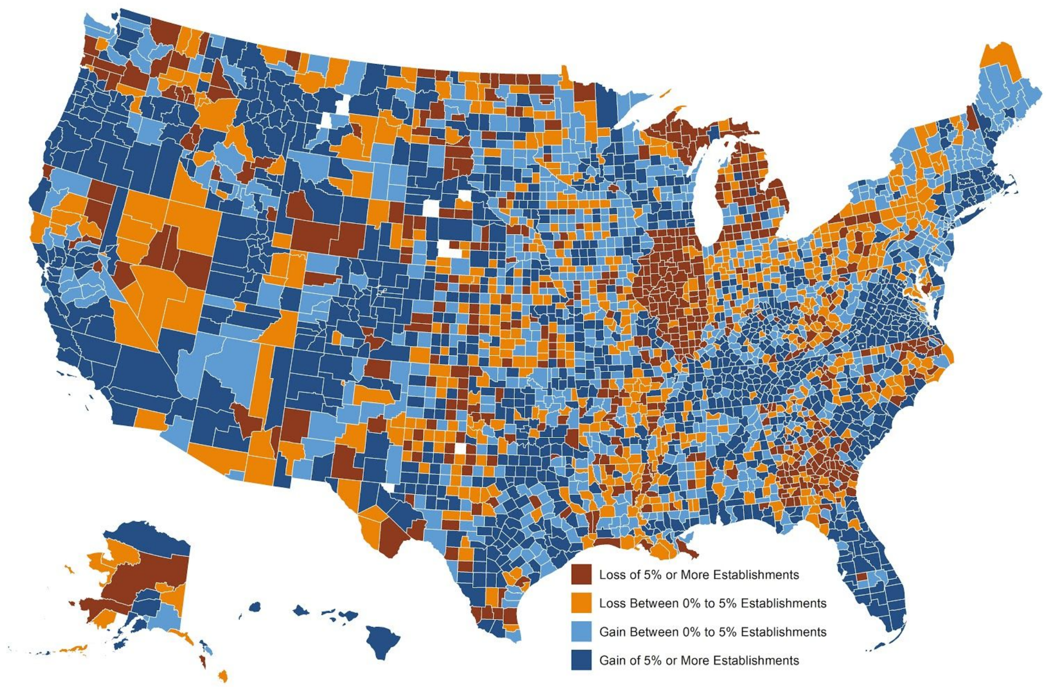
Figure 4. Metro area firm birth and death rates over the initial recovery years



County-level findings reinforce the unevenness of modern growth. From 2012 to 2018, 37 percent of counties lost establishments and 34 percent lost employees.[9] On the other end of the spectrum, one-third of counties accounted for 98 percent of new establishments and jobs. Large metro areas claim an outsized proportion of the gains: 96 percent of 2012 to 2018 establishment and job growth occurred in a metro area and around a fifth of job and establishment growth occurred in the 10 with the largest increases. Rural counties, for their part, only accounted for 1 percent of establishment and job growth among all U.S. counties—by this measure barely improving after six years of national recovery.

