

Entrepreneurs

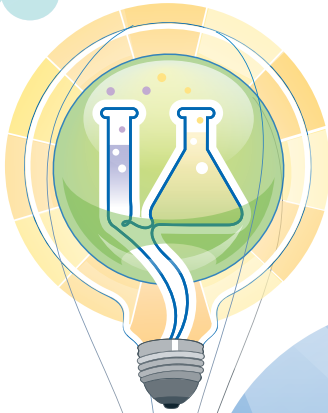


Everyday Economics



Once
Upon a
Time...

in a land far, far
away lived an
entrepreneur who
had an idea...



Entrepreneurs

If you were asked to name an entrepreneur, who would come to mind? Would it be a tech wizard who founded a software company that revolutionized the way friends communicate? Or would it be one of the 19th or 20th century industrialists who built a business that still plays a major role in the American economy? Maybe you would think of a person who produces handcrafted items in a developing country to export to developed nations? Or is the first person who comes to mind the owner of the boutique, the repair shop or the restaurant in your neighborhood?



What Is an Entrepreneur?

An entrepreneur is a person who brings together productive resources to produce a good or service and then assumes the risk of taking that product or service to the marketplace. The entrepreneur has an idea and takes the initiative to act upon it. A healthy economy has many entrepreneurs who are opening new ventures, but not all entrepreneurial work is the same.

Some entrepreneurs create entirely new ventures to sell products or services that are new to the consumer, or they revolutionize a process or system that transforms the way a business operates. These entrepreneurs are innovators, and the companies they build can create jobs, increase income and offer new investment opportunities, all of which increase standards of living by keeping an economy growing.

Fred Smith is a good example of an innovative entrepreneur. In 1965, as a student at Yale University, he wrote a paper that described the need for an airfreight company that would deliver packages with a guaranteed arrival time. He realized that businesses could change the way they operated if shipments arrived at the door when they were needed. In 1971, he established Federal Express, and two years later he began operations with only 14 planes. Within 10 years, the Tennessee-based company had reached

\$1 billion in revenue. By 2011, the company offered express shipping in 220 countries and territories. In a 24-hour period, the fleet routinely traveled nearly 500,000 miles while its couriers logged 2.5 million miles a day – the equivalent of 100 trips around the earth.

Larry Page and Sergey Brin are also innovative entrepreneurs. They met at Stanford University in 1995. While they were in graduate school, they developed an Internet search engine that would allow users to search the rapidly expanding number of webpages that were being created and posted to the World Wide Web. Page and Brin coined the name Google, after the mathematical term for a 1 followed by 100 zeros. In 1998, the pair received a \$100,000 check from an early investor, incorporated the company and began to grow the business around the search engine. In that year, Google indexed 26 million webpages, and just two years later, the number had grown to 1 billion. Since then, the number of unique pages on the web has grown exponentially, and the Google index catalogs billions and billions of pages. In 2010, the company had revenue of \$29.3 billion, and the founders were worth more than \$17.5 billion each.

In February 2004, less than a decade after Page and Brin began their search engine venture, Mark

Zuckerberg and three fellow undergraduate friends at Harvard University started a new website based on the student photo directories of some private schools. Facebook was originally open only to a select group of students. Within nine months, this changed and the website had more than 1 million users. Within six years, Facebook had more than 500 million active users, with a majority outside the U.S. While the company is privately held and does not release financial statements, some business analysts estimated that 2010 revenue was between \$1.1 billion and \$2 billion. Zuckerberg serves as chief executive officer, dreaming of new ways for Facebook to enhance the connections between the people of the world. The network that Facebook has created has transformed the way many people and companies interact with the Internet.

Fred Smith, Larry Page, Sergey Brin and Mark Zuckerberg are excellent examples of innovative entrepreneurs. As a result of the companies they built, incomes rose, new investment opportunities were offered and a multitude of jobs were created — computer programmers, airplane pilots and mechanics, office staff, graphic designers, accountants and corporate lawyers, to name a few. But not all entrepreneurs are innovative or create something totally new. Some entrepreneurs provide familiar goods and services and start businesses similar to those already in existence. These replicative entrepreneurs recognize an opportunity in the market

and use a common idea — like a bakery, a bookstore or a barbershop — as they open the doors to potential customers in their community. The economic effects of these individual ventures might not be felt outside the immediate neighborhood, but together these small businesses are vital to the economic health of the country. In developing countries, in particular, starting a successful business has been a means of raising one's living standard.

