Entrepreneurship in the 21st Century

Conference Proceedings
March 26, 2004

U.S. Small Business Administration
Office of Advocacy *and*

The Ewing Marion Kauffman Foundation

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Foreword

Just as it is valuable to reflect on the accomplishments and struggles of the past, it is important to look to the future so that appropriate strategies and resources can be anticipated. In spring 2004, the Office of Advocacy of the U.S. Small Business Administration and the Ewing Marion Kauffman Foundation, two organizations devoted to advancing small business and entrepreneurship, organized the forward-looking conference, "Entrepreneurship in the 21st Century."

Over the recent past, Americans have seen many changes that have altered the economic and political environment, both nationally and globally. But one thing has not changed: the importance of entrepreneurs. Founders of new businesses play a vital role in creating employment and real output, and their innovations produce new ventures and jobs. So it is no surprise that many policymakers have looked to the small business community to "seed" the economic recovery.

The conference proceedings that follow illustrate some of the challenges that small firms and policymakers will face in the coming years: finding new opportunities for economic development through technology and innovation, integrating more women and minorities into the economic mainstream by encouraging them to become entrepreneurs, and accommodating the ways in which bank consolidations and new financing technologies have changed financing markets. As changes occur, quality research and data will drive smart public policy.

We want to thank the top-notch panelists from around the country who contributed their time and efforts to the success of this conference. The outstanding caliber of the presenters has been a hallmark of this event from the beginning. When the conference was announced, there was overwhelming demand to attend, and we immediately began to seek alternatives for those who would not be able to participate directly. These proceedings and videos of the presentations are designed to address that need.

The following compilation summarizes the discussions of the "Entrepreneurship in the 21st Century" conference and reflects the contributions of the economists within the Office of Advocacy. It is also the product of invaluable editorial assistance of the editor, Kathryn Tobias. The video of the conference was made possible by Ron Johnson from the U.S. Small Business Administration.

Thomas M. Sullivan
Chief Counsel for Advocacy
U.S. Small Business Administration

Robert Litan
Vice President for Research and Public Policy
The Ewing Marion Kauffman Foundation

Chad Moutray
Chief Economist
Office of Advocacy
U.S. Small Business Administration

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Overview and Discussion

Four years into the new millennium, Americans face a global economy that seems very different in many ways from the economy of a few years ago. Technology and innovation are transforming our daily lives and forcing structural changes to achieve higher productivity. From an economic perspective, that will be good for the U.S. economy in the long term. But long-run economic efficiency is not always pleasant in the short term. For example, the impact on employment of a brief recession in 2001, followed by growth in real output, is still unclear. Policymakers, therefore, are evaluating the sources of new job creation, and small businesses are expected to play a crucial role in supplying needed economic growth.

With this dynamic economic climate as the backdrop, the Office of Advocacy of the U.S. Small Business Administration and the Ewing Marion Kauffman Foundation co-sponsored a forward-looking conference, "Entrepreneurship in the 21st Century," on March 26, 2004.[1] Prominent academics and policymakers gathered to discuss future trends of importance to small firms.

Several themes emerged from the conference. First, new innovative entrants play a critical role in maintaining our competitive economic balance and provide the tools for economic development in local communities. Second, while much progress has been made by women and minorities, more can be done to promote entrepreneurship among them. Third, many forces, including technology, regulation, and consolidation, will change the environment for small business lending. Fourth, small businesses face a number of burdens that are ripe for new policy solutions. Finally, policymakers will need access to quality data and research on small business to better inform their decisions in the future.

1 Refer to co-sponsorship agreement #04-3111-07. The support given by the U.S. Small Business Administration and the Kauffman Foundation to this activity does not constitute an expressed or implied endorsement of any cosponsor's or participant's opinions, products, or services. All SBA programs or cosponsored programs are extended to the public on a nondiscriminatory basis.

What follows is an overview and general discussion based on this conference. The next chapter will contain summaries of the panel discussions and other speeches. The appendices will contain speaker biographies and the PowerPoint slides used at the conference.

