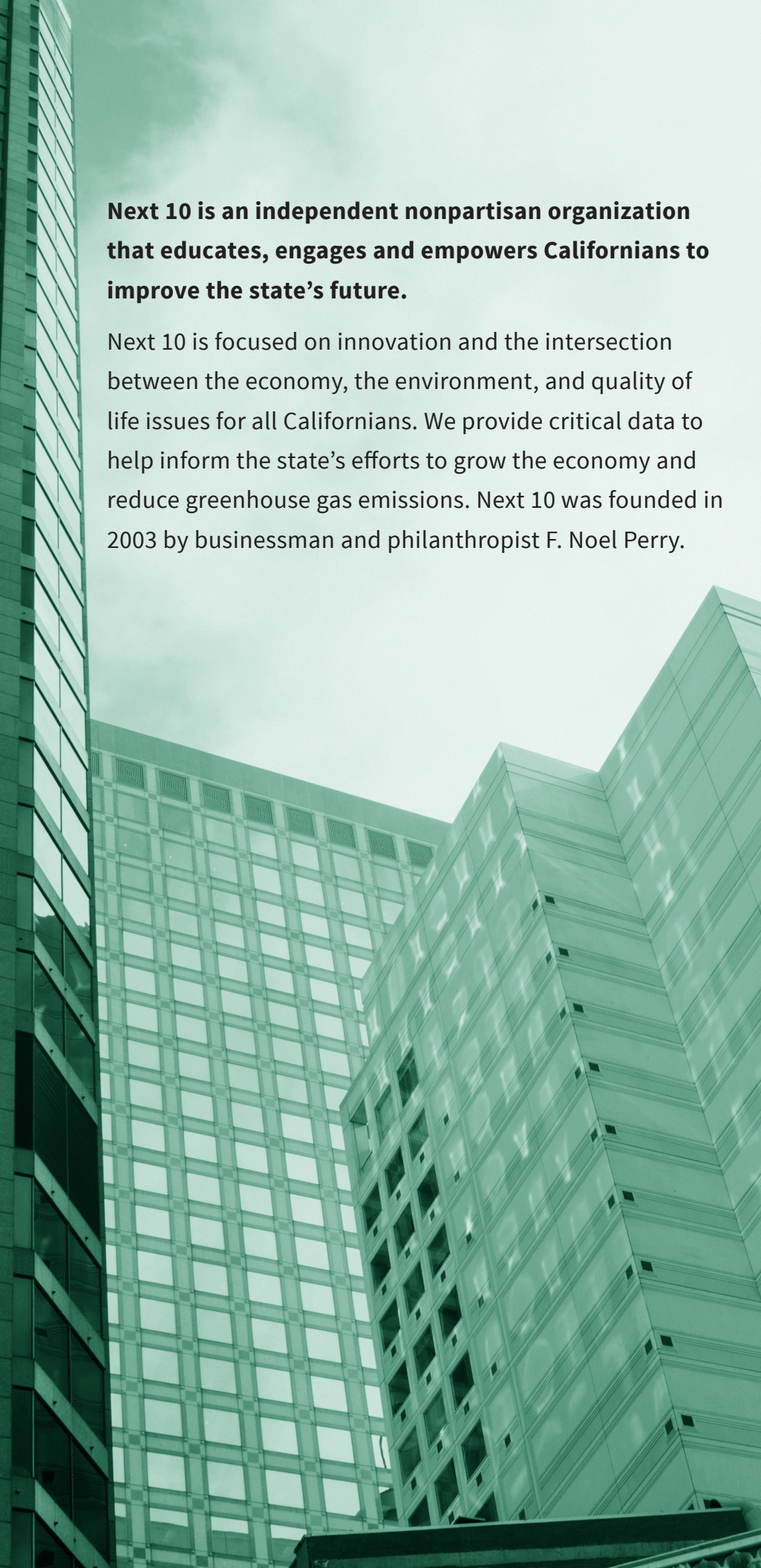




CALIFORNIA NEW BUSINESS CREATION

ISSUE BRIEF

DECEMBER 10, 2015



Next 10 is an independent nonpartisan organization that educates, engages and empowers Californians to improve the state's future.

Next 10 is focused on innovation and the intersection between the economy, the environment, and quality of life issues for all Californians. We provide critical data to help inform the state's efforts to grow the economy and reduce greenhouse gas emissions. Next 10 was founded in 2003 by businessman and philanthropist F. Noel Perry.

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OVERVIEW

For many years California has been criticized for its business climate. Google the words “California business unfriendly” and you’re sure to find hundreds upon thousands of articles attacking California and making negative claims and assertions about business creation and destruction in the state. From the Tax Foundation ranking California 48 out of 50 states for its unfriendly business taxes, to the Wall Street Journal publishing op-eds describing how California drives away jobs and businesses, an outside (and often inside) observer might think the current state of business in California is rather grim.

In reality, California is not anywhere near the bottom of the pack in terms of the state’s ability to foster new business formation. While it is true the rate of new business creation has slowed over the past several decades, so too has the rate of business destruction. This report details the data on:

Where California ranks among other states in terms of new business growth and small business growth

Whether the secular decline in new business creation is unique to California, or whether it is happening nationwide

How California business creation has compared to select states and the nation as a whole over the last twenty years

This analysis is based on the U.S. Census Bureau’s Business Dynamics Statistics (BDS). This is the most robust source of information on business formation, and is unique in terms of detailing both business creation and destruction. The BDS series provides annual statistics from 1976 to 2013 for each state and the entire U.S. economy. BDS data tables show key economic data for employment - job creation and destruction, number of establishments, establishment openings and closings, and the number of firm startups and shutdowns.