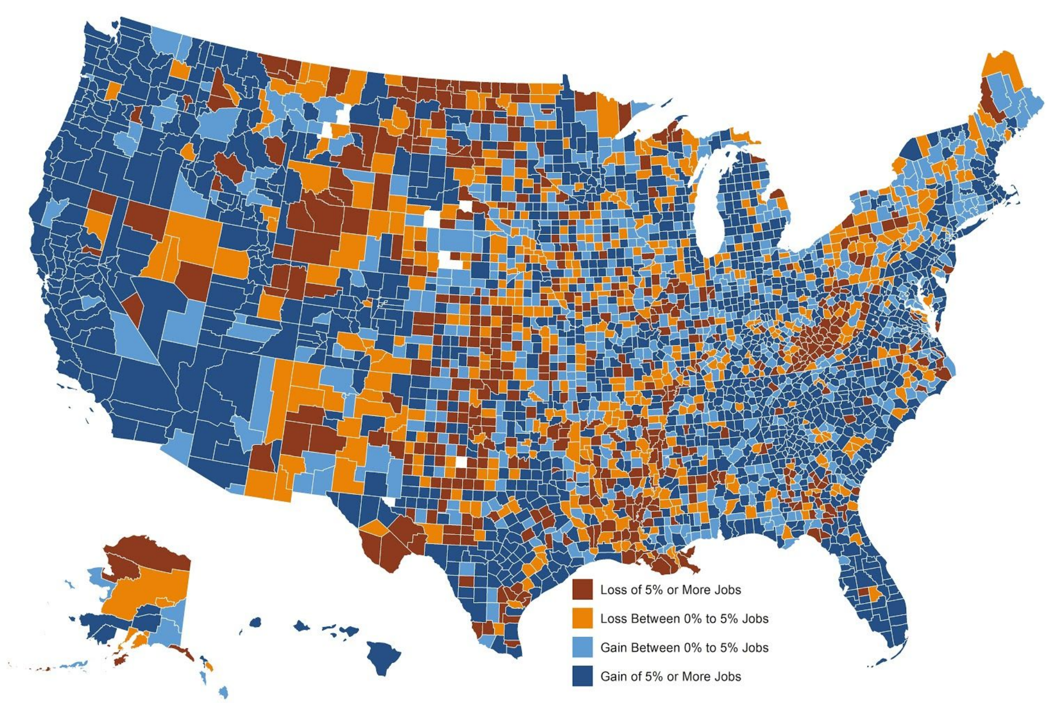
[9] EIG analysis of Bureau of Labor Statistics' Quarterly Census of Employment and Wages data.

Figure 5. Change in establishments from Q2 2012 to Q2 2018



Source: Bureau of Labor Statistics, QCEW

Figure 6. Change in employment from June 2012 to June 2018



Source: Bureau of Labor Statistics, QCEW

EIG's Distressed Communities Index goes further to explore down to the zip code level where the fruits of recovery have concentrated. It finds that prosperous communities -- those that rank in the top fifth of all zip codes nationwide on a comprehensive assessment of well-being -- dominated job and business growth over the past several years. In other words, jobs and businesses have grown increasingly concentrated in the places where incomes are already high and where housing vacancies, poverty rates, and worklessness are all low.

The defining characteristic of such places? They are also the communities where the country's college-educated and advanced degree-holding populations congregate. Highly educated American workers and many of their communities have, so far, proven reasonably able to prosper despite the national decline in dynamism. Indeed, prosperous zip codes have produced more jobs and businesses over the recovery than the bottom four-fifths of American communities combined. Communities without such critical masses of human capital are much more clearly vulnerable to the downsides of the trends discussed here.

Demographics and dynamism

Up until very recently, high rates of population growth put wind in the sails of the U.S. economy and bolstered our entrepreneurs. Population growth not only provided a steady stream of new business owners, but it also stoked demand, provided new and fast growing firms with needed labor, and eased the piloting of new business models. Not long ago, we consistently pointed to demographic tailwinds as reasons to be optimistic about the future health of the U.S. economy.

No longer. At 0.6 percent, the rate of U.S. population growth now stands at its lowest level in over 80 years and half the level of the early 1990s.[10] Population growth is projected to remain muted as net international migration stagnates and birth rates fall. EIG will soon release new research that unpacks these trends as they play out across the map. This research finds that 86 percent of counties are now growing even more slowly than the country as a whole.[11] Half of counties are losing population each year, and two-thirds are losing prime age adults. And two out of every five U.S. counties have already reached Japan-level demographic stagnation.

[10] William Frey, "U.S. Population Growth Hits 80-Year Low," *Brookings Institution*, December 21, 2018.
[11] Forthcoming research with Adam Ozimek of Moody's Analytics.

In recent years, a burgeoning academic literature has explored the relationship between demographics and dynamism, and the findings are sobering.[12] Two prominent studies demonstrate how the slowing growth and aging of the population leads to fewer new firm starts.[13] Another compellingly shows how the aging of the large baby boom generation may be contributing to multiple related phenomena: fewer firm starts, an aging firm distribution, a growing concentration of employment into larger firms, and a falling share of national income going to workers.[14] These structural transformations suggest that small businesses, new businesses, and American workers will find themselves navigating uncharted and unfriendly terrain in the years ahead without aggressive new policy efforts to reverse current trends.

