Allowing Entrepreneurship

Evansville Rotary Club
Evansville, Indiana
March 30, 2004

In my speeches discussing the outlook for the economy, I almost invariably finish by mentioning that I am an optimist about the long-run economic performance of the United States because of the superb entrepreneurial environment in this country. Today, instead of just mentioning this view, I will discuss it in some detail. I don't think many appreciate how important it is to our future that we build on our success in this regard. I do not know how to measure the rate of return to the nation's investment in institutions and practices that are so nurturing to new firms, and growth of existing firms, but I'm sure that the return is high.

Note that my title is "Allowing Entrepreneurship" rather than "Encouraging Entrepreneurship." We are extremely fortunate in the United States that people here have an abundance of entrepreneurial spirit. For the most part, the issue we face is that of removing impediments and disincentives. We do a pretty good job with public policies favorable to economic growth. I won't dwell on what we can do better, but improvements are certainly possible.

Before proceeding, I want to emphasize that the views I express here are mine and do not necessarily reflect official positions of the Federal Reserve System. I thank my colleagues at the Federal Reserve Bank of St. Louis, especially Howard J. Wall, Research officer, for their comments, but I retain full responsibility for errors.

ENTREPRENEURIAL AMERICA

Observers comparing the U.S. economy to the economies of other countries often note that Americans seem to be much more willing to become entrepreneurs. Indeed, a recent survey found that more than 70 percent of adult Americans would prefer being an entrepreneur to working for someone else.[1] In contrast, the same survey showed that only 46 and 41 percent of adults in Western Europe and Japan, respectively, preferred being an entrepreneur. One possible explanation for this difference is that, because the United States is an immigrant nation, we have inherited our dynamism from past generations. Many of those who came here had the gumption to migrate half way around the world in search of a better life. Not only were the distances long but also the travel was often dangerous. However, even in Canada—another nation of immigrants—only 58 percent of adults would prefer entrepreneurship over working for someone else.

So, what is it that sets the United States apart? Clearly, there is something intangible at work—which we can call "entrepreneurial spirit"—that is independent of economic policies. In addition, though, the United States has been relatively successful in creating a policy environment that takes advantage of this intangible, yet vital, asset. I will discuss the roles of entrepreneurial spirit and the policy environment in turn. Along the way, I will argue that the two are interwoven and that policymakers should keep in mind that the real key to entrepreneurial success—entrepreneurial spirit—is already in abundance and that we should be careful not to waste it.

ENTREPRENEURIAL SPIRIT

When economists try to explain differences in entrepreneurship across countries or regions,

1 Blanchflower, Oswald, and Stutzer (2001).

they typically examine the roles of a long list of economic and institutional factors. What they tend to find is that, while these factors are important, a large component of the differences in entrepreneurship has nothing to do with them.[2] In other words, even if all countries had the same economic conditions and policies, some would still be more entrepreneurial than others, and the United States would be among the leaders. The best explanation for this finding is that there are social factors at work that are difficult or impossible to quantify. These social factors can be referred to collectively as entrepreneurial spirit.

Policymakers in the European Union, for instance, have been grappling with their perceived gap in entrepreneurial spirit. What they have come to recognize from comparing their countries with the United States is that it is not enough to have appropriate laws and regulations. After all, in many respects, compared with the United States, some European countries have equivalent or superior institutional arrangements for allowing entrepreneurship.

Take, for example, the Scandinavian countries, which, as judged by the World Bank, have among the best institutional arrangements to allow entrepreneurship to thrive. Despite the favorable institutional environment, these same countries have relatively low percentages who say that they would prefer to be an entrepreneur over being an employee of someone else. Recall that in the United States, more than 70 percent of adults say that they would prefer to be entrepreneurs. In contrast, only 30 percent or so of Scandinavians express this preference.[3]

Americans stand out in other ways in their attitudes towards entrepreneurship.[4] For example, a much higher proportion of Europeans than Americans say that the idea of starting a business has *never entered their minds*. Americans also have a greater tolerance for the risk associated with entrepreneurship, whereas many Europeans appear to be extremely averse to risk: Nearly one-half of Europeans who were surveyed said that one should not start a business if there is *any risk at all* that it might fail.

POLICY ENVIRONMENT

Discussion of the role of government in the entrepreneurial process should begin by recognizing the relative abundance of entrepreneurial spirit in the United States. To this end, it is useful to draw a distinction between passive and active policies toward entrepreneurs. Passive policies are those meant to facilitate entrepreneurship by establishing institutions, laws and regulations to reduce the transactions costs of running a business. Active policies, on the other hand, are things such as targeted tax breaks, subsidies and so forth that are meant to direct resources into particular business activities by creating specific incentives.

