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Positive economic signs abound but new businesses still need to launch



By Mark Zandi, September 28, 2014

On the whole, I'm upbeat about our economy's current prospects. Growth has kicked into higher gear since the start of 2014, as job creation has picked up, particularly for middle- and higher-paying positions.

But the better news still leaves plenty to worry about. Most immediate is the prospect of rising interest rates. Given the Federal Reserve's unprecedented action to combat the weak economy, it is not clear whether the central bank can pull back in a way that neither ignites inflation nor undermines growth.

The mayhem in the Middle East and Vladimir Putin's aggressive moves toward Ukraine pose serious threats. Terrorism here at home would be hard to bear, and Russia remains the globe's largest oil producer. Despite America's growing energy independence, higher oil prices would hurt.

Disparities in U.S. income and wealth are also a problem. The widening gulf between the rich and the rest may not matter a lot in any given year, but over the long term it will be corrosive to growth. It is hard to see how our economy can flourish if a third of the population is struggling financially.

But what worries me most is the sharp slowdown in new business formation since the Great Recession. The number of new U.S. enterprises started each year has been trending lower since the late 1990s, following a peak during the tech boom, but it took a dive during the recession. Business starts stabilized in the subsequent recovery but show few signs of rebounding.

Recent research shows the preponderance of new jobs coming from new firms. They are the principal source of innovation and long-term growth as they turn new ideas into products and services. The longer business starts remain depressed, the dimmer our longer-term prospects look.

Weak business starts are a problem across nearly all industries. The energy sector is an exception, reflecting the fracking boom in many parts of the country. Business formations have also held up in health care due to the rapid changes forced on the industry by Obamacare. But significantly fewer new firms are being formed in manufacturing, retail, and financial services.

The tough economy is clearly one reason why. Starting a business is nerve-racking even in the best of times. During the first year my own firm was in business, I was so nervous about whether things would work out that I often literally had a hard time breathing. The nightmare of the recession surely dampened the entrepreneurial spirits so vital to risk-taking.

Another factor likely weighing on new business formations is the age composition of the population. Most new businesses are formed by people in their 30s, as I was when my best friend, my brother, and I started our company. Unfortunately, the share of thirtysomethings in the U.S. population is at a cyclical low. This is the baby-bust generation, the small cohort between the baby-boomers and their kids, now the twentysomething millennials.

Moreover, the bad economy has slowed the start of careers for many millennials. It may thus take them longer to acquire the skills and experience necessary to start businesses. The heavy debts many took on to finance their educations won't help.

Starting businesses also takes capital, which has been in short supply. Until recently, getting a bank loan for a start-up was extraordinarily difficult. It is still tough to find venture capital funding unless you live in Silicon Valley and write computer code, or are working on the next big app for smartphones.

Even more disconcerting are the pace and type of innovation these days. New things are getting invented, but less quickly than in the past and, possibly, with less impact on society. One respected economist argues that while the iPhone is impressive, getting one isn't nearly as life-changing as was acquiring an indoor toilet for past generations.

This seems overstated. Who knows what will come from 3-D printing, nanotechnology, drones, driverless cars, or genomics? Technological change appears to occur in waves, and the lulls often produce hand-wringing over where and when the next new thing will appear.

Regardless, we need to take the slump in business formations seriously. Immigration reform to admit more highly skilled workers from abroad would provide a significant boost. Immigrants by definition are risk-takers - they take big chances moving to a new country - who have historically started lots of new businesses.

More investment in public infrastructure would be another plus. Today's start-ups are globally oriented and need world-class telecommunications, airports, seaports, and roads.

Spending more on education and training, and easing student debt burdens, would help get the millennials on track. One step in this direction would be reducing taxpayer subsidies for student lending, and using that money to increase the supply of educational services.

Patent reform and a more aggressive government effort to protect intellectual property rights from global competitors would mean a lot to new technology firms. Lawmakers should also be sensitive to the implications of the legal and regulatory changes they make on new businesses.

It has always been a mistake to underestimate the dynamism of the American economy. I suspect that is still the case today. But the recent slowdown in business formations is worthy of careful attention. New businesses are that make our economy tick.

Mark Zandi is chief economist of Moody's Analytics. help@economy.com

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