Where have all the entrepreneurs gone?

Australia's falling business entry rate

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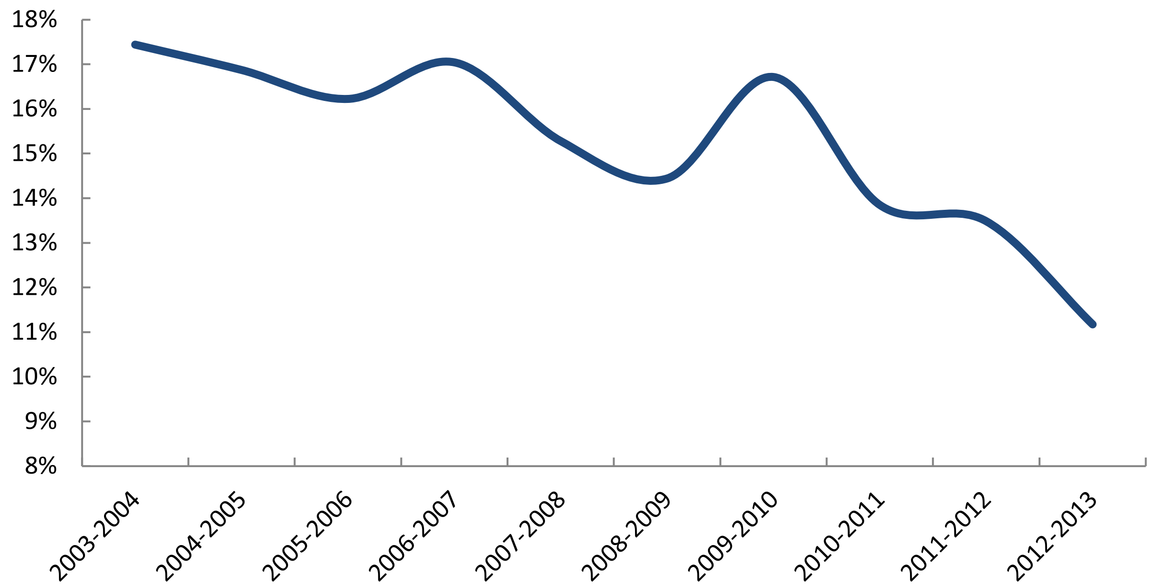
Dom has previously worked as an intern at United Kingdom Trade and Investment and has a long history in small business. Dom won a number of academic prizes while completing his Masters in European and International Studies at Monash University. He has also completed a Bachelor of Arts from the University of Melbourne.

Executive summary

- The formation of new firms plays an important role in economic growth, job creation, social mobility and long term productivity increases.
- Australia's new firm entry rate – the number of new firms as a percentage of total firms operating – has been in steady decline over the decade to June 2013.
- In 2003-2004, Australia's business entry rate of 17.4 per cent indicated a robust and dynamic economy. By 2012-2013, the entry rate had fallen to 11.2 per cent.
- In raw numbers there has been a fall from 325,935 new businesses launched in 2003-2004 to just 239,229 in 2012-2013.

Figure 1: Australia's new firm entry rate



Source: Australian Bureau of Statistics Cat. No. 8165.0

- The fall in dynamism is not confined to one segment of the economy, with all major sectors seeing a decline over the surveyed period.
- Likewise, the decline has occurred in every state and territory. However, the most severe fall in the rate of business entry has occurred in Tasmania and South Australia.
- International research has shown that the most effective method for fostering entrepreneurship is to increase economic freedom.
- Governments can provide a more economically free society by better protecting property rights, reducing the levels of taxation, and easing the burden of regulation. Increasing economic freedom also requires governments to refrain from interfering in the ability of people to make their own decisions to enter and compete in labour and product markets.

Contents

Introduction

A key characteristic of a dynamic and competitive free market economy is that its citizens have the ability to continually engage in new profitable ventures in local and international markets. With Australia's economy in a period of sustained transition, this entrepreneurial spirit will be at the centre of our future economic growth and job creation.

Over the last decade Australia's economy has changed significantly. The recent announcements signalling the departure of major manufacturers from our shores and plateauing mining investment are illustrative of this. A similarly noteworthy and disturbing change that has received far less attention has been the dramatic decline in the rate of new firms being launched annually in Australia over the last decade.

Of course, business entry and exit is inherently disruptive. However, it is also crucial for long run economic growth and improvements in quality of life. Economic research strongly demonstrates that this process of 'creative destruction' – as first theorised by Joseph Schumpeter – is critical for long-run productivity gains, as more dynamic and innovative firms are able to displace less productive firms. As a result, labour and capital can then flow to new firms and to different areas of the economy where it will be of better use.

Entrepreneurs and risk-takers play a central role. They are the embodiment of economic change and progress. By launching new businesses they take action under uncertainty to create new opportunities from which the whole community benefits. But the number of entrepreneurs in Australia is in steady decline.