The Importance of Small Business and Innovation

Small businesses will play a major role in shaping the 21st century's economic landscape. They account for half of the U.S. nonfarm private gross domestic product[2] and employ half of the U.S. private work force.[3] More importantly, over the past decade, small firms have provided 60 to 80 percent of the net new jobs in the economy,[4] and according to a U.S. Bureau of the Census working paper, almost all of these net new jobs stem from start-ups in the first two years of operation.[5]

Much of the new employment in the economy will come from innovation, and new patents will spur new entrepreneurial endeavors. Among the findings of recent Office of Advocacy research on innovation and entrepreneurship are the following: (1) small patenting firms are more likely to generate "scientifically important" innovations and have produced 13 to 14 times

2 Joel Popkin and Company, "Small Business Share of Economic Growth," U.S. Small Business Administration, Office of Advocacy, Research Summary 211, January 2002.

3 Based on firm size statistics provided to the Office of Advocacy from the U.S. Department of Commerce, Bureau of the Census, Statistics of U.S. Businesses (SUSB) database. The most recent data available are for 2001. See http://www.sba.gov/advo/stats/us_tot.pdf.

4 The change in employment is based on SUSB data, and accounts for births, deaths, expansions, and contractions of firms. The statement, "60 to 80 percent of net new jobs," is based on comparing the change in employment for firms with fewer than 500 employees to the total employment change. See http://www.sba.gov/advo/stats/dyn_b_d8901.pdf.

5 Zoltan J. Acs and Catherine Armington, "Endogenous Growth and Entrepreneurial Activity in Cities," U.S. Department of Commerce, Bureau of the Census, Center for Economic Studies, working paper, January 2003.

more patents per employee,[6] and (2) universities that devote more dollars to research and development (R&D) tend to see a greater number of firm formations in the areas that surround them.[7] Such knowledge spillovers are consistent with recent literature on growth theory.

In their remarks at the conference, both Zoltan Acs and David Audretsch compared the production functions of Robert Solow and Paul Romer. Solow's model mirrors the predominant view of the 1950s and 1960s; firm size mattered, and large firms with economies of scale were more efficient and competitive in the global marketplace. Romer, however, stressed the importance of acquiring knowledge. Today, economies of scale are still important in a number of well-established industries, but in Romer's more contemporary view, growth comes from newer, more innovative firms.[8]

Innovation as an engine for job growth has its roots in the churning of new entrants and closing businesses, or Schumpeter's "creative destruction." John Haltiwanger noted that the entry and exit of firms play a large role in increasing overall productivity. New entrants must innovate in order to compete with their older, existing counterparts in the marketplace. The closing firms are often less productive as a result, and are at a competitive disadvantage. As an example, he noted that new entrants in the manufacturing sector account for roughly 30 percent of the productivity growth in the industry.

Paul Almeida, who has studied this issue for the past decade, has observed that much of the small firm innovation emphasizes technological space, and much of the start-up activity has centered on new and emerging technologies. He and Maryann Feldman focused much of their discussion on the

Paul Almeida focuses on innovation issues.

clustering of knowledge locally. Referring to the famous quote by former Speaker of the House Thomas P. O'Neill, Dr. Feldman said that "all economic growth is local." Industry clusters allow for knowledge to be highly concentrated in a specific technology (e.g., semiconductors) or region (e.g., Silicon Valley). One of the key advantages of "clustering" is the ability to utilize informal social networks with other peer industries and academia. Such ties also breed "serial entrepreneurs," who will reinvest their profits in new enterprises that are also connected to the local area.

Geographic regions are not self-sufficient entities, however. There are limits to what governments can induce in terms of successful clusters, particularly if the motivation to create a cluster did not coalesce around a shared vision for all of the parties. Moreover, entrepreneurs might need to look beyond the local resources found in informal networks, colleges and universities, and elsewhere. Thus, businesses must build bridges across regions to fill key knowledge gaps in the process.

6 CHI Research, Inc., "Small Serial Innovators: The Small Firm Contribution to Technical Change," U.S. Small Business Administration, Office of Advocacy, Research Summary 225, February 2003.

7 BJK Associates, "The Influences of R&D Expenditures on New Firm Formation and Economic Growth," U.S. Small Business Administration, Office of Advocacy, Research Summary 222, October 2002.

8 For more information, see Robert M. Solow, "Technical Change and the Aggregate Production Function," Review of Economics and Statistics, 39(3), 1957: 312–320; Zoltan J. Acs and David B. Audretsch, "Innovation, Market Structure, and Firm Size," *Review of Economics and Statistics*, 69(4), 1987: 567–574; and Paul M. Romer "Endogenous Technical Change," *Journal of Political Economy*, 98(5), 1990, S71–S102.

