Behind the Productivity Plunge: Fewer Startups

New businesses were created at a 30% lower rate in 2012 than the annual average rate in the 1980s.

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In the first quarter of 2014, GDP in the U.S. plunged at a 2.9% annual rate, and productivity—the inflation-adjusted business output per hour worked—declined at a 3.5% annual rate. This is the worst productivity statistic since 1990. And productivity since 2005 has declined by more than 8% relative to its long-run trend. This means that business output is nearly $1 trillion less today than what it would be had productivity continued to grow at its average rate of about 2.5% per year.

Lagging productivity growth is an enormous problem because virtually all of the increase in Americans' standard of living is made possible by rising worker productivity. In our view, an important factor contributing to declining productivity growth is the large decline in the creation of new businesses. The creation rate of new businesses, as well as new plants built by existing firms, was about 30% lower in 2011 (the most recent year of data) compared with the annual average rate for the 1980s. (The data is the Census Bureau's Business Dynamic Statistics.) The decline affected nearly all business sectors.

Virtually every state has suffered a drop in startups, which suggests that this is a national, and not a regional or state, problem. It may not be surprising that states hit hard by the recession, such as Arizona, California and Nevada, have a 25% to 35% lower rate of startups. But the startup rate in such business-friendly states as Tennessee, Texas and Utah is also down substantially, and in some cases exceeds the declines in the states that suffered most during the recession. Even North Dakota, which has benefited enormously from oil and gas fracking, has a startup rate lower than in the 1980s.

These numbers are likely to underestimate the decline in new business formation, because they do not count changes in the pace of new ideas and new business activity in existing establishments. The fact that the economy has been weak since 2007 suggests that new business activity has also declined in existing companies.

New businesses are critical for the U.S. economy to grow because a small fraction of today's startups will become tomorrow's economic heavyweights. Most of today's workers are employed at older, established
businesses, but the country cannot rely on existing companies to boost the economy. Businesses have a life cycle, in which even the largest and most successful reach a stage at which they stop expanding.

If history is any indication, many of today's economic heavyweights will ultimately decline as new businesses take their place. Research by the Kaufman Foundation shows that only about half of the 1995 Fortune 500 firms remained on the list in 2010.

Startups also have declined in high technology. John Haltiwanger of the University of Maryland reports that there are fewer startups in high technology and information-processing since 2000, as well as fewer high-growth startups—annual employment growth of more than 25%—across all sectors. Even more troubling is that the smaller number of high-growth startups is not growing as quickly as in the past.

Surveys of small-business owners clearly indicate that changes in economic policy are required to reverse this trend. Chamber of Commerce surveys show that roughly 80% of small-business owners believe that the U.S. economy is on the wrong track and that Washington is a major problem. Surveys by John Dearie and Courtney Gerduldig, authors of "Where the Jobs Are: Entrepreneurship and the Soul of the American Economy" (2013), show that entrepreneurs report being hamstrung by difficulties in finding skilled workers, by a complex tax code that penalizes small business, by regulations that raise the costs of doing business, and by difficulties in obtaining financing that have worsened since 2008.

There are clear solutions to these problems. Immigration reform that increases the pool of skilled workers and potential new entrepreneurs. Tax reform that reduces and equalizes marginal tax rates on capital income, including reducing the corporate income tax, which currently exceeds 40% in some states. Reforming Dodd-Frank to make it easier and cheaper for small business to obtain loans. Reducing the regulatory burden on all businesses.

In the absence of these reforms, there is little reason to believe that the depressed rate of new business creation will reverse itself. And if the trend is not reversed, then the current shortfall of $1 trillion per year in lost output due to lost productivity will continue.

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