The main findings include:

- Both job creation and job destruction have been falling in California over the years. As a result, the long term pace of net job creation has remained relatively constant.
- California job creation and destruction has mirrored that of the broader economy. Not only has a similar trend occurred in the United States, but every other state has experienced a similar trend—without exception.
- Despite a high correlation with national trends, since 1976 establishment birth rates have actually been higher in California than in the United States overall in absolute terms.

Overall, California is creating jobs at a rate that often exceeds the national average. However California, like other states, is also experiencing a secular decline in labor and business turnover.

CALIFORNIA'S STRONG ESTABLISHMENT & JOB GROWTH

In 2013, California ranked 4th among states in terms of net job creation according to the Census Bureau's Business Dynamics Statistics. This illustrates how much of the negative press associated with California business and labor markets is painting a skewed picture that doesn't coincide with empirical findings. In addition, several of the states that are leading California in job creation, such as North Dakota, have done well primarily due to an increase in jobs associated with the energy boom that has been underway for the last several years.

However, net job creation is a high-level statistic and doesn't tell the whole story. This analysis is trying to show not just that plenty of new *jobs* are being created in California, but that a healthy amount of that growth is coming from new *firms* and *establishments*.

To illustrate this, data on establishment entry and exit rates will be used, as will data on the amount of new job creation that arises from the birth of new establishments. Due to more availability, data on establishments — defined as a single physical location where business is conducted or where services or industrial operations are performed — is relied upon more often than data on firms — which are defined as any business organization that consists of one or more establishments. Keep in mind these are rates of change and not absolute change, an important distinction because while absolute figures would clearly be biased toward the largest states like California, looking at *rates* of change is more of an apples to apples comparison.

In 2013, California was tied for 5th in establishment entry rates – a two-way tie with North Dakota. In addition, over the last 20 years, California has had an establishment entry rate very similar to Texas, while Florida has consistently been a national leader in establishment entry rates. It is

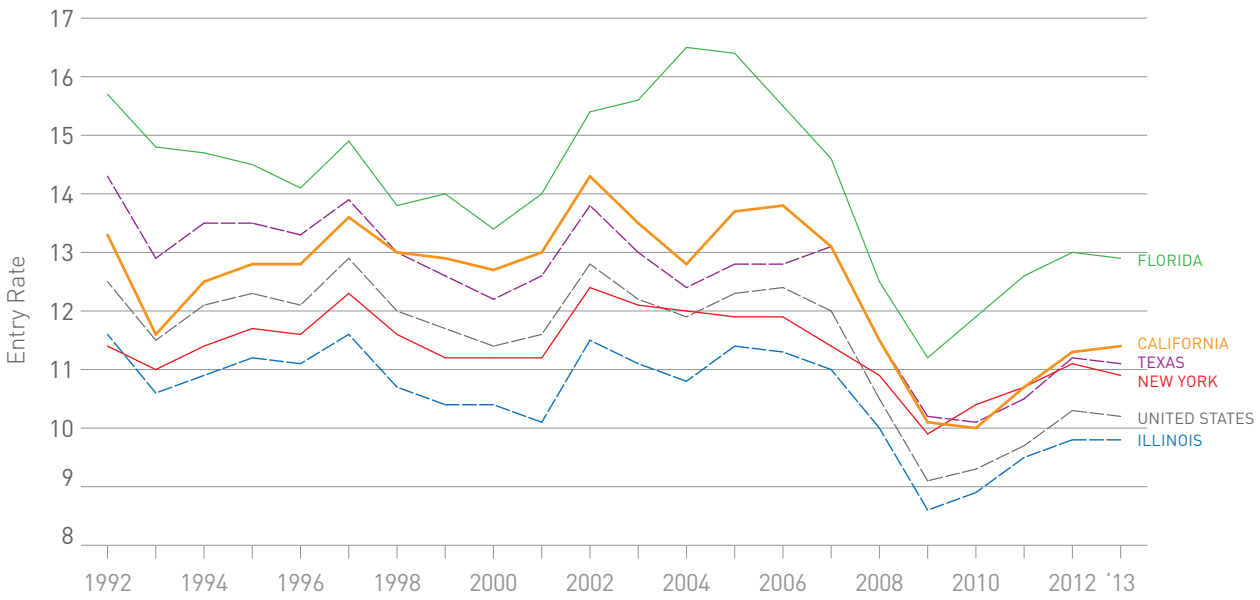
Table 1: Net Job Creation Rate, 2013

Rank	State	Rank %
1	Delaware	6.4
2	North Dakota	4.3
3	Montana	4.1
4	California	4.0
5	Idaho	3.8
6	Texas	3.5
7	Oregon	3.4
8	Colorado	3.1
T-9	Utah	3.0
T-9	Alaska	3.0
11	Oklahoma	2.9
T-12	Kansas	2.8

Data Source: Business Dynamics Statistics

Figure 1: Establishment Entry Rate by State, 2013

Select States & US Total, 1992-2013



Data Source: Census Bureau

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clear that, despite deterrents that are often cited as ills for California businesses, establishments continue to enter the state economy at a faster rate than they enter the United States economy as a whole.