Entrepreneurship as a Resource

When any good or service is produced, resources are necessary. All of the world's productive resources can be grouped into four broad categories: land, capital, labor and entrepreneurship. Land represents more than just the lot where a business is built. It includes a wide range of natural resources — the fertile soil, various minerals, fossil fuels, food crops and water, just to name a few. Capital is made up of manufactured resources such as the buildings, equipment, hardware and tools needed for production. Labor is also called a human resource because it includes all the people involved in the production process — for example, the farmers, accountants, cab drivers, barbers, assembly-line workers, computer programmers, etc., who provide skills and expertise to build products or offer services in exchange for wages and salaries. The fourth type of productive resource is entrepreneurship. An entrepreneur is the person who assumes the risk of acquiring the other resources necessary to begin production of a good or service.

(Continued on page 4)



Julie Clark was an English and art teacher who wanted to expose babies and parents to classical music, art and nature. She founded the Baby Einstein Co. in 1996 and produced the first two videos (*Baby Einstein* and *Baby Mozart*) in her home. She used borrowed video equipment and edited the videos on her home computer. Clark and her products were featured on many television shows and in a variety of publications. In five years, the fledgling company produced 30 children's books, 10 videos and six music albums before the Walt Disney Co. bought the enterprise from the founders.

Microcredit: Supporting Aspiring Entrepreneurs



For some aspiring entrepreneurs, access to credit can be an enormous obstacle to starting a business. An important means of gaining this access is microcredit. Microcredit—also called microfinance—is a small loan granted to a borrower not served by a traditional financial institution. The loans are frequently too small to be considered by commercial banks. Other times, the borrowers lack the credit history or the collateral to qualify for traditional financing. Around the world, microcredit institutions seek to provide financial services in areas where these services would not otherwise be available. Two well-known examples are Acción and Grameen Bank.



Acción

In 1961, Acción began as a charitable organization that sought to support economic development among poor residents of Venezuela. In 1973, volunteers in Brazil saw that many informal business owners could not access the credit that would allow the business to grow. Acción began to make small loans to these “microenterprises.” This lending program spread to other countries across Latin America and eventually came to the United States. More recently, the organization has expanded to Africa and Asia.



Grameen Bank

In 1976, economist Muhammad Yunus began to develop a microcredit program in Bangladesh. His work led to the founding of Grameen Bank. Yunus and the Grameen Bank received the Nobel Peace Prize in 2006 for their efforts to create economic and social development. In one business model funded by credit from the bank, women purchased mobile phones and then charged users to make and receive calls. Through these businesses, the “telephone ladies” earned income while connecting many rural villages to the rest of the world.

Microcredit has been criticized as it has grown and expanded. Some lenders have been accused of charging exorbitant interest rates, while others have been condemned for using harsh tactics to force repayment. Microlenders can fail in helping people attain permanent self-employment if the loans are not actually used to start small businesses. In other instances, competition can quickly undermine the original business model. The programs that work best generally invest resources in training and support services. Microlending for developing small businesses is a complex process that requires forward thinking, good business models and an understanding of the economic and cultural factors that impact the aspiring entrepreneur.

Usually, it is easy to identify the labor, the land and the capital resources that are used in production. When friends go to dinner at their favorite restaurant, the meals are prepared by a chef and served by a waiter. The vegetables were grown on a farm and cooked on a stove. But how did all those resources come together to allow the restaurant to operate? It was the entrepreneur who conceived the idea for the restaurant, procured the building, hired the staff, bought the stove, purchased the ingredients and assumed the risk of its success.

Even with a great idea for a business, an entrepreneur must have money to purchase all the other resources that are required for production. This money can come from the savings that the entrepreneur has accumulated. Some entrepreneurs seek investors or partners who can provide the money that a new business requires. Many entrepreneurs need to access credit from banks or other financial institutions to get their businesses started.

Remember, the contribution of an entrepreneur is different from the contribution of labor. Many times the person who starts a business is also one of the hardest-working employees of the company. In this case, one person is wearing two hats. An entrepreneur who works in the business or manages day-to-day operations is contributing human resources, or labor.

But when the same person devises the idea for the venture, develops a business plan, uses savings or loans to acquire other resources and assumes the risk of its success, that person is acting as an entrepreneur.

Entrepreneurs in the Marketplace

Entrepreneurs and the innovation they often bring to the marketplace are the driving forces in a market economy. The market might be as narrow as a neighborhood or a city or as broad as a nation or even the entire world, but the entrepreneur sees the opportunity to launch a new idea and assumes the risk of its success. Profits are the way the market signals to entrepreneurs that they are on the right track. Profits reward the entrepreneur for doing things that customers value. Likewise, financial losses are the way the market signals that a product or idea may not provide enough value to the customer. This is the risk of entrepreneurship. If the entrepreneur pays for the resources required to produce a product or service but fails to sell it for a profit, the business will eventually shut down. The market can be a harsh critic and a sound judge.

