

Staying Out of the Way of Entrepreneurs

“Striking the Right Notes on Entrepreneurship”

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I have long had an interest in entrepreneurship. Every school boy and school girl learns of examples of great entrepreneurs such as Henry Ford. As I was growing up in Wilmington, Delaware, local lore emphasized the importance of the duPont family; evidence of the family’s business success over many generations was obvious to everyone who lived in northern Delaware. It is always risky to pick out names, because there are so many who will be left out, but here in Memphis I am sure that those who built FedEx naturally come to mind. Indeed, I think it accurate to say that every community in the United States can point to entrepreneurs who left at least a local mark and many communities can point to their home-grown entrepreneurs who have built firms of national and international importance. It is also noteworthy that great entrepreneurs have enriched the country not only by the businesses they have built but also by their contributions to universities, museums, libraries and many other cultural resources. That is certainly the case in Delaware, where many public schools bear the names of duPont family members who provided large gifts to establish and expand the schools.

As suggested by the title of my talk, my inclination is that the best way to encourage entrepreneurship is for the government to stay out of the way of entrepreneurs. After all, as the Kauffman Foundation says, entrepreneurship is:

...associated with individuals who create or seize business opportunities and pursue them

without regard for resources under their control...Words that describe entrepreneurship include innovative, creative, dynamic, risk-tolerant, flexible, and growth-oriented.¹

Some will say that keeping government out of the way of entrepreneurs is a simple-minded approach, and it certainly is true that we can find examples of successful entrepreneurs within government. Nevertheless, words such as “innovative,” “creative,” “dynamic,” “risk-tolerant,” “flexible,” and “growth-oriented” are not used very often to describe government employees. And it is certainly true that countries that have relied on government enterprise rather than private enterprise have a poor record of achievement.

What is an entrepreneur? Entrepreneurs organize, manage, and assume the risks of a business or enterprise. They are willing to take on greater risks than other individuals and depend primarily on their individual initiative to achieve success. When an entrepreneur goes to work in the morning, his or her assets and economic future are on the line.

What kinds of government policies can help such a person to be successful? My basic theme is that government should concentrate on providing the fundamental legal and security infrastructure necessary for a democratic society to function, and should avoid detailed regulation of business practices and market structures. As much as possible, we should rely on competitive

¹ Kayne, Jay. *State Entrepreneurship Policies and Programs*. Kauffman Center for Entrepreneurial Leadership at the Ewing Marion Kauffman Foundation, Kansas City, Missouri, 1999.

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forces rather than government forces to constrain private power.

That's not to say that governments should do nothing about entrepreneurship, but their role should be limited to creating a policy environment that allows entrepreneurs to make their own decisions with the absolute minimum involvement of government regulators. The Federal Reserve, for example, plays an important role in promoting entrepreneurship and general business growth. Businesses in general—and entrepreneurs in particular—benefit from price stability, a strong banking system and an efficient payments system. All three of these are central Federal Reserve responsibilities.

Similarly, government has other functions of critical importance to a market economy, such as maintaining an efficient and honest legal system, security of person and property, and a regulatory system that deals effectively with conditions of modern life such as environmental hazards. I obviously cannot treat all the complexities of this subject here, but simply want to emphasize my general view that regulation should be kept at a minimum and entrepreneurs nourished rather than shackled.

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 for their comments, especially Thomas A. Garrett, senior economist, and Howard J. Wall, assistant vice president, who provided special assistance. I retain full responsibility for errors.

ENTREPRENEURIAL SPIRIT SETS THE UNITED STATES APART

Before discussing the relative merits of the various policies to encourage entrepreneurship,

let's consider the reasons that the level of entrepreneurship differs across areas. Although the largest differences in entrepreneurship exist between countries, the lessons that these differences provide can be useful for understanding differences between regions and states within the United States. 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.² In contrast, the same survey showed that fewer than half of the adults in Western Europe and Japan would prefer being an entrepreneur.

So, what is it that sets the United States apart? When economists try to explain differences in entrepreneurship across countries or regions, they typically examine 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 economics or institutions.³ Clearly, there is something intangible at work—which we can call “entrepreneurial spirit”—a set of attitudes independent of economic policies. 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. The United States has been relatively successful in creating a policy environment that takes advantage of these intangible, yet vital, assets.

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.

² Blanchflower, David; Oswald, Andrew and Stutzer, Alois. “Latent Entrepreneurship Across Nations.” *European Economic Review*, 2001, 45(4-6), pp. 680-91.

³ Georgellis, Yannis and Wall, Howard J. “Entrepreneurship and the Policy Environment.” Federal Reserve Bank of St. Louis Working Paper No. 2002-019B, 2004.

After all, in many respects, compared with the United States, some European countries have equivalent or superior institutional arrangements for allowing entrepreneurship.

Americans stand out in other ways regarding their attitudes toward entrepreneurship.⁴ For example, many more 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.

PASSIVE VS. ACTIVE POLICIES

Discussion of the role of government in the entrepreneurial process should recognize the relative abundance of entrepreneurial spirit in the United States. To this end, we can draw a distinction between passive and active policies directed 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. Passive policies create an entrepreneur-friendly environment without concern for the type and form of entrepreneurial activity. 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. These policies require direct intervention by state and local governments into the entrepreneurial process.

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. Entrepreneurship cannot be planned or managed centrally. Rather,

we should have in place basic institutions to facilitate business transactions, along with minimal interference in the actual operation of businesses. In writing our regulations, we should carefully weigh the costs and benefits while keeping in mind that excessive interference can squash or misdirect our greatest advantage.