Over the last ten years, the business entry rate – a measurement of the total number of businesses one year old or younger as a percentage of total businesses operating – has been in a sustained period of decline in Australia. This precipitous drop indicates a worrying trend for the state of enterprise, which, if allowed to continue unaddressed will have a detrimental impact on the long-term living standards of all Australians – particularly given the vital role new firm formation plays in job creation.[1]

While the fall in the business entry rate has occurred in all Australian states and territories, Tasmania and South Australia have both witnessed the most substantial drop over the surveyed period. In both states entry rate fell into single figures in 2012-2013.

Overall, there are few bright spots to be found across the national economy. Declining business entry rates have had an impact on all industrial sectors. Of particular note are the decreases in the rate of entry in the retail, construction and manufacturing sectors, which collectively make up 28.6 per cent of total employment in Australia.[2] Without sufficient new business entries, employees with skills tailored to these industries will have difficulty finding employment opportunities following business exits.

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[1] See, for example, J. Haltiwanger, R. Jarmin, and J. Miranda, *Business Dynamics Statistics Briefing: Jobs Created From Business Startups in the United States* (Kansas City: Ewing Marion Kauffman Foundation, 2009); D. Stangler and R. Litan, *Where Will the Jobs Come From?* (Kansas City: Ewing Marion Kauffman Foundation, 2009).

[2] Australian Bureau of Statistics, *Year Book Australia, 2012,* Cat. No. 1301.0 (May, 2012).

To address this development, it is critical to foster a culture of entrepreneurship in Australia, and improve the environment in which businesses operate. Making Australia a more entrepreneurial society will benefit all citizens. Encouraging wealth creators to take risks and to launch new businesses will help drive our future economic growth and job creation.

The right environment can only be created by a swathe of mutually reinforcing policy initiatives. For the most part these policies affect the economy as a whole, such as sound fiscal and monetary management. However, they also include the structural factors that determine the overall economic framework that businesses operate in, such as industrial relations, the regulatory environment, and the tax system.

Business dynamism

The Australian economy is in a constant process of renewal. Over the ten years to June 2013, a new business was launched in Australia every 103 seconds, every 108 seconds an existing business exited. This process of new business formation, failure, growth and contraction is known as business dynamism.

The economy progresses and develops through competition between firms and the exploitation of previously unseen opportunities. New firms, even at the most basic level, bring new products, methods of production, and organisational structures. Incumbent operators are therefore forced to compete more vigorously to maintain their position.

Under the current cloud of rising unemployment seen in many developed countries – which is particularly pervasive among youth – many governments have started to recognise the pivotal role entrepreneurship can play in driving employment opportunities. International research has shown that a small group of high growth firms will be disproportionately responsible for driving the growth of new jobs.[3] Of course, it is almost impossible to tell which businesses are likely to survive and grow at the time that they are founded; however, the more businesses that are launched, the more likely high-growth firms will emerge that can provide these employment opportunities.

A Brookings Institution study from May this year found that the United States had seen a steady decline in the rate of business entry over the last three decades.[4] This decline in new firm formation was highlighted by the Chair of the U.S. Federal Reserve Board of Governors, Janet Yellen, in a recent speech at the Conference on Economic Opportunity and Inequality in Boston, Massachusetts. Yellen noted this decline was concerning because 'it may serve to depress the pace of productivity, real wage growth, and employment.'[5]

Since business ownership has been shown to be associated with higher levels of economic mobility,[6] Yellen also pointed out that a 'slowdown in business formation may threaten… a significant source

[3] World Economic Forum and Stanford University, *Global Entrepreneurship and Successful Growth Strategies of Early-Stage Companies* (2011), accessed 19 November, 2014, http://www3.weforum.org/docs/WEF_Entrepreneurship_Report_2011.pdf.
[4] I. Hathaway and R. Litan, *Declining Business Dynamism in the United States: A Look at States and Metros* (The Brookings Institution, 2014).
[5] J. Yellen, "Perspectives on Inequality and Opportunity from the Survey of Consumer Finances" (speech given at the Conference on Economic Opportunity and Inequality, Federal Reserve Bank of Boston, Boston, Massachusetts, 2014), accessed 19 November, 2014, http://www.federalreserve.gov/newsevents/speech/yellen20141017a.htm.
[6] See V. Quadrini, "Entrepreneurship, Saving, and Social Mobility," *Review of Economic Dynamics,* Vol. 3 (2000): 1-40.

of economic opportunity for families below the very top in income and wealth.'[7] This is an interesting point, and highlights another reason why Australia's falling business entry rate is so troubling.

National business dynamism

Table 1 demonstrates the decline in businesses entering the market in Australia over the ten years to June 2013. In raw numbers, 2012-2013 saw only 239,229 new businesses launched. This was the lowest number of business start-ups in the period.

Business exits have risen over the same period. Exits fell to a low of 268,745 in 2009-2010 before steadily rising to 300,843 in 2012-2013, leading to a fall in number of businesses operating in Australia for the first time since the financial crisis.