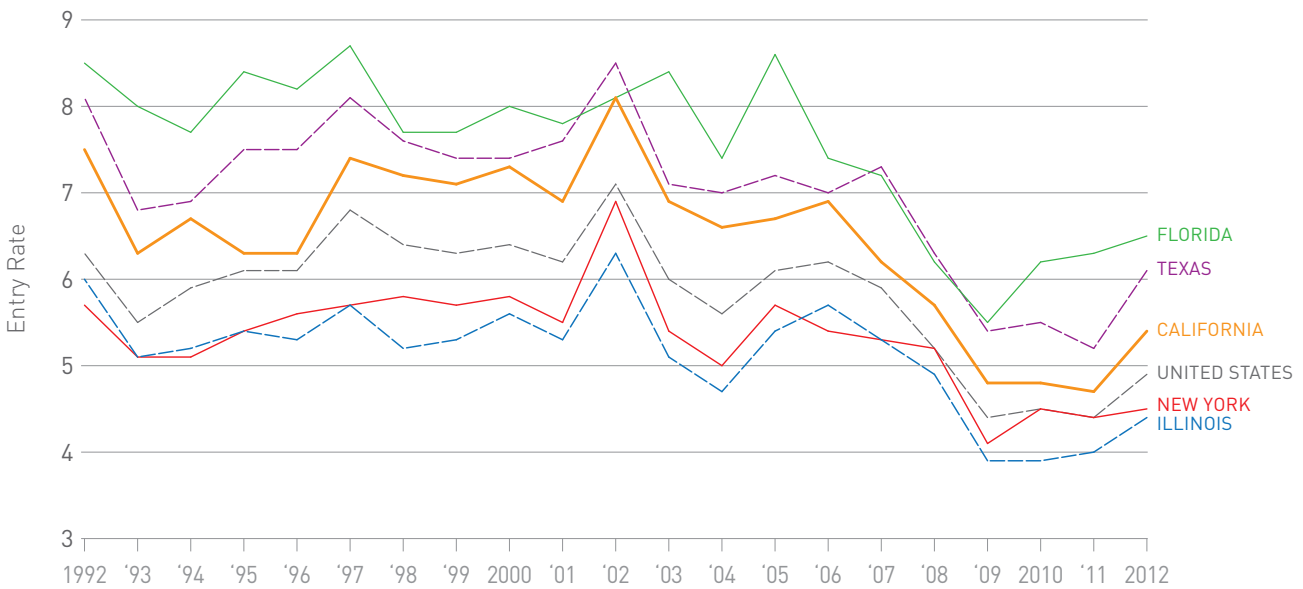
Perhaps the most effective way to measure the impact of new business creation on a state’s economy is to look at the rate of job growth that stems from the birth of new firms (i.e. the amount of jobs created by start-up firms each year). In 2013, Delaware was the leader of the pack, with a 6.4% job creation rate from firm births. California tied for 4th in job creation stemming from new business creation with a growth rate of 5.5%. Looking at the chart above, a pattern similar to the chart on establishment entry rates emerges. From 1992 to 2013, Florida was a consistent leader in job creation stemming from new business creation, while California and Texas had similar job creation rates from new firm growth. California outpaced the national average in job creation from new firm start-ups in every single year from 1992 to 2013.

Table 2: Establishment Entry Rate by State, 2013

Rank	State	Rank %
1	Florida	12.9
2	Nevada	12.8
3	Utah	12.5
4	Colorado	11.9
T-5	California	11.4
T-5	North Dakota	11.4
7	Arizona	11.3
T-8	Washington	11.1
T-8	Texas	11.1
10	Idaho	11.0
T-11	Montana	10.9
T-11	New York	10.9

Data Source: Business Dynamics Statistics

Figure 2: Job Creation Rate (Births)
 Select States & US Total, 1992-2013



Source: Census Bureau

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Most new firms and establishments that enter the economy are also small businesses. Looking at establishments by size, we can see that California is also outpacing the nation in small businesses job growth. This is significant as small businesses bring a great deal of jobs into the economy. While small establishments have very high turnover rates, in aggregate they have higher levels of job growth than establishments of other sizes, and thus, they contribute much more to the employment picture in each state than most people tend to realize.

In 2013, California ranked 10th highest for entry rate of small establishments (establishments with 1 to 4 employees). California’s small establishment entry rate of 19.1% was only marginally lower than the rates in states that are often compared to California, such as Florida (19.8%) and Texas (19.5%). Moreover, with the exception of 1993, California has outpaced the nation overall in terms of small establishment entry rates (1992 to 2013).

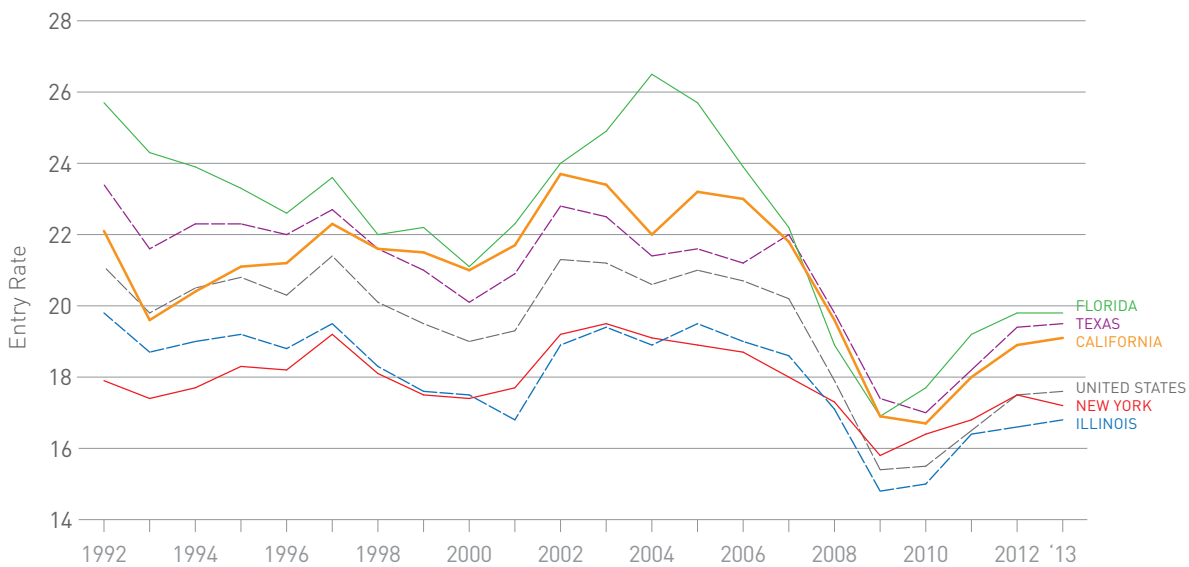
Table 3: Job Creation Rate (Births), 2013