How should policymakers respond?

In spite of the headwinds, there is no need to accept a future in which entrepreneurs and innovation play increasingly diminished roles. Public policy can make a difference if geared towards the right fundamental goals. We need a labor market that allows workers to move fluidly and deploy their skills where they can best be of use. We need to encourage stronger attachments to the labor force, especially for lower-skilled workers. We should do far more to welcome highly-skilled workers and entrepreneurs from around the world into our economy and ensure they spread to more communities. And we should encourage higher rates and a broader geographic distribution of entrepreneurship using all the policy and regulatory tools at our disposal.

These are achievable goals. Accordingly, I would like to offer the following recommendations.

<u>Remove harmful barriers to labor market churn.</u> There is a simple way to boost wages, innovation, and entrepreneurship without enacting any new programs or incurring any cost to the federal government: ban the use of non-compete agreements in all but the most narrow of circumstances. While commonly believed to apply only to top executives, roughly one in five American workers are covered by a non-compete agreement that places time and geographic restrictions on their ability to pursue

[12] For one of the first kicking off the recent round of inquiry, see Ian Hathaway and Robert E. Litan, "What's Driving the Decline in the Firm Formation Rate? A Partial Explanation," Brookings Institute, November 2014.
[13] Fatih Karahan, Benjamin Pugsley, and Aysegul Sahin, "Demographic Origins of the Startup Deficit," Working paper, May 2018.; Joseph Kopecky, "An Aging Dynamo: demographic change and the decline of entrepreneurial activity in the United States," Working paper, 2017.
[14] Hugo Hopenhayn, Julian Neira, and Rish Singhania, "From Population Growth to Firm Demographics: Implications for Concentration, Entrepreneurship and the Labor Share," Working paper, December 2018.

alternative employment in the same industry as their current employer. These clauses are almost never negotiated and rarely come with any added benefits for the employee. An estimated 38 percent of workers have signed at least one non-compete agreement in the past.

Why should policymakers care? Because they are both unnecessary to protect trade secrets and proven to stifle the very forces of healthy churn that are desperately needed in our economy. They clog the arteries of our labor markets and mute the productive potential of workers and entrepreneurs.

Consider what the current literature tells us about the effect of non-competes.[15] States in which non-competes are aggressively enforced see significantly lower firm entry rates. The new businesses that do form tend to be weaker, smaller, and more likely to fail within their first three years. Enforcement of non-competes also seems particularly bad for female entrepreneurs.[16] Worse still, enforcement of non-competes hurts wages and job satisfaction. Workers in states that enforce non-competes earn less than equivalent workers in states that do not enforce them. Those bound by a non-compete stay in their jobs 11 percent longer with no offsetting increase in pay or satisfaction. There is even evidence that merely signing a non-compete -- even in states where they are unenforceable -- has a chilling effect on worker mobility. And these provisions likely diminish overall levels of innovation in the economy by restricting the mobility of the economy's most productive workers and lowering rates of firm formation.

Banning or greatly curtailing the use of non-competes would have an immediately favorable effect on entrepreneurship, innovation, and wages. I urge Congress to do so.

<u>Improve incentives to work.</u> It is critical to get marginally attached workers into the labor market and keep them there. Strong demand from employers is key, but so too are work-oriented incentives, such as the Earned Income Tax Credit (EITC). Unfortunately, the *Tax Cuts and Jobs Act* was a missed opportunity to reform and expand the EITC, or augment it with something more robust. Oren Cass of the Manhattan Institute has proposed a wage subsidy that would operate as a sort of reverse payroll tax, providing a more immediate and efficient boost to low-income workers than the EITC, and thus, in

[15] For a thorough review of the findings, see Evan Starr, "The Use, Abuse, and Enforceability of Non-Compete and No-Poach Agreements: A Brief Review of the Theory, Evidence, and Recent Reform Efforts," Economic Innovation Group, February 2019.
[16] Matt Marx, "Employee Non-compete Agreements, Gender, and the Timing of Entrepreneurship," Working paper, May 2018.

theory, an even stronger incentive to find work. This idea deserves thorough consideration.

