2012

STATE OF ENTREPRENEURSHIP ADDRESS

February 9, 2012

KAUFFMAN
The Foundation of Entrepreneurship

KAUFFMAN
The Foundation of Entrepreneurship

©2012 by the Ewing Marion Kauffman Foundation. All rights reserved.

Third Annual

State of Entrepreneurship Address "A Roadmap for State Growth"

The National Press Club, Washington, DC
February 9, 2012

By Benno C. Schmidt,
Interim President and CEO, Ewing Marion Kauffman Foundation

Good afternoon, and thank you all for coming today. It's a great honor to be delivering this year's State of Entrepreneurship address. I am aware that I am following in the very large footsteps of Carl Schramm. He made countless contributions to the Kauffman Foundation during his nearly ten years as President and CEO, and none bigger than advancing rigorous scholarship and debate about entrepreneurship and its central connection to economic growth.

That scholarship continues, and today the Foundation is releasing two reports—one lays out an agenda for state-level policymakers to foster entrepreneurship, and the other showcases barriers to entrepreneurship imposed by state and local governments. These papers build on past scholarship sponsored by the Kauffman Foundation, including an important book released at last year's State of Entrepreneurship event called *Rules for Growth*, which focuses on promoting innovation and growth through legal reforms, primarily aimed at the federal level, but also some at state and local governments.

Much of the material in the two papers released today is focused on the law, which makes it particularly interesting to me. Some years ago—more than I care to admit—I was a law professor at Columbia and, later, the law school's dean. Through those experiences, I developed some understanding of the intersection between law and economics, and how the two disciplines can complement—and conflict with—each other. Today I will highlight some of the conflicts, and draw on the papers to lay out a roadmap for helping states, in particular, foster entrepreneurial growth.

We're fortunate to have with us today two individuals who are well positioned to initiate reforms at the state level. One is the Governor of Nebraska, Dave Heineman, who also serves as chairman of the National Governors Association. The other is the Governor of Delaware, Jack Markell, who is vice chair of the NGA. We're looking forward to hearing from them later.

There are a number of reasons why our focus on entrepreneurship, which up to now has been aimed primarily at federal policymakers, has turned to the state and local level. I'll emphasize two. First, with gridlock in Washington, states and localities have more opportunities for reform and fewer institutional obstacles. Second, our scholars' discussions with entrepreneurs turned up a finding that will be surprising to some—it's state and local laws and regulations that matter to them as much, or more, than federal statutes do.

Like so many other sectors of the U.S. economy, there has been a downturn in entrepreneurship over the past few years. In fact, dating back to even before the onset of the recession, the number of jobs created by startup companies less than five years old was declining. This is a worrying development, given that, until the recession, new firms over the past three decades generated virtually all net new jobs in the U.S. economy. Moreover, because major technological advances are disproportionately commercialized by new firms, the slowdown also portends slower growth in living standards.

The biggest economic payoff from the formation of new firms comes when some fraction of them grow, ideally as rapidly as possible, consistent with achieving sustained profitability. Remarkably, the top 1 percent of growing firms of all ages account for *40 percent* of net new jobs created in any given year. Fast-growing *young* companies (those three to five years old), or about 1 percent of all companies, account for 10 percent of net new jobs. So an important challenge for policymakers—at all levels of government—is to create the conditions that enable an increase in the number of fast-growing job creators or to enhance the pace at which the most successful firms expand.

We need to foster new thinking about how to stimulate job creation. The old model for doing this is colloquially known as "smokestack chasing," whereby state and local governments try to attract companies by offering them generous packages of subsidies and tax preferences. Other countries are moving away from this approach, recognizing that it's short-sighted, and that there's no guarantee companies will stay once their benefits end. States should move away from it, as well. A much more beneficial long-term strategy is to create an environment that supports innovation and entrepreneurship, and attracts the individuals who will launch companies that create jobs that remain where they are created and generate valuable tax revenue for state and local governments.

The bottom line from our reports is simple: States should do all they can to make it easier to start a business. I'm sure at least one of our panelists will agree wholeheartedly with that. Bill Aulet, who leads MIT's entrepreneurship center, will be sharing his views on our panel from the perspective of someone who has started multiple businesses.

Unfortunately, while the United States traditionally has been one of the easiest places in the world to launch and grow a business, that is no longer true. Globally, the United States ranks fourth overall in the World Bank's Doing Business rankings, but 72nd in terms of how easy it is for new and young companies to pay taxes, and 13th overall on the indicator of starting a business, which includes procedures, days, cost, and paid-in minimum capital.

These numbers underscore the need for states to reduce the paperwork, time, and effort involved in the administrative niceties of firm formation. This requires an easy-to-use, "one-stop" place for online business registration and, ideally, consolidation of physical space for in-person registrations, as well. States also should make business shutdown and liability costs as low as possible, since not all new ventures succeed.

The Doing Business survey has spurred a healthy competition among countries to improve their rankings by making their business environments more hospitable to business creation. There should be a similar survey here in America, with states ranked annually on a variety of indicators measuring how their policies help advance innovation and entrepreneurship. This recommendation is contained in a comprehensive proposal our Foundation released last summer, and is contained in the bipartisan Startup Act introduced in the U.S. Senate by Senators Mark Warner and Jerry Moran.

I'd now like to turn to some specific issues, and start with one of the little-noticed changes in U.S. regulation in the past few decades, which is the proliferation of occupational licensing.