Rank	State	Rank %
1	Delaware	6.4
2	Florida	6.0
3	Utah	5.6
T-4	Nevada	5.5
T-4	California	5.5
6	Montana	5.4
7	Texas	5.3
8	North Dakota	5.2
T-9	Wyoming	5.0
T-9	Virginia	5.0
T-9	Arizona	5.0
T-12	Oklahoma	4.9

Data Source: Business Dynamics Statistics

Figure 3: Establishment Entry Rate (1 to 4 people)

Select States & US Total, 1992-2013



Source: Census Bureau

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In sum, far from being a national laggard, California consistently outpaces the nation in the creation of small establishments, the creation of establishments as whole, job creation from new firms, and net job creation. While the state continues to face significant challenges, it is far from the economic failure the headlines often suggest.

Table 4: Establishment Entry Rate (1 to 4 rmp.), 2013

Rank	State	Rank %
1	Nevada	22.7
2	Utah	21.0
T-3	Florida	19.8
T-3	Arizona	19.8
5	Washington	19.6
6	Texas	19.5
T-7	Colorado	19.4
T-7	Alaska	19.4
9	North Dakota	19.3
10	California	19.1
11	Missouri	18.7
12	Idaho	18.5

Data Source: Business Dynamics Statistics

DECLINE IN ESTABLISHMENT ENTRIES AND EXITS

One of the reasons behind criticism of California’s business climate is that over the long-term, the establishment entry rate has been declining. The establishment entry rate started at about 17% in 1977 and slowly declined to roughly 12% in the early 1990s, where it remained relatively constant until the ‘Great Recession’.

However, this decline isn’t unique to California. In fact, this pattern has been occurring at the national and state level for nearly every state. Given the prevalence of this trend across the nation, including states with high and low taxes and perceived friendly and unfriendly business climates, the pattern cannot be explained by California’s business climate specifically. Nevertheless, when a change in the dynamics of establishment entries and exits emerges on such a large scale, it is important to look for reasons why.

Interestingly, while this study is by no means the first to point out this puzzling development in new business dynamism, report authors are not aware of a study that has identified a reason as to why this is occurring. The Brookings Institution points out in a 2014 paper that “doing so requires a more complete knowledge about what drives dynamism, and especially entrepreneurship, than currently exists.” We simply do not have a complete enough understanding to explain the trend. Still, policymakers should be watching closely. As we’ve demonstrated in this report, establishment entry rates and net job creation from firm births are two primary drivers of net job creation in the economy. An important first step in addressing this challenge will be to develop and maintain more timely, frequent, and detailed statistics on business owners and entrepreneurs to complement the data available on firm and job creation.

Establishment entry rates and net job creation from firm births are two primary drivers of net job creation in the economy.