A particular advantage of passive policies is that entrepreneurs themselves pick the most promising areas of innovation to pursue. In contrast, active policies involve the efforts of government officials to select specific businesses or individuals eligible for tax breaks or other financial incentives. Special interests, of course, try to influence government decisions either by seeking subsidies and tax breaks or by seeking to disadvantage competitors. Experience indicates that governments have a poor track record in identifying promising new technologies. Consequently, subsidies often prove wasteful, as they direct resources toward ultimately unproductive ventures. At the same time, taxes imposed to support the subsidies create disincentives to entrepreneurs in general.

PASSIVE TAX POLICIES

Taxes are one of the biggest expenses a business incurs. Certainly some minimal level of taxation is required to have a functioning government. While few people would disagree with this statement, disagreement does arise over what constitutes “minimal.” One fact is clear—a tax raises the cost of an activity, thereby discouraging it.

Entrepreneurship is an activity that requires investment, consumption and income generation to be successful. Economics tell us that a sales tax reduces personal consumption; personal income taxes reduce the incentive to work; corporate income taxes reduce the incentive to start or expand a business; and capital gains taxes reduce the incentive to invest. Policymakers concerned with entrepreneurship should understand that a tradeoff exists between entrepreneur-

⁴ EOS Gallup Europe. *Flash Eurobarometer 146. Entrepreneurship*. European Commission, Brussels, 2004.

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ial growth and taxes. The benefits of additional government programs funded through taxation must be weighed against the costs of reduced economic growth and entrepreneurial activities.

That's not to say that the correct policy is to provide lower taxes to particular businesses to encourage their ventures. Tax breaks targeted to a particular type of business necessarily require a higher tax burden on other businesses and/or on households. We lack clear standards and evidence that permit a government agency to accurately judge the relative merits of thousands of existing and potential businesses. Thus, inevitably, political clout weighs quite heavily in government decisions providing subsidies and tax breaks. A passive tax policy would be neutral in terms of the type and location of business activities that may occur. Not only would this neutrality limit the role of political clout, but it would leave government officials out of the process of deciding which businesses are more worthy than others and allow all businesses to operate in a lower-cost environment.

ACTIVE ECONOMIC DEVELOPMENT POLICIES

The National Governors Association (NGA) has produced a best-practices guide for strengthening states' entrepreneurship policies.⁵ This guide provides a number of sound suggestions to streamline the operations of government and to limit the scope of some regulations. The guide also recognizes the important role of entrepreneurial spirit and suggests ways to foster it through the public education system. However, unfortunately, along with these sound suggestions are other suggestions that would inject state governments directly into the decision-making process of entrepreneurs.

One such unattractive active policy is the integration of entrepreneurship into state economic development efforts. Through various

government centers and agencies, states act as brokers for entrepreneurial services such as marketing, business strategies, and technology. States also manage capital and entrepreneurial networks. The idea here is that states can direct entrepreneurs to capital sources, investors and other entrepreneurs. The problem with these policies is that the direction of entrepreneurship is, at least in part, in the hands of state agencies. Are government officials really qualified to determine the resources that potential entrepreneurs need? Providing entrepreneurs with information on where to obtain resources is one thing, but active participation by state government in the management of entrepreneurial services is likely to limit and misdirect entrepreneurial activity. In addition, state economic development agencies and associated programs require funding, which comes from tax revenue. Such state programs reduce the pool of private funds, which can stifle entrepreneurship. Is it really true that the private sector fails to provide information and other services required by entrepreneurs?

The NGA report also suggests that states should invest in diverse sources of risk capital. Specifically, the report suggests that states should award certain investors with tax breaks and other financial incentives, and also ensure that adequate capital is available in underserved areas. However, through targeted tax breaks and financial incentives state officials are managing and, to some degree, controlling entrepreneurship. Yet, if tax breaks and financial incentives are seen by states as a means of fostering entrepreneurship, then the more appropriate policy is to lessen the overall tax burden faced by all potential and existing entrepreneurs. This approach would create a more positive environment for entrepreneurs by removing state management and oversight from the process.

The NGA also recommends that the costs of complying with regulations should be lowered to foster entrepreneurship. While reducing compliance costs certainly cannot be harmful to

⁵ Psilos, Phil; Harpel, Ellen and Crawford, Steve. *A Governor's Guide to Strengthening State Entrepreneurship Policy*. NGA Center for Best Practices, 2004.

entrepreneurs, the NGA fails to recognize that it is not only compliance cost that hurts entrepreneurs but also the regulations themselves that can place unnecessary burdens on entrepreneurs. The question that should really be asked is whether a given regulation is necessary in the first place. Many regulations can be eliminated without detrimental effects on society, while at the same time unshackling entrepreneurs and setting the entrepreneurial spirit free.

While the NGA offers some positive policies to foster entrepreneurship, several other NGA policies I just discussed place state governments in control of fostering entrepreneurship. History has proven time and time again that, if left unfettered, the free market will provide entrepreneurs ample resources and ample opportunities to be successful.

CONCLUSION

Government involvement in entrepreneurship can be both active and passive, and although much of the policy discussion involves active policies it is the passive policy environment that is more important for supporting entrepreneurship. It is unfortunate that active policies receive so much attention, even while states are sometimes neglecting their most basic responsibilities such as maintaining a court system that resolves disputes quickly.

A passive policy environment that is friendly to entrepreneurs, and to all businesses, is one that balances the use of regulations and taxes against the burdens that they impose. More broadly, an entrepreneur-friendly government is one that respects private property rights and provides a well-functioning legal system that recognizes and protects these rights. A good rule might be to never impose a new regulation or establish a new agency without disbanding an old one. With such a policy environment, governments would be allowing entrepreneurship to flourish by staying out of the way of entrepreneurs.