Given the entrepreneurial energy we have in the United States, active policies are of relatively limited importance. The focus has been, and should continue to be, on ensuring that we have the proper passive policies in place to allow our entrepreneurial spirit to thrive. We should have in place basic institutions to facilitate business transactions, along with minimal interference into how businesses actually operate. In writing our regulations, we should carefully weigh the costs and benefits while keeping in mind that excessive interference can quash or misdirect our greatest advantage.

A particular advantage of the passive approach is that entrepreneurs themselves pick the most promising areas to pursue. In contrast, active policies ordinarily involve efforts of government to pick the winners to subsidize. Experience indicates that governments have a poor track record in identifying promising new technologies. Consequently, subsidies often prove wasteful as they

[2] Georgellis and Wall (2000) and Blanchflower (2000).

[3] Blanchflower, Oswald, and Stutzer (2001).

[4] EOS Gallup Europe (2004).

direct resources in directions that turn out to be unpromising. At the same time, taxes imposed to support the subsidies create disincentives to entrepreneurs in general.

It is not possible to outline the entire array of policies that affect entrepreneurship. Because of the vast scope of these policies, I have chosen a few examples to illustrate the ways in which the United States stands out in balancing public policy requirements with the needs and incentives of entrepreneurs and other businesses.

First, the structures of our fundamental legal institutions tend to differ from those of other countries. Second, our competitive financial system provides entrepreneurs with a ready source of funds. Third, in general we do not overregulate our labor markets, and fourth, we have generally lower tax rates. However, improvements in all these areas are certainly possible, especially with regard to labor market and tax policies. But I'll not take up this subject because my main purpose today is to discuss the issue in general and emphasize the conditions we have created in the United States that are so conducive to economic growth.

Before going into the role that other policymakers play in allowing entrepreneurship, I should point out that the Federal Reserve also plays an important role in promoting growth. Businesses in general—and entrepreneurs in particular—benefit from price stability. When the general price level is unstable, businesses face more uncertainty about the future, making it more difficult for them to plan efficiently. And when people plan inefficiently, unavoidable mistakes are more common, leading to greater variability in business investment and growth. Inflation has been kept in check for more than two decades, and you can rest assured that the Fed remains vigilant on that front.

Opening a Business

Generally speaking, policymakers in the United States have done a good job of creating fundamental institutions. A good illustration of U.S. success is a very basic institutional arrangement: the act of establishing a business as a legal entity. You might be surprised to hear that countries differ a great deal in terms of what an entrepreneur has to do simply to establish a business as a legal entity. This rather basic step may seem trivial, but there are significant advantages to simplifying this step. Once a business is established as a legal entity, it gains access to the legal and financial system, thereby affording it the ability to borrow and to enforce contracts through legal means. If it is too cumbersome or expensive to establish a business, potential entrepreneurs might decide to forgo their ventures altogether or they will enter the informal sector, with only limited access to the legal system and to credit markets.

Generally speaking, the view in the United States is that owning a business is an inherent right and that the operation of the business should be left to the entrepreneur. The simplicity of the process to establish a business reflects this view: In the United States, it typically takes 4 days and \$210 to establish a business as a legal entity.[5] The process amounts to registering the name of the business, applying for tax IDs, and setting up unemployment and workers compensation insurance.

Many other countries seem to view the ownership of a firm as a privilege to be bestowed by bureaucrats. Additionally, some countries impose regulations that take basic business and entrepreneurial decisions out of the hands of entrepreneurs. This approach often leads to government micromanagement of the actual workings of the business, even before the business exists. It is common, for example, that before a company is even allowed to exist as a legal entity, its owner must: (i) meet requirements for the level of capital available to the company, (ii) submit detailed descriptions of corporate rules and organization, (iii) obtain government pre-approval of financial and business plans, and (iv) be a member of a trade association. In the course of satisfying these requirements, the entrepreneur often pays exorbitant fees while waiting weeks or months for vari-

[5] World Bank (2004).

ous forms and applications to make their way through the system.

To establish a business in Japan, for example, a typical entrepreneur spends more than $3,500 and 31 days to follow 11 different procedures. In Belgium, it takes 56 days and more than $2,600. Greece requires that an entrepreneur satisfy 16 different procedures and pay more than $8,000, including $1,200 for something called "Certification by lawyers' welfare fund" and $3,700 to simply notify tax authorities that business activities are about to commence. Remember that all these steps have to be completed just to establish the business as a legal entity.

In many ways, the differences between the United States and other countries with regard to establishing a business reflect more than simple differences in institutional arrangements. They also reveal a great deal about governments' underlying attitudes towards entrepreneurship. Also, given that this procedure is handled primarily at the state level in the United States, the ease of creating a new business provides a good illustration of how our federal system works to our advantage. States must compete with one another to provide suitable business environments, or risk losing out to other states. And as we all know, states do indeed compete vigorously for new businesses.