Figure 3a: Establishment Entry and Exit Rates California & US Total, 1992-2013

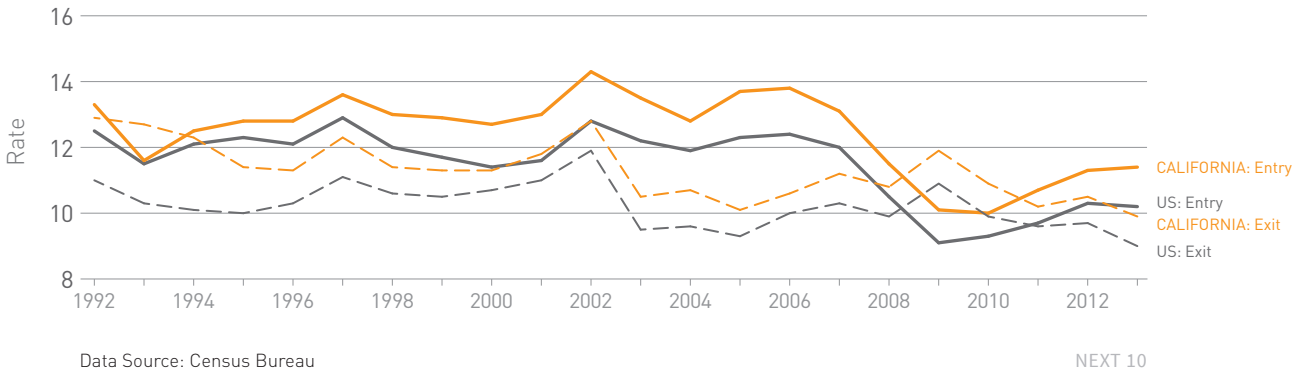


Figure 3b: Establishment Entry and Exit Rates Florida & US Total, 1992-2013

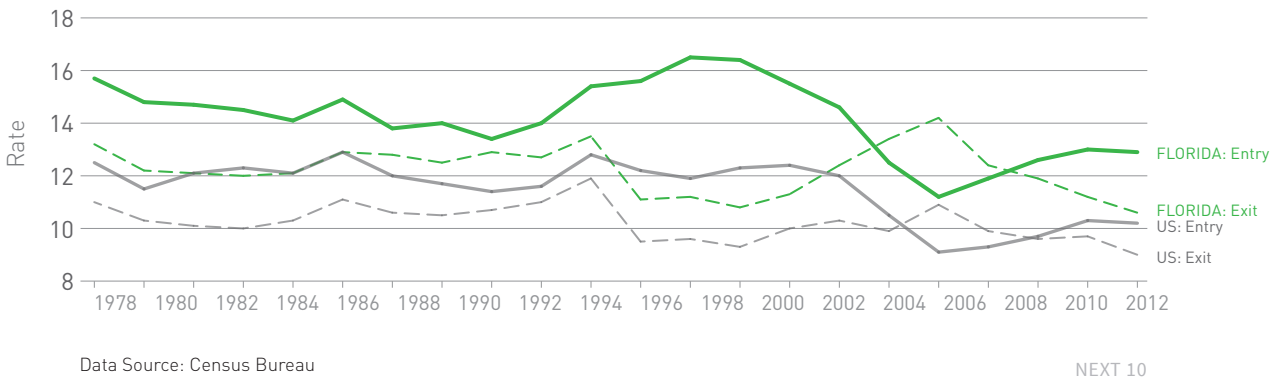


Figure 3c: Establishment Entry and Exit Rate Texas & US Total, 1992-2013



YOUNG FIRMS AND ESTABLISHMENTS LEAD THE JOB CREATION CHARGE

One of the most interesting findings from the BDS is the importance of new establishments and firms to job creation. The above graphs display data on establishment entry and exit rates, job creation and destruction rates, and net job creation. The conclusion illustrated by the data – that start-ups and young establishments account for virtually all job creation – may be surprising and even seem counterintuitive. However, upon closer scrutiny, it does make sense on an intuitive level.

Consider the physical limitations of an establishment. There is a limit on the amount of growth and job creation that can fit within an existing set of walls. Often, an age 1+ establishment will destroy both itself and its jobs, and then up pops a brand new, suspiciously similar establishment on the other side of town in a purpose-built new construction project with more jobs than were destroyed and space for additional growth.

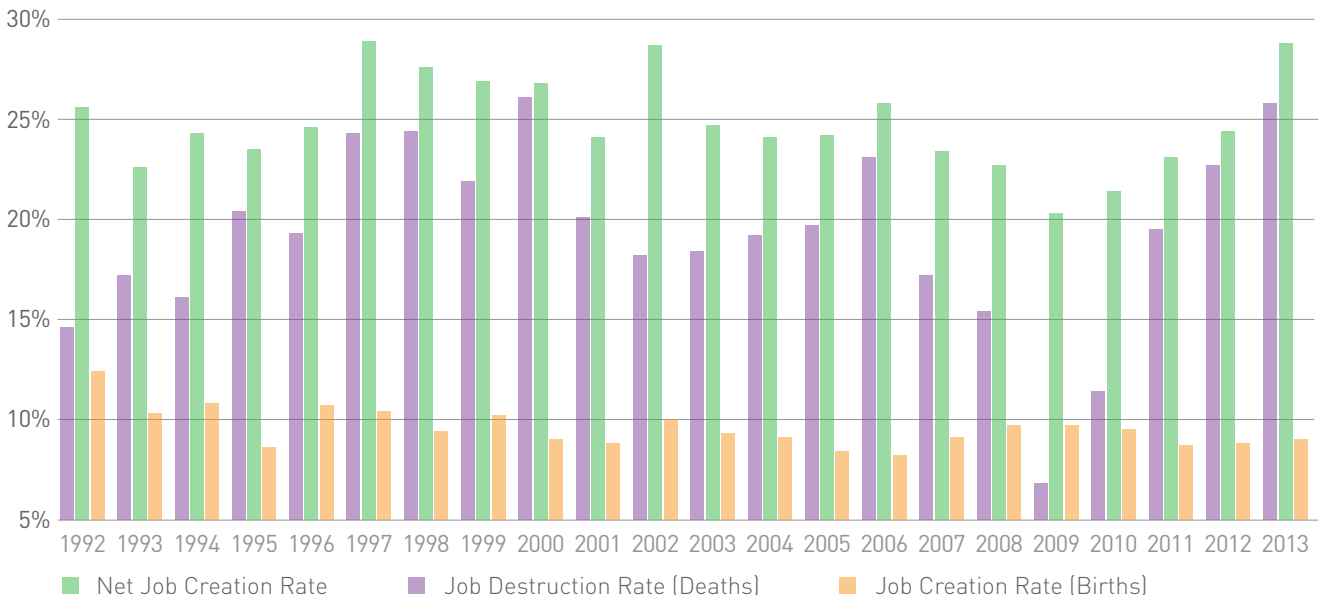
With this comes an important point which helps explain why there appears to be a great deal of real world context missing from the numbers. Age 1+ destruction is not strictly disconnected from age zero creation when looking at these figures on an establishment level. An older firm might close an older establishment to open a new one. Therefore, although the firm may be older and growing, this would not show up in the data aggregated at this level.

The job creation trends present in the establishment level numbers are still present for firms, but to a lesser extent. There are years of net job growth for firms age 16 and over, and the net job destruction for firms age 5 to 15 is less pronounced at the firm level.