Table 1: Count of Australian businesses, including entries and exits

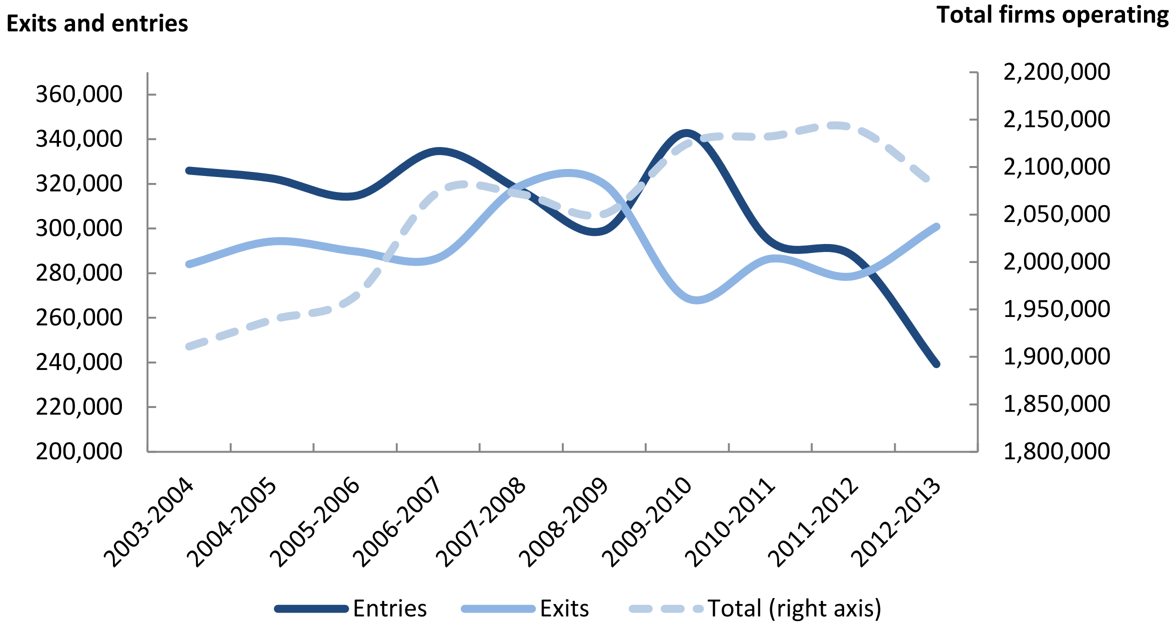
Year	Entries	Exits	Entry rate	Exit rate	Total businesses operating
2003-2004	325,935	283,997	17.4%	15.2%	1,910,907
2004-2005	322,400	294,219	16.9%	15.4%	1,939,088
2005-2006	314,578	289,759	16.2%	14.9%	1,963,907
2006-2007	334,689	286,826	17.0%	14.6%	2,073,793
2007-2008	316,850	319,283	15.3%	15.4%	2,071,360
2008-2009	299,123	319,841	14.4%	15.4%	2,050,642
2009-2010	342,753*	268,745	16.7%	13.1%	2,124,650
2010-2011	294,210	286,448	13.9%	13.5%	2,132,412
2011-2012	287,521	278,653	13.5%	13.1%	2,141,280
2012-2013	239,229	300,843	11.2%	14.1%	2,079,666

Source: Australian Bureau of Statistics Cat. No. 8165.0

Notes: Because of inconsistencies in methodology between ABS releases, entries and exits do not equal total businesses in 2006-2007
*A spike is visible in 2009-2010 due to an administrative change by the ABS in the long term non-remitters (LTNR) rule.[8]

[7] Yellen, "Perspectives on Inequality and Opportunity".
[8] The ABS notes that the LTNR rule refers to 'businesses that have not submitted a Business Activity Statement (BAS) for a defined period of time, and are considered dormant businesses and therefore excluded from the counts. For annual remitters, this LTNR period has been increased from 5 consecutive quarters to 3 consecutive years. This administrative change has resulted in a noticeable and identifiable increase in the business counts at June 2010. More specifically, it has led to an increase in business entries, as those businesses that would have previously been excluded have been brought back into scope, and therefore appear as business entries. For example, the entries for June 2009 are 299,123. This then spikes to 342,753 in June 2010, and reverts to 294,210 in June 2011. Further investigations reveal that at a minimum, 21,000 of these June 2010 entries can be attributed to the new LTNR methodology, and the majority are clustered in the non-employing size category. As such, care is exercised when interpreting the 2010 business counts.'