Support and renew effective place-based policies. It is necessary to consider creative place-based policy approaches in light of the deeply uneven map of post-recession economic growth. Previous place-based programs have a mixed and somewhat underwhelming track record, but it is easy to see why: they are often absurdly complicated, lacking in scale, and rigidly inflexible in structure.

The recently-enacted Opportunity Zones incentive is a sharp departure from many of the design limitations of previous programs. For this reason, it has generated enormous interest among local leaders, investors, philanthropic organizations, and economic development practitioners. EIG was a leading advocate for Opportunity Zones, and I believe it holds great potential to provide a new capital lifeline to entrepreneurs and small businesses in struggling communities nationwide -- but only if implemented properly. The rulemaking process is still underway, but significant questions and concerns are holding back market activity among investors who wish to deploy capital into operating businesses (as opposed to real estate projects). It is crucial these issues are addressed by Treasury in the next round of proposed rulemaking.

Even as we seek new tools to address declining entrepreneurship and regional inequality, we should also look to build upon past successes. The State Small Business Credit Initiative (SSBCI) was a resoundingly successful and relatively unheralded component of the *Small Business Jobs Act of 2010* that seeded entrepreneurial activity in parts of the country desperately in need of it. Its novel design not only provided $1.5 billion in flexible financing to entrepreneurial ventures throughout the country (nearly one-third in low- and moderate-income census tracts), but it also leveraged impressive state and private sector follow-on capital as it strengthened the capacity of local organizations to deliver for the future. The initiative lapsed in 2017; Congress should reauthorize it.

Enact a coherent immigration strategy. In his last speech as president, Ronald Reagan said: "We lead the world because, unique among nations, we draw our people -- our strength -- from every country and every corner of the world. And by doing so we continuously renew and enrich our nation."[17] President Reagan well understood how immigrants add to the vitality of the U.S. economy. Research finds they are roughly

[17] Ronald Reagan, "Remarks at the Presentation Ceremony for the Presidential Medal of Freedom," January 19, 1989.

twice as likely as native-born Americans to start new businesses.[18] The Center for American Entrepreneurship found that 43% of the 2017 Fortune 500 companies were founded or co-founded by an immigrant or the child of an immigrant.[19]

An effective immigration policy could help us boost entrepreneurship, spur innovation, and tackle demographic challenges all at once, which makes it all the more frustrating to see us squander such a key advantage. While comprehensive immigration reform is a much broader topic than the scope of this hearing, I would emphasize two ideas that get to the heart of the issues I have covered in my testimony. First, like a long list of other advanced nations, the United States should have a startup visa. Any entrepreneur who can pass a national security check and demonstrate the ability to fundraise against a sound business plan should be welcome to start his or her business in this country. Second, in addition to existing programs, we should open new pathways for immigrants -- particularly high-skilled immigrants -- to connect with communities facing chronically slow or negative population growth. Enacting a *place-based* visa -- one tied to certain geographies rather than a single employer -- would help declining communities make better use of their excess capacity (e.g., housing stock, schools, and infrastructure), improve their fiscal stability, and boost local dynamism to the benefit of all residents.

Conclusion

Even in the best of times, the share of workers starting a business, switching jobs, or relocating to a different part of the country at any given moment will be relatively small. Nevertheless, the economy depends on them to stay vibrant. Thus, the decline of entrepreneurship and the geographic concentration of economic dynamism pose significant threats to this country's long-term economic well-being. Policymakers should move quickly to enact bipartisan solutions, like the ones noted above, that help American workers, entrepreneurs, and communities thrive.

[18] Robert Fairlie, Sameeksha Desai, and A.J. Herrmann, "2017 National Report on Early-Stage Entrepreneurship," Ewing Marion Kauffman Foundation, February 2019.
[19] "Immigrant Founders of the 2017 Fortune 500," Center for American Entrepreneurship, December 2017.