Formal networking structures are one method of building such bridges. Melissa Schilling cited the increasing importance of technology and research alliances. She said that the number of such alliances has doubled worldwide since 1980, and in 2000 alone, at least 574 new alliances were formed in advanced materials, aerospace, automotive, biotechnology, chemicals, and information technology. Dr. Schilling argued that these formal networks allow for more shared information and other resources. Moreover, firms in well established networks tend to be more innovative; although the overall structure, governance, and size can influence the level of innovation within the network. While large firms tend to serve as "hubs" in the network, small firms can clearly benefit by membership.

Demographics Hurdles and Entrepreneurship

Women and minority entrepreneurs have become more prevalent in the marketplace, with both experiencing tremendous growth in recent decades. For example, Advocacy studies show that the number of minority-owned businesses doubled from 7 percent of the total number of businesses in 1982 to almost 15 percent in 1997, while women's self-employment increased from 1.76 million in 1976 to 3.75 million in 2000.

Despite these gains, though, Robert Fairlie presented data that suggested some longstanding structural hurdles still exist in terms of business ownership. According to the 2000 Census, non-Latino Whites and Asians tend to have the highest ownership rates, self-employment earnings, average sales and receipts, and number of employees. African Americans, Native Americans, and Latinos lag behind in these categories. More troubling is the fact that self-employment rates by ethnicity have not changed significantly since 1979, according to the Current Population Survey. Non-Latino Whites and Asians maintain self-employment rates between 10 and 11 percent, Hispanics, around 6 percent; and African Americans; around 4 percent. On the bright side, African Americans and Native Americans experienced tremendous self-employment earnings growth rates between 1980 and 2000—equal to or greater than those of non-Latino Whites.[9]

The Diana Project documents the importance of women entrepreneurs and, in particular, focuses on their financial needs. While this ongoing analysis continues to show the strides made by women, Patricia Greene, one of the Diana Project researchers, identified hurdles that women still must face when it comes to accessing venture capital. The venture capital industry, for instance, is dominated by men. This has implications since personal connections are so important. Without such networking opportunities, there could be fewer funding opportunities for women. With that said, women in positions of authority at venture capital firms invest in firms based on their expected performance.[10]

While these hurdles are gender-specific, many might also be relevant for minority entrepreneurs. In discussing the challenges of ethnic and immigrant business owners, Marta Tienda noted the importance of informal networks. Social support can play a crucial role for many minorities in providing mentors, financing, and knowledge. Policymakers who are aware of such informal networks will be able to better assist communities with large minority populations to design effective interventions for more economic development.

An Evolving Small Business Financial Environment

According to Allen Berger and Gregory Udell, three key trends will emerge in small business financial markets. First, technology is changing the lending practices of many banks. Small businesses are increasingly receiving loans from lenders through credit scoring rather than through the traditional lending practice of building a relationship with a banker. While there has been concern over whether credit scoring would leave "unbankable" businesses out in the cold, reliance on statistical models and more standardization should serve to increase the number

9 See Robert W. Fairlie, "Recent Trends in Ethnic and Racial Employment," *Small Business Economics*, print version forthcoming, also at http://econ.ucsc.edu/~fairlie/papers/recent13.pdf.

10 Candida Brush, et al., "Gatekeepers of Venture Growth: A Diana Project Report on the Role and Participation of Women in the Venture Capital Industry," Kauffman Foundation, March 2004. This report is also available at: http://www.kauffman.org/pdf/Diana_2004.pdf.

of small business loans that are securitized in a still-developing secondary market. As more information is available to creditors, the overall credit market should expand.[11]

A second key trend involves new regulation of capital requirements. The Bank for International Settlements, an international organization consolidating monetary policies among many industrial nations, is active in developing the New Basel Capital Accord (also known as "Basel II"), which would revise the current international capital requirements and should be in effect by the end of 2006.[12] U.S. implementation of the new accord would require the largest U.S. banking organizations[13] to use an internal ratings-based approach to assign risk to its loan portfolio. Other banking organizations could also opt in. Banks that adopt this approach would face capital requirements in the small firm credit market that would reflect the degree of perceived default risk. This could lower the marginal costs for small business lending and could spur more competition in this market. Moreover, since standardization of lending would be essential, more securitization of small business loans could be an indirect outcome.[14]