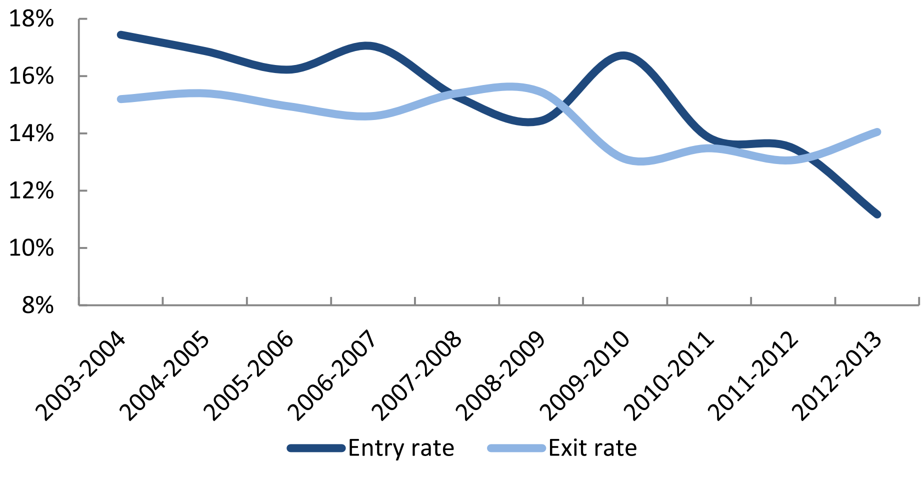
Figure 2: Count of Australian businesses, including entries and exits



Source: Australian Bureau of Statistics Cat. No. 8165.0

Note: Because of data inconsistencies between ABS releases, entries and exits do not equal total businesses in 2006-2007.

Figure 3: Australian business entry and exit rates



Source: Australian Bureau of Statistics Cat. No. 8165.0

As figure 3 demonstrates, there has been a rapid decline in business entry visible over the last decade. In 2003-2004, Australia's business entry rate of above 17 per cent indicated a robust and dynamic economy. By 2012-2013, the entry rate had fallen to just 11.2 per cent. Given that the spike in 2009-2010 was partly due to administrative changes by the Australian Bureau of Statistics (see footnote 8), the trend indicated in the graph becomes even clearer.

The last three years have also seen an increase in the business exit rate from 13.1 per cent in 2009-2010 to 14.1 per cent in 2012-2013 which, taken alongside the trend in business entries, illustrates the difficulties of operating in the current business environment.

Business entries by firm size

At June 2013, there were 1,264,298 non-employing businesses and 815,368 employing businesses in Australia. Of the employing businesses:

- 563,412 were micro businesses employing 1 to 4 employees;
- 197,412 were small businesses employing 5 to 19 employees;
- 50,946 were medium businesses employing 20 to 199; and
- 3,598 were large businesses employing more than 200 employees.

Table 2 indicates a steady decline in the number of new businesses entering in every category. Entry rates remain highest in non-employing businesses and micro businesses employing fewer than 5 employees. This is explained by the fact that most new businesses start small and expand in line with their ability to take market share from incumbent operators or in line with demand if a product not previously available in the market is being offered.

Due to the nature of the available statistics, it is also important to keep in mind that the entry rate of new large businesses is somewhat deceptive. A new business is counted when a new ABN is registered, even if the new business is wholly owned by previously existing businesses. As such, it is probable that a large proportion of new large businesses entries have occurred due to the merger of two pre-existing medium sized businesses.[9]

Table 2: Business entry rate by business size (2004-2013)

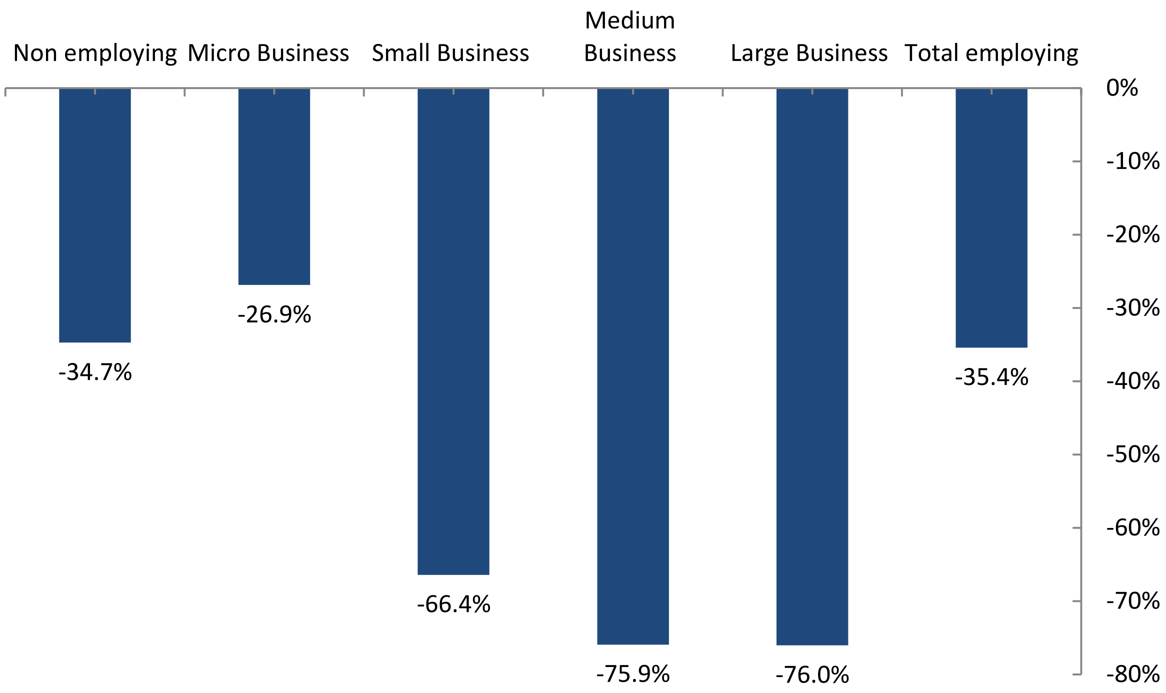
	Non-employing	Micro business	Small business	Medium business	Large business	Total employing
2003-2004	19.0%	16.0%	12.8%	10.8%	9.6%	14.4%
2004-2005	18.0%	18.2%	11.2%	8.4%	9.0%	15.1%
2005-2006	18.4%	16.8%	8.3%	4.8%	9.0%	13.1%
2006-2007	19.7%	17.1%	8.1%	4.6%	9.9%	13.2%
2007-2008	17.6%	15.3%	7.3%	4.0%	7.3%	11.9%
2008-2009	16.6%	14.4%	6.7%	4.0%	8.3%	11.2%
2009-2010	19.9%	15.2%	4.9%	2.2%	8.9%	11.9%
2010-2011	15.3%	14.6%	4.9%	2.7%	2.8%	11.6%
2011-2012	14.7%	14.5%	5.0%	2.7%	2.3%	11.6%
2012-2013	12.4%	11.7%	4.3%	2.6%	2.3%	9.3%