Many firms grow as they age, but there are also many that divest portions of their businesses to specialize, and still more that die as they age: Circuit City, Kodak, Blockbuster, etc. There are firms that grow by acquiring other firms and eliminating redundant personnel, achieving efficiencies of scale along with net job destruction. There are also “blue chippers” like IBM, Coca-Cola, Microsoft, and Procter & Gamble that are big, old, healthy, and expected to keep growing, but actually cut many jobs when they acquire other firms and undertake other mergers and acquisitions activity as they change and adapt for the future. We tend to only hear about firms that grow large, quickly, and make headlines, often distorting our perception.

It should also be noted that establishment- and firm-level data for any other state besides California would exhibit nearly identical trends. With this knowledge one must ask the question if it may be better to identify ways to create an environment where new firms and establishments can thrive, and spend less time providing incentives to larger, older firms and establishments.

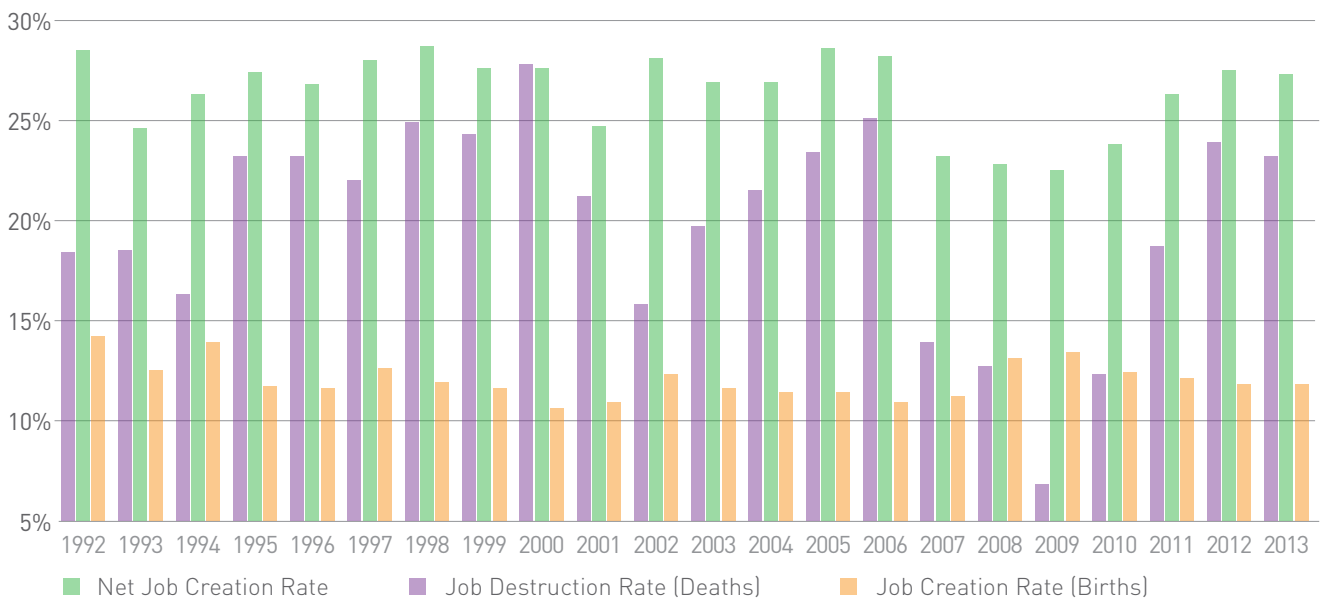
Figure 4a: Establishment Dynamics (0 to 4 years) California, 1992 to 2013



Data Source: Census Bureau

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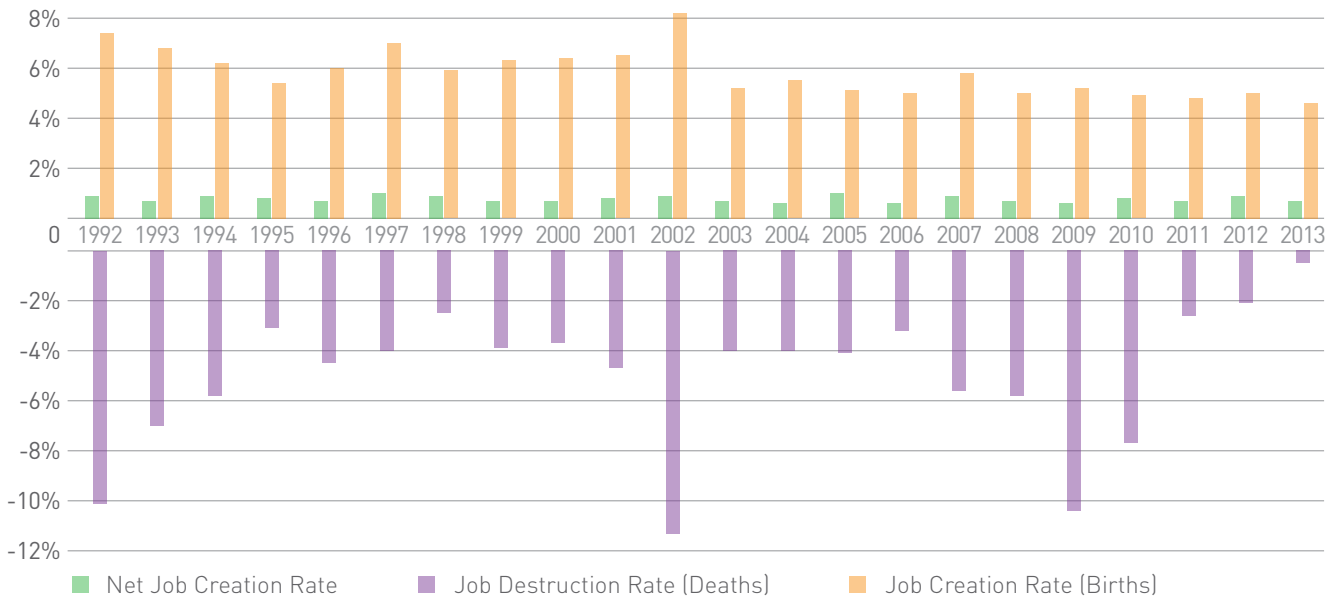
Figure 4b: Firm Dynamics (0 to 4 years) California, 1992 to 2013



