

ISSUE BRIEF

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Why the Slow Economic Recovery?

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The slow economic recovery since 2009 has not hewn closely to the patterns set by previous recoveries. One explanation that matches the key facts of this recovery-less recovery is that the fixed costs of production have risen. Higher regulation, tight credit, and other costs affect small, start-up businesses more than incumbents. Since start-ups normally create all of the net new jobs in the economy, job creation and investment are slack.

The Slow Recovery. Here's what we know about the recovery from the 2008–2009 recession.

1. It has been a very slow recovery. Usually, gross domestic product (GDP) grows fastest right after a recession as it bounces back to trend. Since 2009, GDP has been growing parallel to—but

far below—the long-term trend. Employment has remained flat since 2009. Employment dropped drastically in 2008 and has not recovered.

2. Non-residential investment fell by almost 25 percent in two years but has grown steadily since the end of 2009. It has not yet returned to its 2007 level.
3. Corporate profits are booming. Corporations have strong revenues but are not purchasing much capital or labor.

Start-Ups. How can we account for these three facts? An extra piece of the puzzle suggests an explanation: Employment at start-up companies has fallen for five years in a row, reaching unprecedented lows in 2010 and 2011.

As John Haltiwanger, Ron S. Jarmin, and Javier Miranda show in a recent paper,¹ most net new jobs come from start-up companies. In fact, existing firms rarely create net new jobs. And as Tim Kane documents,² the economy expands with the creation of new firms, not from the expansion of existing firms.

Start-ups have been a constant source of new employment in the U.S.

economy, hiring about 15 of every thousand working-age American adults every year for decades. Previous recessions featured big job losses from existing firms, but even in recessions, start-up job creation has been a constant—until now.

Kane shows that hiring by start-ups has slowed to 10 jobs per thousand adults. In 2010 and 2011 alone, “missing” start-up hiring amounted to 2 million net jobs. With normal start-up hiring, growth in the employment rate would have been three times as high as it was.

Fixed Costs. Why would business start-ups fade in a period of booming corporate profits? After all, the last two peaks of corporate profitability were both followed by peaks in start-up job creation in 1998 and 2006. And why are corporate profits so strong when the economy is weak?

A simple explanation is that fixed costs are high.

With new regulations³ and business requirements in health insurance, small-business finance, environment, energy, and tax compliance,⁴ not to mention the ever-expanding reach of state licensure boards,⁵ it is expensive to open a business.

High fixed costs and onerous regulation are textbook “barriers to

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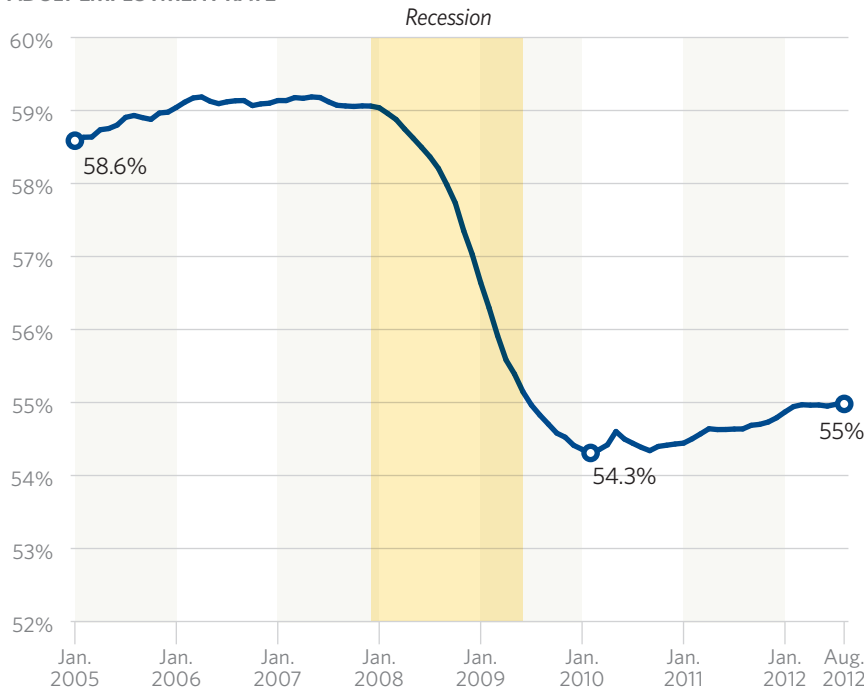
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CHART 1

Since the Recession, Employment Rate Has Grown Slowly

ADULT EMPLOYMENT RATE



Source: U.S. Department of Labor, Bureau of Labor Statistics data via Federal Reserve Economic Data, data series PAYEMS and USAWFPNA, <http://research.stlouisfed.org/fred2/> (accessed October 1, 2012).