Source: Australian Bureau of Statistics Cat. No. 8165.0

[9] Department of Industry, *Australian Small Business: Key Statistics and Analysis* (Canberra: Australian Government, December, 2012), 48.

Figure 4 shows the percentage change that has occurred in the rate of new business formation over the surveyed period. The largest falls were seen in the large business and medium business categories, which both fell by around 76 per cent. The number of new micro businesses entering the market saw the smallest drop, down 26.9 per cent to 11.7 per cent.

Figure 4: Percentage change in business entry rate by firm size (2004-2013)



Source: Australian Bureau of Statistics Cat. No. 8165.0

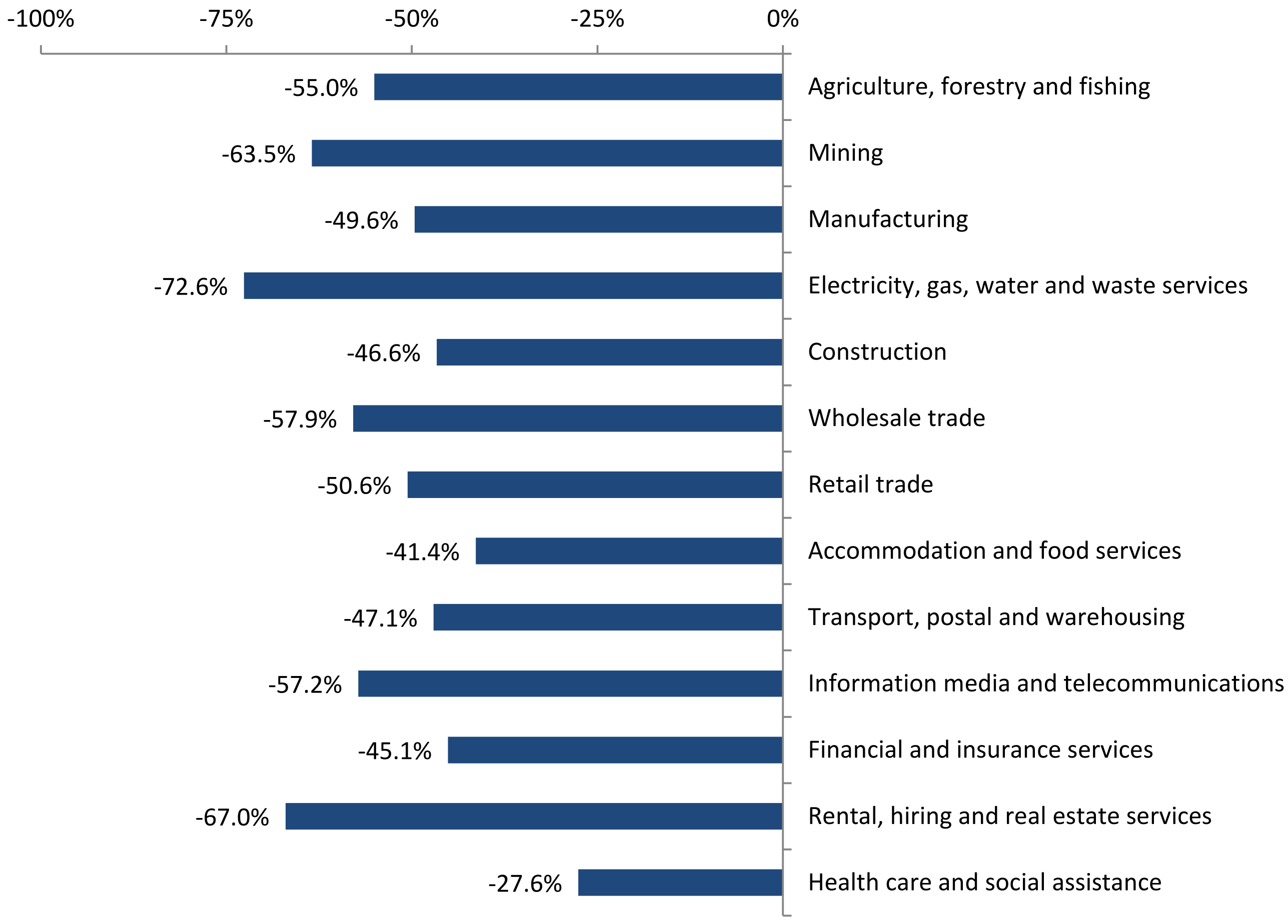
Business entries by industry

All major sectors of the economy saw a decline in the decade surveyed. The most substantial decline in levels of entry can be seen in Electricity, gas, water and waste services; however there have also been major falls in Rental, hiring and real estate services, Mining, Wholesale trade and in Information media and telecommunications.