The third trend will be continued consolidation in the banking industry. In 1980, there were 14,434 banks; 33.4 percent of bank assets were in community banks. By 2001, the number of banks halved, to 7,631; 16.0 percent of assets were in community banks. Small business lending has traditionally been more the domain of smaller banks; thus, more consolidation has raised questions about the impact on small firm financing. The Office of Advocacy has conducted research showing that lending to small businesses can help diversify a large bank's portfolio;[15] yet, in the 1998 Survey of Small Business Finances, small firms were less likely to borrow from banks in regions where banks were highly concentrated.[16] Since the 1998 survey, though, large banks have aggressively pursued small business lending, and recent research suggests that consolidation may not be as detrimental to small businesses as some feared.[17] Community banks specializing in small business lending and non-bank sources have emerged as alternatives to large banks.

Entrepreneurs Face Many Obstacles

Policymakers will continue to wrestle with a number of issues confronting small business. Chief among them, according to some presenters, is health insurance, a priority also identified in the National Federation of Independent Business's monthly survey. Advocacy research shows that administrative costs for small health plans are significantly higher than for large businesses, putting entrepreneurs at a disadvantage for providing health coverage to their employees.[18] Further, insurance premiums have continued to increase significantly over the past few years.[19]

11 For more information on the effects of credit scoring and the securitization of small business loans, see W. Scott Frame, Aruna Srinivasan, and Lynn Woosley. "The Effect of Credit Scoring on Small Business Lending," *Journal of Money, Credit, and Banking*. 33(3), 2001: 813–825; A.N. Berger, S.D. Bonime, L.G. Goldberg, and L.J. White. "Credit Scoring and the Availability, Price, and Risk of Small Business Credit," *Journal of Money, Credit, and Banking*, forthcoming; and Kormendi/Gardner Partners, "An Exploration of a Secondary Market for Small Business Loans," U.S. Small Business Administration, Office of Advocacy, Research Summary 227, April 2003.

12 For more information, see: http://www.federalreserve.gov/generalinfo/basel2/default.htm.

13 The largest U.S. banking institutions are defined for these purposes as those having total assets of at least $250 billion or at least $10 billion in on-balance-sheet foreign exposures.

14 Allen N. Berger, "Potential Competitive Effects of Basel II on Banks in SME Credit Markets in the United States," Board of Governors of the Federal Reserve System, working paper, February 2004, also available at: http://www.federalreserve.gov/generalinfo/basel2/docs2004/basel2sme508.pdf.

15 James W. Kolari, "Assessing the Profitability and Riskiness of Small Business Lenders in the Banking Industry." U.S. Small Business Administration, Office of Advocacy, Research Summary 229, May 2003.

16 Steven G. Craig and Pauline Hardee. "The Impact of Bank Consolidation on Small Business Credit Availability." U.S. Small Business Administration, Office of Advocacy. Research Summary #234, February 2004.

17 A.N. Berger, S.D. Bonime, L.G. Goldberg, and L.J. White, "The Dynamics of Market Entry: The Effects of Mergers and Acquisitions on Entry in the Banking Industry," *Journal of Business*, 77, 2004; and D.A. Carter, J.E. McNulty, and J.A. Verbrugge, "Do Small Banks Have an Advantage in Lending? An Examination of Business Loans at Large and Small Banks," *Journal of Financial Services Research*, 25, 2004.

18 Rose C. Chu and Gordon R. Trapnell, "Study of the Administrative Costs and Actuarial Values of Small Health Plans," U.S. Small Business Administration, Office of Advocacy, Research Summary 224, January 2003.

19 According to the Kaiser Family Foundation, employer-sponsored health insurance premiums increased 13.9 percent between spring 2002 and spring 2003, the third consecutive year of double-digit increases. For more information on the Employer Health Benefits 2003 Annual Survey, see: http://www.kff.org/insurance/ehbs2003-1-1.cfm.

Regulations can also impose undue burdens on new and existing businesses. In fact, Advocacy research shows that small businesses pay 60 percent more than their larger counterparts to comply with federal regulations, including twice as much on federal tax regulations.[20] The Office of Management and Budget's Office of Information and Regulatory Affairs (OIRA) Administrator John D. Graham addressed this issue in his remarks, and he said that OIRA and the Office of Advocacy are working to reduce the burdens on small businesses in the rulemaking process. A large volume of existing regulations also continues to impose costs on all businesses, small and large. These regulations need to be reviewed and those that are no longer relevant, eliminated.