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entry.” Incumbent firms favor many of these barriers because they keep competitors out of the market, which keeps profits high. In banking, the stringent regulations of the Dodd–Frank Act not only make it hard for small or start-up banks to survive; they discourage banks from lending

to borrowers who do not have a strong track record. Less credit for unknown borrowers means fewer start-up jobs created.

Other factors that might discourage competition and firm creation include:

- Elevated uncertainty over the implementation of new regulations,
- Expectations of higher tax rates in the future due to rising debt,
- Implicit promises of bailouts for large incumbent firms, and
- Slow demand growth since the recession.

As long as upstart start-ups are held down by bad policy and feckless deficits, incumbent firms can earn profits without expanding supply.

What Policymakers Can Do.

Policymakers need to ease entry by new firms. This can be done at all levels of government.

At the state level:

- Licensure boards should be composed of industry customers, not industry insiders, and
- Licensing requirements should be repealed wherever safe.

At the federal level:

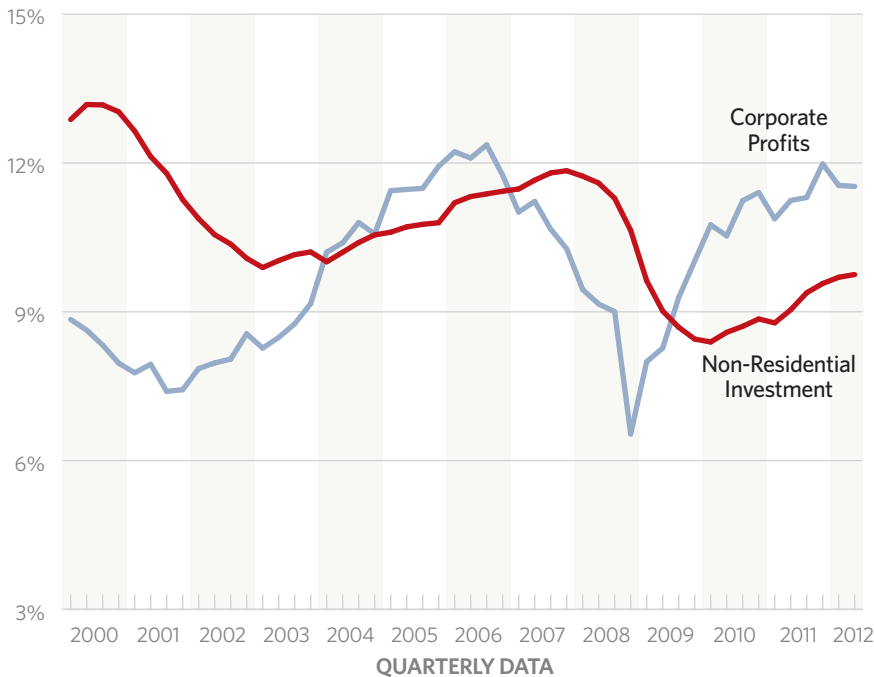
- Repeal Dodd–Frank’s over-regulation of the financial services industry and its implicit promise of bailouts, and
- Replace Obamacare, which was written with input from the

1. John Haltiwanger, Ron S. Jarmin, and Javier Miranda, “Who Creates Jobs? Small vs. Large vs. Young,” working paper, August 2011, http://econweb.umd.edu/~haltiwanger/size_age_paper_R&R_Aug_16_2011.pdf (accessed October 1, 2012).
2. Tim Kane, “The Collapse of Startups in Job Creation,” Hudson Institute, September 16, 2012, <http://www.hudson.org/files/publications/Kane--TheCollapseofStartupsinJobCreation0912web.pdf> (accessed October 1, 2012).
3. James L. Gattuso and Diane Katz, “Red Tape Rising: Obama-Era Regulation at the Three-Year Mark,” Heritage Foundation *Backgrounder* No. 2663, March 13, 2012, <http://www.heritage.org/research/reports/2012/03/red-tape-rising-obama-era-regulation-at-the-three-year-mark>.
4. Guinevere Nell, “Obama’s Small-Business Tax Could Average \$25,000,” The Heritage Foundation, *The Foundry*, July 13, 2012, <http://blog.heritage.org/2012/07/13/obamas-small-business-tax-could-average-25000/>.
5. Morris M. Kleiner and Alan B. Krueger, “Analyzing the Extent and Influence of Occupational Licensing on the Labor Market,” National Bureau of Economic Research *Working Paper* No. 14979, May 2009.