The largest sector by employment, Health care and social assistance, which makes up around 11.4 per cent of total employment, saw the smallest drop in business entry rates. The next largest sectors by employment – Retail trade, Construction and Manufacturing, which between them provide 28.6 per cent of employment in Australia[10] – saw large falls in the number of new businesses being launched. Particularly noteworthy was the 50.6 per cent drop in the number of new entrants in the Retail sector.

[10] Australian Bureau of Statistics, "Year Book Australia, 2012," Cat. No. 1301.0 (May, 2012).

Figure 5: Percentage change in business entry rate by sector (2004-2013)



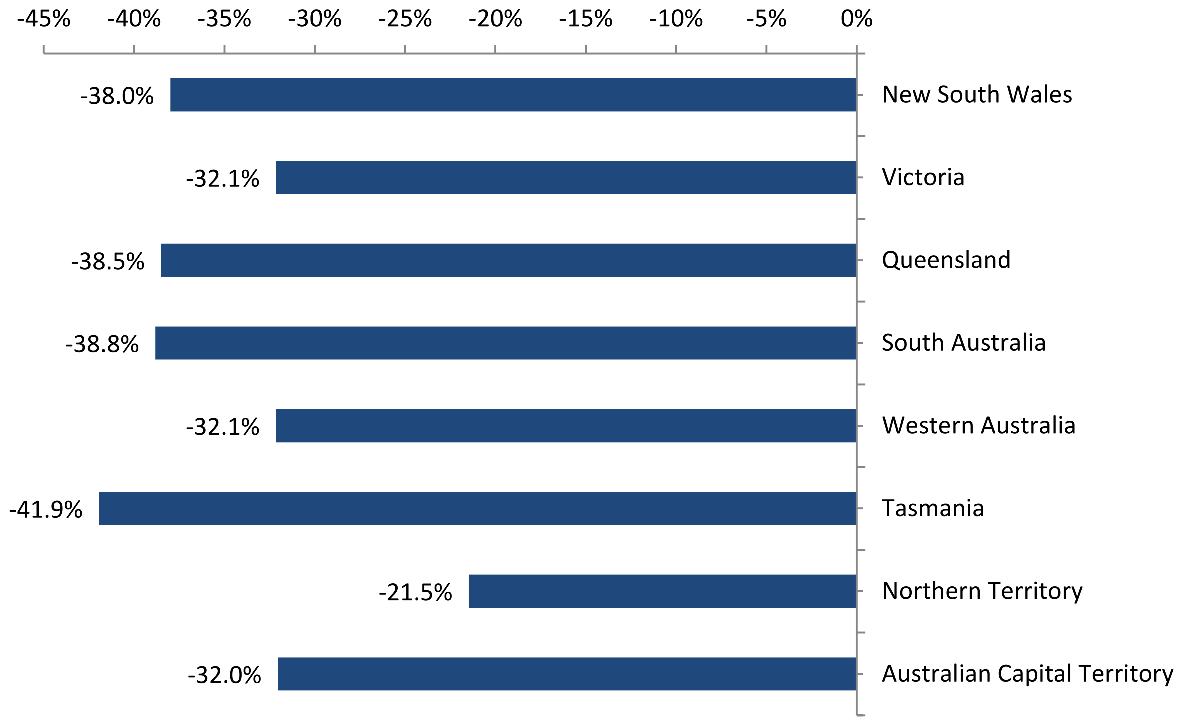
Source: Australian Bureau of Statistics Cat. No. 8165.0

Business entries by state

All states and territories have seen a decline in the business entry rate over the decade surveyed. The most substantial fall occurred in Tasmania, which had a 41.9 per cent drop – from a 15.5 per cent entry rate in 2003-2004 to 9 per cent in 2012-2013. Notable also are the major falls in South Australia – from 15.2 per cent to 9.3 per cent – and Queensland – from 18.7 per cent to 11.5 per cent.