Competitive Financial System

Establishing a business as a legal entity allows entrepreneurs greater access to credit markets, access that is denied to informal firms in many other countries. But if credit markets are overregulated, even legally established entrepreneurs may have difficulty financing their ventures. Recent research has shown that the wave of banking deregulation that began in the late 1970s has led to increased rates of entrepreneurship in the United States.[6] In the 1970s, commercial banks faced a variety of restrictions that varied from state to state. They often faced restrictions on the interest rates that they could charge to borrowers and pay to depositors. In addition, they could not operate across state lines and could deal only in classic financial intermediation activities—deposit-taking and lending. Today, most of these restrictions have been removed.

Other financial innovations have also led to a variety of new entrepreneurial ventures. One in place many years is the venture capital industry, which hunts for promising new firms to finance and help manage. A more recent innovation, dating to the late 1970s and early 1980s, is the "junk bond." These are simply high-risk/high-yield bonds that allow firms with credit ratings below "investment grade" to have access to investors willing to carry higher levels of risk in exchange for higher rates of return. New firms have been able to raise substantial amounts of capital by issuing junk bonds. Following a handful of scandals in the 1980s, junk bonds have often been disparaged, although, in reality, they fueled a great deal of investment then and continue to do so today.

Labor-Market Regulations

Another area that sets the United States apart is the extent to which the government regulates the relationship between businesses and their employees. There is wide agreement about the necessity of some regulation to protect workers from illegal discrimination or employer fraud. There is less agreement, however, on the extent to which workplace regulations—including minimum wage laws, mandatory severance pay, right-to-work laws and legislated fringe benefits—are necessary. Overregulation of hiring, firing and working conditions can make the labor market too rigid and make businesses reluctant to start up and to hire workers.

One of the reasons that the United States has been able to generate jobs so successfully is that we do not regulate labor markets nearly to the extent that other countries do. Without question, this looser regulation provides entrepreneurs in the United States with much greater flexibility.

6 Black and Strahan (2002).

Among OECD countries, employers in the United States have the most flexibility in terms of both hiring and firing workers.[7] In addition, U.S. firms face by far the least regulation of the conditions of employment. Although hiring a worker is still a costly proposition for a small business in particular, for the most part, in the United States these costs do not derive directly from regulation of the relationship between businesses and their employees.

Examples of labor-market rigidity in Europe are abundant, and one can imagine the effect that they must have on the decisions of existing and potential entrepreneurs. In Belgium, for instance, fixed-term employment contracts are prohibited. In France, the maximum work week is 35 hours and the minimum paid vacation time is five weeks. In Germany, the mandatory Saturday closing time for retailers has only recently been extended from 4 p.m. to 8 p.m., and stores are still prohibited from operating on Sundays. Many other types of labor-market rigidities are common in Europe. Several governments produce a list of allowable grounds for dismissal, others require third-party approval prior to layoffs, and most mandate severance pay of several months of salary.

Tax System

As April 15th gets ever nearer, this might be a sensitive time of year to discuss taxes, but another advantage for entrepreneurs in the United States is that businesses and individuals bear relatively low tax burdens. Among rich countries, only Japan imposes a comparably low tax burden. Taxes, although necessary to finance public services, place a burden on economic activity. High tax rates tend to suppress economic activity of all types, not just entrepreneurship. But for entrepreneurs, high tax rates create an additional incentive that distorts effort. A high tax burden creates an incentive for avoiding taxes, thereby leading some businesses into the informal sector, where their access to credit markets and the legal system is limited.

Again, one of the reasons that the United States has been able to maintain its relatively business-friendly tax policies is its federal system. Many governmental services are provided at the state and local level. For this reason, state and local governments are forced to compete with one another to provide effective services while minimizing the tax burden.

CAUSES FOR CONCERN

I should point out that, although I have been describing ways that the policy environment in the United States is in pretty good shape relative to other countries, we should not rest on our laurels. Even in the policy areas I have been praising, there is still a great deal of room for improvement. Many environmental and other regulations place too much of a burden on the activities of entrepreneurs, without generating correspondingly large benefits to society as a whole; the tax codes for individuals and businesses are, in many ways, needlessly complicated and introduce countless distortions to day-to-day decision-making; and there are rumblings that we should impose new labor-market restrictions to make it more costly for firms to move some of their operations overseas.

In addition, many business people tell me that they are reluctant to hire new workers because rising health care costs make it increasingly expensive to do so. Other businesses, including many doctors, refuse to engage in certain activities because, without major tort reform, they find it too risky or too expensive to pay for the necessary insurance.

When addressing these and other important policy issues, I hope that we are able to keep in mind what I have been trying to convey today. The source of much of U.S. economic dynamism is the entrepreneurial spirit that has been instilled in Americans over generations. We should be careful that we do not needlessly restrict or suppress this spirit. It is a precious resource, not to be wasted or squandered.

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[7] World Bank (2004).

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