In addition to health insurance costs and regulatory burden, the participants at the conference listed a variety of other issues that affect entrepreneurs, including the tax burden, the cost of litigation, and global competition. Policymakers are currently debating these issues, and their decisions will have large future impacts. In his keynote speech, Treasury Secretary John W. Snow noted the strong entrepreneurial spirit in the United States. He and Stephen Friedman both argued that public policy should remove the burdens that stand in the way of free enterprise, and government should continue to foster an environment where small business owners can thrive and compete in a global economy.

Informed Public Policy Starts with Quality Data and Research

One challenge faced by small business researchers is the lack of current data. Time lags characterize information from a number of government sources, making evaluation of the "state of small business" more difficult for those who seek timely updates. Limited access to longitudinal databases also frustrates many academics. Privacy concerns have restricted access to microdata and significantly limit the amount of research that can be pursued.[21]

20 W. Mark Crain and Thomas D. Hopkins, "The Impact of Regulatory Costs on Small Firms," U.S. Small Business Administration, Office of Advocacy, Research Summary 207, October 2001.

21 Participants at each of the Office of Advocacy economic research focus groups conducted between May 2003 and April 2004 stressed the importance of access to data for research. While they understood the privacy concerns that limit such access, several academics suggested access to "cleansed" data to encourage more research on small business and entrepreneurship issues.

The Ewing Marion Kauffman Foundation is underwriting a two-year research project with the Committee on National Statistics to review and assess federal business statistics. Ten to 12 expert panelists will evaluate statistics for accuracy, currency, coverage, and reliability, and after a thorough analysis, recommendations will be made for improving the current system. It is hoped that this panel study will lay the groundwork for enhancing existing data sources, encouraging more federal data to be available by firm size, and improving access for researchers.

Robert Litan discussed the development of the Kauffman Survey of New Firms. This new longitudinal database, which should be available sometime in 2005, will contain a national sample of new firms that began in 2003 (and perhaps as early as 2001). This publicly accessible information will contain pertinent demographic and financial characteristics of the founders of the business, and there will be sufficient over-sampling to assure that the sample can accurately reflect women and minority business owners.

According to both Congressional Budget Office Director Douglas Holtz-Eakin and Chief Counsel for Advocacy Thomas Sullivan, a primary reason to encourage more data and research on small business issues is for access by policymakers. Smart policies start with sound data and methodologies, and OIRA has stressed the importance of quality information and research for shaping new regulations. Having federal agencies ensure the quality of the studies that influence their regulations, through peer review and other methods, is essential to developing rules based on good science. Data and methodologies should be transparent, allowing external constituencies to replicate and/or challenge the results for such influential studies.

Conclusion

Entrepreneurs will drive economic growth in the 21st century. Given the contributions of small businesses to the U.S. economy, it is important that policymakers recognize and support them. Sound data and methodology are needed to accurately understand and model our dynamic economic marketplace.

Researchers will continue to document the role of innovation in engendering new enterprise and growth. The acquisition of knowledge is crucial for local economic development, firm formation, and job creation; business networks, both formal and informal, will facilitate greater knowledge transfer and increased efficiency.

Technology will shape small business lending in the years to come. Credit scoring and other modes of evaluation will further standardize the loan process, and more credit will be securitized in the future. Moreover, with increased consolidation in the banking industry, two things should start to occur. First, more large banks will target the small business market, and second, new community banks and non-bank alternatives that specialize in small firm lending should emerge.

In a global marketplace, Treasury Secretary John Snow notes, America must promote the spirit of enterprise. That means both promoting new start-ups and strengthening existing businesses. While more women and minorities are actively engaged in self-employment, more could be done to reduce the hurdles they often encounter. Initiatives to enhance their ability to finance their new ventures might include widening the social networks around them for additional support. Government has a role. It can work to reduce unnecessary burdens and address small business concerns, such as health care insurance, litigation, and the regulatory burden.

Audience members posed tough questions during Q&A

To view videos of the conference presentations, visit
http://www.sba.gov/advo/video/advo_video.html