The Northern Territory has seen the smallest drop, with a 21.5 per cent fall from 16.3 per cent to 12.8 per cent. The Northern Territory's 2013-2014 entry rate of 12.8 per cent was the highest of any state or territory, followed by the Australian Capital Territory with 12.3 per cent, Queensland with 11.5 per cent, Victoria and Western Australia with 11.4 per cent and New South Wales with 11.1 per cent. South Australia and Tasmania had the lowest entry rates with new businesses making up just 9.3 per cent and 9 per cent of businesses operating in each state.

Figure 6: Percentage change in business entry rate by state and territory (2004-2013)



Source: Australian Bureau of Statistics Cat. No. 8165.0

Low rates of business entry in Tasmania and South Australia correspond with low levels of economic freedom in these states. Using 2011 data, a report released by the Institute of Public Affairs earlier this year found that these two states had the worst ranking of all Australian states on a range of indicators of economic freedom, including government expenditure, taxation and debt, government dependency, and the regulatory environment.[11]

[11] J. Novak, *2014 IPA Economic Freedom Index* (Melbourne: Institute of Public Affairs, 2014), accessed 19 November, 2014, http://www.ipa.org.au/portal/uploads/PAPER-ECONOMIC_FREEDOM_INDEX_2014-FINAL.pdf.

Conclusion

Australia has experienced a significant decline in business dynamics and entrepreneurship over the last decade. Despite the range of opportunities that have become available for disrupting incumbent operators through technological developments in recent years, the figures indicate that there has been a considerable decrease in the number of people that are trying to start a business.

Understanding why individuals are choosing not to go into business for themselves and instead opting for employment in existing firms is innately difficult; however, international studies have shown that the most effective mechanism to increase entrepreneurial behaviour, and subsequently economic growth, is to increase economic freedom.[12]

Governments can provide a more economically free society by increasing property rights, reducing the levels of taxation, and easing the burden of regulation. Increasing economic freedom also requires governments to refrain from interfering in people's ability to make their own decisions to enter and compete in labour and product markets.

Recommendations:

1. **Reform industrial relations:** The Australian government must foster the best industrial relations environment possible through reforms that increase flexibility and enable fast growing firms to grow in line with their full potential.[13] According to the World Economic Forum, Australia currently ranks 137th for the rigidity of hiring and firing practices and 135th for the rigidity of wage setting.[14] Anti-bullying amendments to the *Fair Work Act 2009*, introduced at the start of this year, add to the litigious nature of the IR system and are unnecessary given the range of other jurisdictions that employees can utilise to address such issues.[15] Similarly, businesses with 100 or fewer staff should be exempted from unfair dismissal laws. The government must also reintroduce the right of employers and employees to negotiate individual workplace contracts and overhaul the current penalty rate system which adds huge costs to the operation of many businesses and discourages jobs growth.
2. **Cut taxes:** A lower level of taxation has been shown to increase the level of entrepreneurship.[16] Australian states should abolish payroll taxes, which effectively act as a tax on jobs. The federal government must decrease the personal income rate which, now at 49 per cent due to the government's debt levy, acts as a disincentive to pursuing profitable

[12] See, for example, N. Foss and C. Bjørnskov, "Economic Freedom and entrepreneurial activity: Some cross-country evidence," *Public Choice* Vol. 134 No. 3-4 (2008); S. Kreft and R. Sobel, "Public Policy, Entrepreneurship, and Economic Freedom," *Cato Journal* Vol. 25 (2005); N. Campbell, K. Heriot and T. Rogers, "The economic freedom index as a Determinant of Firm Births and Firm Deaths," *Southwest Business and Economics Journal* Vol. 8 No. 16 (2007-2008); J. Hall and R. Sobel "Institutions, Entrepreneurship, and Regional Difference in Economic Growth," *Southern Journal of Entrepreneurship* Vol. 1 No. 1 (2008); R. Sobel, "Testing Baumol: Institutional Quality and the Productivity of Entrepreneurship," *Journal of Business Venturing* Vol. 23 No. 6 (2008).

[13] M. Henrekson, "How labour market institutions affect job creation and productivity growth," *IZA World of Labour* Vol. 38 (2014).

[14] World Economic Forum, *Global Competitiveness Report 2013-2014* (World Economic Forum, 2014), accessed 19 November, 2014, http://www.weforum.org/reports/global-competitiveness-report-2013-2014.

[15] A. Lane, "Bully Law a Case of IR Overload," *The Australian,* 14 January, 2014.