Remarkably, the top 1 percent of growing firms of all ages account for 40 percent of net new jobs created in any given year.

Improving schools has a ripple effect, as the availability of high-quality education factors into the location decisions of companies and workers.

In the United States, hundreds of professions and other occupations are licensed by states, with strictness of regulation varying by state. The median number of occupations licensed by states is eighty-eight. But licensing has ballooned over the past several decades: The percentage of the American workforce covered by occupational licensing has grown from less than 5 percent in the 1950s to more than 20 percent today.

While the benefits derived from this licensing are unclear, the costs are clear: Occupational licensing thwarts competition and acts as a barrier to entry for entrepreneurs seeking to provide services to consumers through new business models at lower cost and/or higher quality.

Existing licensing restrictions can be liberalized without sacrificing health, safety, or quality of service. In the legal profession, for example, specialized certificates could be issued for routine legal services in areas such as estate, divorce, and bankruptcy law, as well as business incorporation. The effect would be to stimulate new competition, helping to reduce prices and raise quality.

States are uniquely positioned to undertake reforms to the legal profession, for the simple reason that the practice of law is governed by state law. A more streamlined approach also would reduce what is now an enormous investment of time and money by law students. Law licensing reform also could save consumers billions of dollars per year, while offering opportunities for a new wave of legal entrepreneurs.

We will hear more about the effects of licensing from our fourth panelist, Morris Kleiner, a professor at the University of Minnesota, who has studied and written extensively on occupational licensing issues.

Another area ripe for state-level reform is education. I speak from some experience here, having spent many years working to bring greater innovation and reform to the K–12 sector. While there is an ongoing debate about effective educational methods, we know that ending the de facto monopoly government holds over education will help states foster innovation and entrepreneurial disruption, which is long overdue.

Improving schools has a ripple effect, as the availability of high-quality education factors into the location decisions of companies and workers. Opening up the education sector to entrepreneurs, by lowering barriers to the formation of charter schools in particular, also could have a huge positive effect on a state's attractiveness to other, existing companies.

I'd also like to touch on one element of university education. As many of you know, the Kauffman Foundation has been a long-time advocate for improving the process of technology commercialization—specifically, to permit university faculty members to retain the right to license the technologies they develop, without having to gain approval from a university's technical transfer office. Taking innovations from the laboratory to the marketplace is essential to unleashing the economic power of these innovations. State governments are in an ideal position to act on this idea without waiting for the federal government to move, and they can do so directly or through their influence over state regents who oversee universities. States are critical because much academic research takes place in state universities, and because the flagship campuses of these state systems often have as part of their mission a responsibility to contribute to the state economy.

Connected to the discussion about education and entrepreneurship is access to talented employees, because we know that a leading challenge for entrepreneurs is recruiting talent. States can help build a supply of skilled, entrepreneurial workers and contribute to the mobility of those individuals, so they're free to switch jobs, change companies, and start new businesses.

A critical element of promoting mobility is maintaining the right legal environment. Regrettably, many states, in hopes of re-creating Silicon Valley, enact all manner of public programs to promote and help entrepreneurs, but leave in place a legal framework that adheres to a different model of employment.

Here's a small but telling example—non-compete agreements, which stifle the spread of talent and ideas and, thus, a state's economic performance. While these agreements are widespread, enforcement varies from state to state. Studies have found that full enforcement of non-competes reduces startup activity, patents, and venture capital. Two states that do not enforce non-compete agreements are Colorado and California, while New Jersey's enforcement is vigorous. These variations have been cited as a possible reason why states differ in their entrepreneurial activity.

I will conclude with a few suggestions about state-level tax policy.

The central objective must to be to avoid taxes and regulations that distort business activity by favoring one sector over another. Tax credits and incentive programs do just this, distorting the environment for new and young firms and all other companies. Yet, nearly every state offers business tax incentives: At last count, forty-one states offered corporate income tax exemptions, forty-five offered tax incentives for job creation, and forty-nine allowed sales and use tax exemptions on new equipment.

The type and structure of a state's taxes also can matter. In particular, some studies have shown that property taxes have a negative impact on new businesses because they must be paid irrespective of company performance.

The best option is to pursue simplicity and a wide base in the corporate income tax structure. These features are important particularly for young, growing companies, on which greater complexity and more distortions will inflict a higher compliance burden.

The notion of states as laboratories of experimentation and reform is a hallmark of America's federalism. Now is the time for the states to become more aggressive about serving as laboratories of innovation and entrepreneurship—creating an ecosystem free of needless licensing and regulation that unleashes job creation and triggers productivity gains.

The reforms being released today are not a one-size-fits-all package—different measures will work for different states, but we're confident that every state will be able to find ways they can be more supportive of innovation and entrepreneurship while maintaining a level playing field.

The National Governors Association is ideally positioned to lead the way in building support for state and local reforms. And the great news is, they are working to do just that, through the NGA's "Growing State Economies" initiative. Before we enjoy our lunch, I'd like to invite Nebraska Governor and NGA Chair Dave Heineman, who is leading this work, to speak to us for a few minutes about their plans.

Thank you very much.

Now is the time for the states to become more aggressive about serving as laboratories of innovation and entrepreneurship.

KAUFFMAN

The Foundation of Entrepreneurship

KAUFFMAN
The Foundation of Entrepreneurship

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

0212QTYPRINTER