Texas Business Starts Outperform U.S.; Formation Rates Decline

By Jack Wang and Michael Weiss

Small firms don't create the bulk of net new jobs, but young firms do. Thus, business formation is a closely watched gauge of economic health and future growth.[1]

Despite the attention given to start-ups and entrepreneurism, particularly in the high-tech sector, overall rates of business formation in the economy have been trending lower since the late 1970s. This pattern has also held in Texas, despite higher rates of overall activity here.

New businesses are important because they help fuel long-term economic growth. Businesses with fewer than 100 workers employed 32 percent of all workers in Texas in 2013 and play an outsized role in the development of new industry in the state, according to a recent study commissioned by the Texas governor's office.[2]

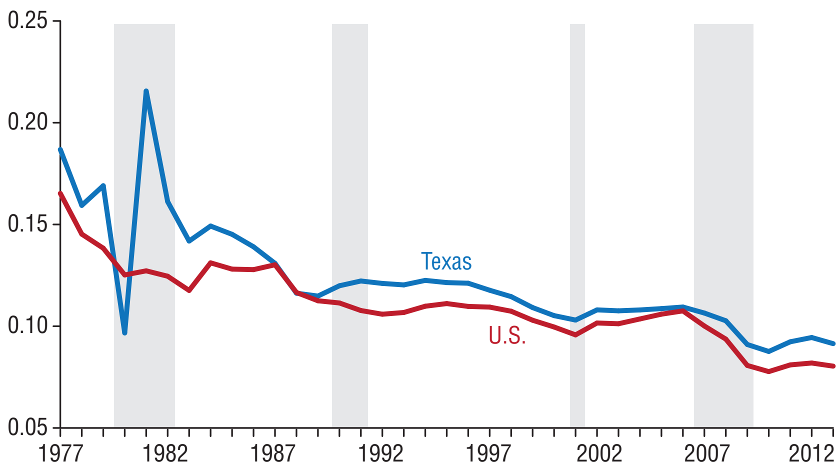
Annual firm entry rates illustrate the slipping rate of business formation nationally and in Texas (*see Chart 1*). The entry rate is the proportion of new firms less than 1 year old relative to the total.

Texas' entry rate has consistently exceeded the U.S. rate, except during years of sharp oil price declines in the early and late 1980s. The energy sector's share of the state economy was 19 percent at its peak, which meant oil busts wreaked havoc on the region's growth.

The state has diversified since 1990—dropping oil's share of gross domestic product to 14 percent in 2014 during the shale boom—with expanding high technology, business and financial services and transportation and logistics sectors making Texas economy more like that of the U.S.

Nonetheless, Texas provides a particularly welcoming business environment. The Vancouver, Canada-based Fraser Institute ranked Texas fifth among states and provinces in North America in terms of economic freedom—"the ability of individuals to act in the economic sphere free of undue restrictions."

Chart 1 Firm Entry Rate Trends Lower for Texas and the U.S.



NOTE: Shaded areas indicate U.S. recessions.
SOURCES: Census Bureau Business Dynamics Statistics; authors' calculations.

Texas secured second place for its business climate in the 2016 CNBC Global CFO Council measure of top states for business. It won top 10 grades for its economy, infrastructure, access to capital and workforce. Its worst grade was for education, ranking 40th.

The average annual firm entry rate for Texas was 14.1 percent from 1980 to 1989, falling to 11.9 percent in 1990–99, 10.5 percent in 2000–09 and 9.1 percent in 2013, the most recent year for which figures are available. Texas shared a falling rate of business formation with each of the other 49 states.[3]

The reasons for the decline are not known, but the same factors that contribute to large-scale business consolidation are the ones that benefit large, established firms and harm small, young enterprise. Retail trade is a powerful example—the replacement of mom-and-pop stores with single "big box" retailers, such as Walmart or Home Depot.

Technological advancement and increased globalization create economies of scale advantages for bigger, established companies that can more easily manage worldwide supply chains and shift resources in the face of adversity than start-ups. Increased regulation also helps drive up the costs of starting and running a business.[4]

To be sure, although the business formation rate has declined, the actual number of newly registered businesses in Texas has grown, increasing at a 4.6 percent annual rate from 2004 to 2015, according to the Texas secretary of state.

Notes

[1] "Who Creates Jobs? Small vs. Large vs. Young," by John C. Haltiwanger, Ron S. Jarmin and Javier Miranda, National Bureau of Economic Research, Working Paper no. 16300, August 2010.

[2] "Small Businesses and Their Impact on Texas," by Thomas Tunstall, Javier Oyakawa, Hisham Eid and Amanda Martinez, Center for Community and Business Research, University of Texas at San Antonio, April 2016.

[3] "Declining Business Dynamism in the United States: A Look at States and Metros," by Ian Hathaway and Robert E. Litan, *Economic Studies*, The Brookings Institution, May 2014.

[4] "The Role of Entrepreneurship in U.S. Job Creation and Economic Dynamism," by Ryan Decker, John Haltiwanger, Ron Jarmin and Javier Miranda, *The Journal of Economic Perspectives*, vol. 28, no. 3, 2014, pp. 3–24.