[16] See, for example, W. Gentry and G. Hubbard, "Success taxes: Entrepreneurial Entry and Innovation," *Innovation Policy and the Economy* Vol.5 (2005); or various studies in J. Slemrod, *Does Atlas Shrug? The Economic Consequences of Taxing the Rich* (Harvard: Harvard University Press, 2000).

ventures in Australia.[17] There must also be a move to reduce Australia's corporate tax rate which, at 30 per cent, is well above the OECD average and makes Australia an uncompetitive place to establish a new business.[18]

3. **Deregulate:** Although the regulatory burden is destructive to all businesses within a given jurisdiction, it inevitably falls hardest on the smallest operators that lack the resources to cope with the seemingly endless amount of government compliance measures that come their way. Australia's regulatory system is designed in a fashion which encourages a seemingly endless stream of regulation and compliance measures.[19] In recent years this growth has seen the Australian regulatory system ranked the 128th most arduous in the world by the World Economic Forum.[20] The government must simplify the process of establishing employee share schemes as it has promised to do, and take measures to reduce the complexity of complying with the Australian Tax Office. According to 2012 research conducted by Philip Lignier enterprises with less than 50 employees spent an average of $28,000 and around 500 hours a year to comply with their tax obligations.[21]
4. **Teach entrepreneurship:** The 2013 Amway Entrepreneurship report found that a major factor diminishing the levels of entrepreneurship in many countries is the lack of entrepreneurial education.[22] Australian universities must start offering more substantive entrepreneurship courses taught by teachers with real world experience to give students the knowledge and confidence to successfully develop their ideas into profitable ventures. A greater emphasis on enterprise should also be encouraged at both our primary and secondary schools. Decisions to bring programs into schools should be driven by school boards and principals rather than directives from bureaucrats and government bodies and should be run by real world entrepreneurs and businessmen such as *Club Kidpreneur* founder Creel Price.

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[17] D. Bruce and T. Gurley, *Taxes and Entrepreneurial Activity: An Empirical Investigation Using Longitudinal Tax Return Data* (Small Business Administration, March, 2005), accessed 19 November, 2014, http://archive.sba.gov/advo/research/rs252tot.pdf.

[18] KPMG, reported in Nassim Khadem, "Australian tax rates above OECD average: KPMG," *Australian Financial Review,* 10 February, 2014, accessed 19 November, 2014, http://www.afr.com/p/national/australian_tax_rates_above_oecd_yjvusbisG0EtOIhlpdJ2AO.

[19] C. Berg, *The Growth of Australia's Regulatory State: Ideology, accountability and the mega-regulators* (Melbourne: Institute of Public Affairs, 2008), accessed 19 November 2014, http://www.ipa.org.au/library/BERG_Regulation.pdf.

[20] World Economic Forum, *Global Competitiveness Report 2013-2014* (World Economic Forum, 2014), accessed 19 November, 2014, http://www.weforum.org/reports/global-competitiveness-report-2013-2014.

[21] P. Lignier and C. Evans, "The rise and rise of tax compliance costs for the small business sector in Australia," *Australian Tax Forum: A Journal of Taxation Policy*, *Law and Reform* Vol. 7 No. 3 (2012).

[22] Amway, *Global Entrepreneurship Report* (Amway, 2013), accessed 19 November, 2014, http://globalnewsassets.amway.com/501483/2013_amway_global_entrepreneurship_report_1.pdf?r=1920.

Glossary

The data used for this study has been obtained from the Australian Bureau of Statistics. This data, in part, is supplied by the Australian Tax Office under the *Income Taxation Administration Act 1953.* This glossary cites meanings as stipulated by the Australian Bureau of Statistics.

Business

The ABS defines a business as 'a legal entity engaging in productive activity and/or other forms of economic activity in the market sector. Such entities accumulate assets on their own account and/or hold assets on behalf of others, and may incur liabilities. Excluded are the economic activities of individuals (except where individuals engage in productive activity either as sole traders or in partnership) and entities mainly engaged in hobby activities.'

The ABS also notes that 'in line with this definition, the business counts in this publication are derived from the ABS Business Register. The starting point is all economically active entities in Australia. From here, various entities are excluded, such as those without an active ABN, those without an active GST role, those no longer actively remitting GST and those not operating in the market sector. These exclusions aim to ensure that only those businesses that are actively trading in the economy are included in the counts.'

Business Entry

A business which has recently registered for an ABN and which has a GST role allocated, as stipulated by the Australian Bureau of Statistics.

Business Entry Rate

Business entry rates are calculated by taking the total business entries during a financial year divided by the total businesses operating at the start of the financial year, multiplied by 100.

Business Exit

A business exit relates to a business for which the ABN or GST role has been cancelled and/or which has ceased to remit GST for at least five consecutive quarters.

Business Exit Rate

The business exit rate is calculated by taking the total business exits during the financial year divided by the total businesses operating at the start of the financial year, multiplied by 100.

Employment size ranges

For the purposes of this paper, businesses are categorised as:

- Employing businesses:
    - Employment of 200 or more persons ('Large Business')
    - Employment of 20 to fewer than 200 ('Medium Business')
    - Employment of 5 to fewer than 20 ('Small Business')
    - Employment of 1 to fewer than 5 ('Micro Business')

- Non Employing business

The method used to quantify employment for Australian businesses in ABS economic statistics is based on the concept of a ‘headcount’, rather than a measure of Full Time Equivalent Persons.

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