Data Source: Census Bureau

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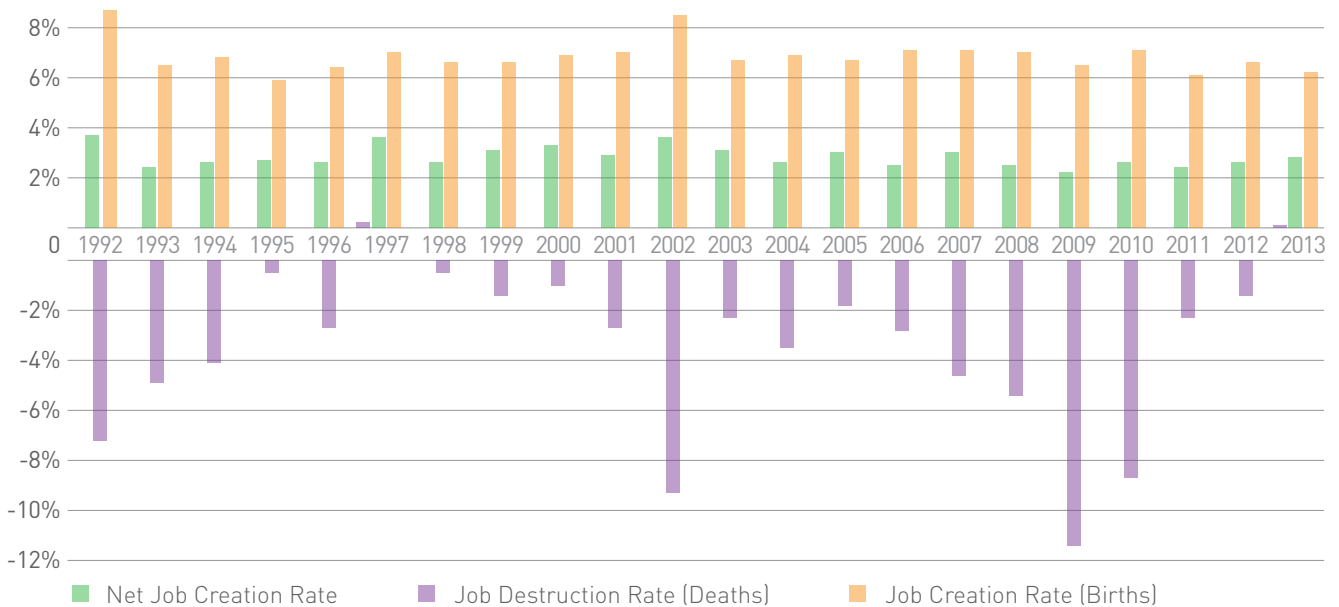
Figure 4c: Establishment Dynamics (5 to 15 years) California, 1992 to 2012



Data Source: Census Bureau

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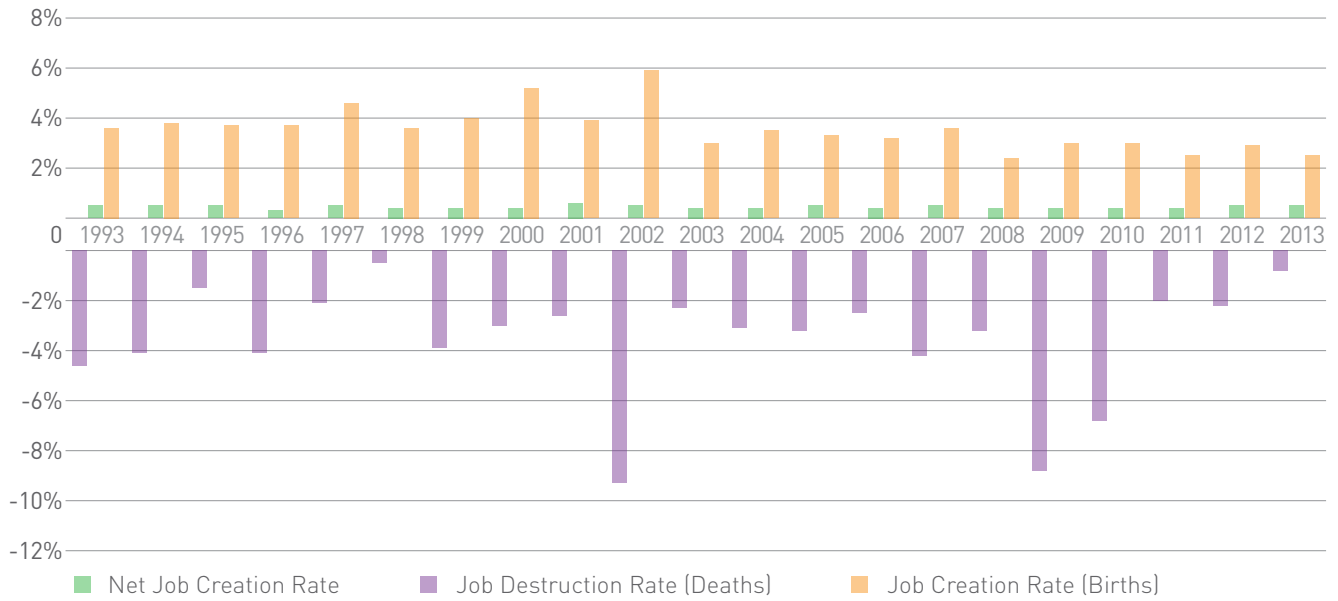
Figure 4d: Firm Dynamics (5 to 15 years) California, 1992 to 2012