CHART 2

Private Investment Fails to Keep Up with Profits

AS A PERCENTAGE OF POTENTIAL GDP



Source: Heritage Foundation calculations based on data from U.S. Department of Commerce, Bureau of Economic Analysis, and Congressional Budget Office, via Federal Reserve Economic Data, data series PNFI, CPROFIT, and NGDPPOT, <http://research.stlouisfed.org/fred2/> (accessed October 1, 2012).

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largest insurance companies, with a sensible health care system based on competition and individual choice.

And at every level of government:

- Rationalize regulations of energy use and the environment by taking account of their broad economic impact.
- Do not write a small-business regulation that could not be followed without a lawyer's help.
- Rebuff lobbying efforts to write special favors and protections into law. The big employers in Congressmen's districts do not create net new jobs; their upstart competitors do.

A Bad Environment for Jobs.

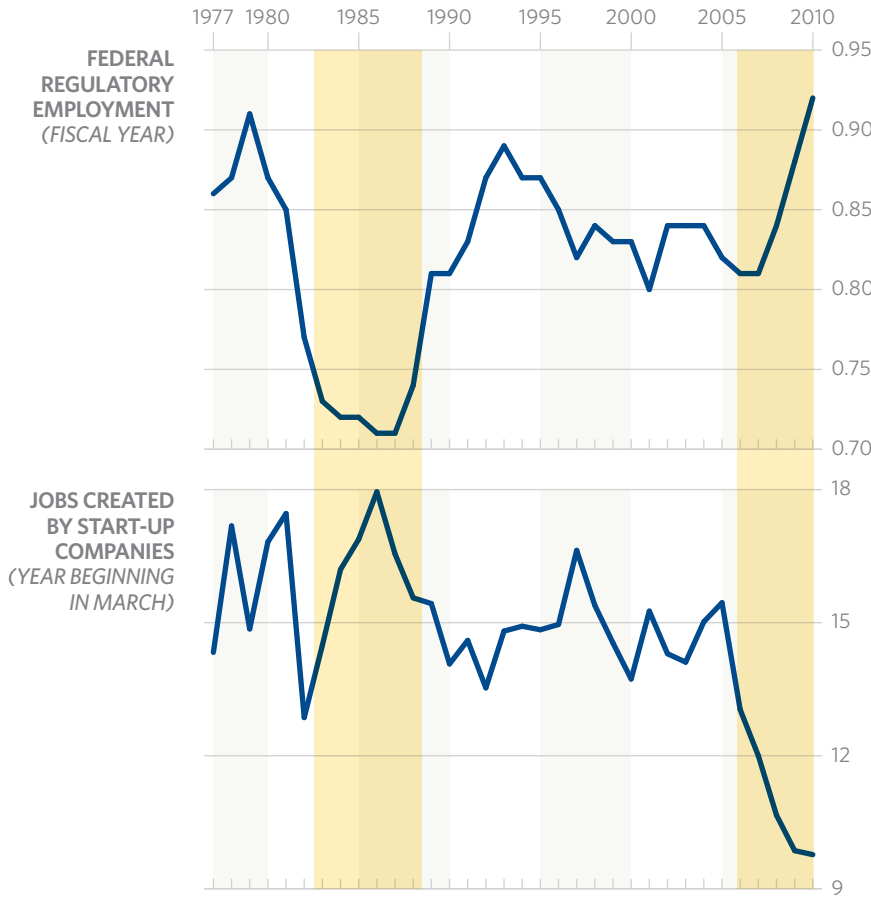
Entrepreneurs have proven their willingness and ability to start new firms and hire new workers in every economic environment. Only since 2007, in a policy environment that puts government first and people second, has their creativity been slowed. Washington should reverse this trend immediately.

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CHART 3

A Mirror Relationship: Start-Up Jobs and Federal Regulatory Jobs

Over the past 30 years, a trend between federal regulatory jobs and jobs with start-up companies has emerged: When regulatory jobs declined, such as during the mid-1980s, start-up employment spiked. Similarly, in recent years when regulatory jobs rose, start-up jobs fell off dramatically. Rates shown are per thousand working-age adults.



Sources: Regulatory employment: Data provided by Susan Dudley, George Washington University Regulatory Studies Center, and Melinda Warren, Weidenbaum Center, Washington University. Start-up employment: Heritage Foundation calculations based on data from U.S. Census Bureau, Business Dynamics Statistics, http://www.census.gov/ces/dataproducts/bds/data_firm.html (accessed October 2, 2012). Population data: U.S. Department of Labor, Bureau of Labor Statistics via Federal Reserve Economic Data, data series USAWFPNA, <http://research.stlouisfed.org/fred2/> (accessed October 2, 2012).