Data Source: Census Bureau

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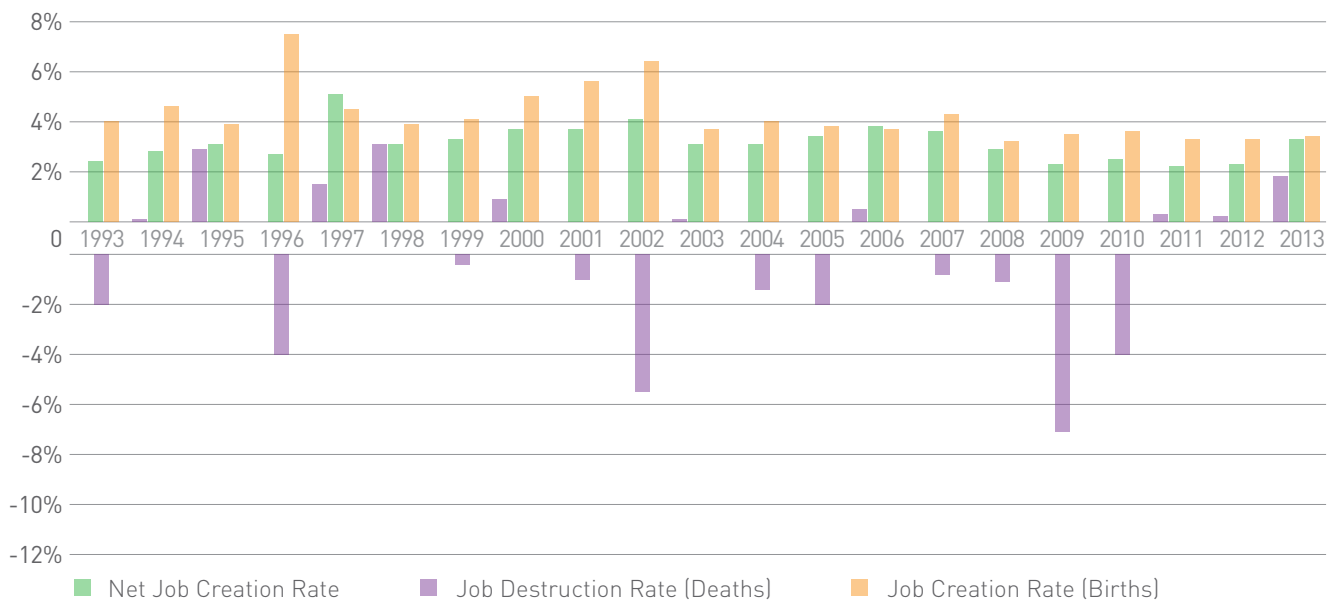
Figure 4e: Establishment Dynamics (16+ years) California, 1992 to 2012



Data Source: Census Bureau

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Figure 4f: Firm Dynamics (16+ years) California, 1992 to 2012



Data Source: Census Bureau

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SUMMARY

In this analysis Next 10 asked Beacon Economics to analyze business dynamism in California in an attempt to either validate or discredit the oft-made claim that California’s business “unfriendly” environment is leading to fewer start-ups and weaker job growth. After examining the BDS data, we find three key takeaways:

- California is not deserving of its bad reputation. In 2013 California tied for 5th in state establishment entry rates, tied for 4th in job creation rates from new firm growth, and 4th in total net job creation. Far from being avoided as a place to do business, California ranks anywhere from above average to one of the best in these main categories.
- The secular decline in business dynamism that is occurring in California is also present in the national economy and in most other states. Economic researchers have yet to offer an explanation for the secular decline in establishment entries and exits, but it is a development that policymakers should follow closely because the creation and destruction of businesses in the economy is vital to sustained productivity and economic growth.
- The importance of encouraging the creation of new establishments and firms in the economy cannot be stressed enough. The BDS data shows that over time, more than 100% of net job creation comes from establishments in their first or second year of existence (denoted by the Census Bureau as years 0 and 1). When we say more than 100% of net job creation that’s exactly what we mean. Many new businesses start up, but many fail, and the ones that fail destroy more jobs than the ones that survive create, so new establishments end up accounting for over 100% of net job creation. A similar narrative holds true for firms overall, though firms age 16 and older frequently show small net gains in job creation. This revelation, illustrated by the data, helps to quantify just how important fostering new business creation is for job growth.

Table 5: 2013 by the Numbers

Variable	Employment (\$ Mill.)	Output (\$ Bill.)	Y-o-Y Emp. Chg.(%)
Job Creation (Births)	5.5	661.2	4.9
Job Destruction (Deaths)	4.6	555.8	4.1
Small Establishment Net Job Creation (1-4 Emp.)	0.3	34.1	4.0
Net Job Creation	3.2	380.2	2.8

Data Source: Business Dynamics Statistics

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