Even successful entrepreneurs cannot rest. Just as potential profit draws the entrepreneur into a market, new entrepreneurial activity can take profit away. In 1926, Henry Ford, founder of the auto company



Tyler Perry had an unlikely start to a successful career in entertainment—a six-year series of unsuccessful productions of his first play. Perry based *I Know I've Been Changed* on a series of letters he wrote to himself. He used his entire life savings to produce the play in Atlanta in 1992. Over the next six years, he held a variety of jobs and even slept in his car, but in 1998 he opened the play one more time and it became a tremendous commercial success.

He began to write and star in plays. One of his best-known characters is Madea, the grandmother who became a central character in the plays and later in several movies. In addition to his writing and acting, Perry founded his own studio, Tyler Perry Studio, as well as a film company called 34th Street Films that develops the work of other screenwriters. Both companies are headquartered in Atlanta and together employ more than 300 people.

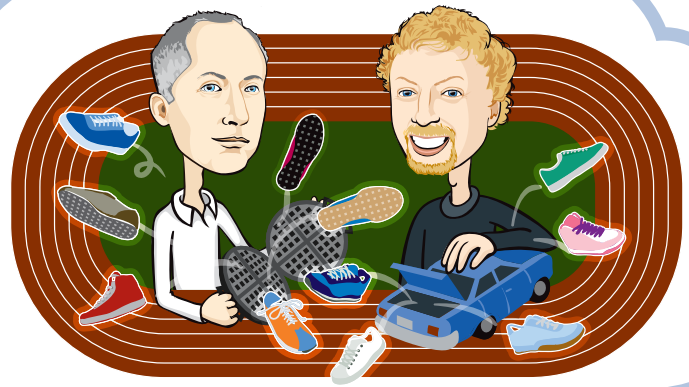
that bears his name, said, “It’s strange how, just as soon as an article becomes successful, somebody starts to think that it would be more successful if only it were different.”

This entrepreneurial spirit Ford was referring to can be quite disruptive in the marketplace. New ideas and new businesses replace current products and services, making them obsolete. This action, called creative destruction, is a process by which something new destroys or alters something older in the marketplace. Innovation and technological advances are often the drivers of creative destruction. A good example is the computer versus the typewriter. Typewriters were once in great demand, but now they are rarely used. Computers, printers and other devices do everything that typewriters did and more. As consumers adapted to the changing technology, a dramatic shift occurred among producers of office equipment. Entrepreneurs created new businesses to offer computer hardware and software to the public. As these businesses grew and sales increased, other businesses that had been started by entrepreneurs in the past saw shrinking markets and declining revenue. Typewriters, ribbons and carbon paper vanished from the market, along with the businesses that produced and sold them.

The same fate awaits other products, processes and services. New technologies replace old ones, and entrepreneurs drive that change as they bring innovations to consumers in the marketplace. Entrepreneurs are like the spark in an engine, igniting new ideas and discoveries that move the economy forward – they have a vision of what might be. A healthy economy is one that allows creative destruction to occur.

An Entrepreneurial Society

To flourish, entrepreneurs need an economic environment that encourages their work. Every country in the world has people who are creative and willing to take risks, people who could become entrepreneurs. But not all economies encourage



People had been selling shoes for centuries, but two men in Oregon recognized an opportunity. **Bill Bowerman** was a track and field coach at the University of Oregon who was always looking for ways to improve the equipment in order to enhance his team's performance. **Phil Knight** had been on Bowerman's team before he went to Stanford to earn an MBA. In 1964, with a handshake and an initial investment of \$500 each, they formed a partnership and imported their first shipment of athletic shoes from Japan. Knight began to sell the shoes at regional track meets from the trunk of his car, and Bowerman began to tear apart and redesign the footwear to improve the athletes' performance.

In 1970, with the business off to a successful start, Bowerman poured rubber into a waffle iron and created an entirely new sole with nubs to give runners additional traction. The following year, a new soccer cleat was named "The Nike" after the Greek goddess of victory and featured the now-famous "swoosh." Eventually, the company adopted the name and the mark, and with continued innovation, creative marketing and endorsements from famous athletes, grew into a globally recognized producer of athletic equipment.

entrepreneurs to develop new products, ideas or services to introduce to consumers. An economic system must provide an environment that encourages entrepreneurs to risk trying something new.

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Explore the Concept...

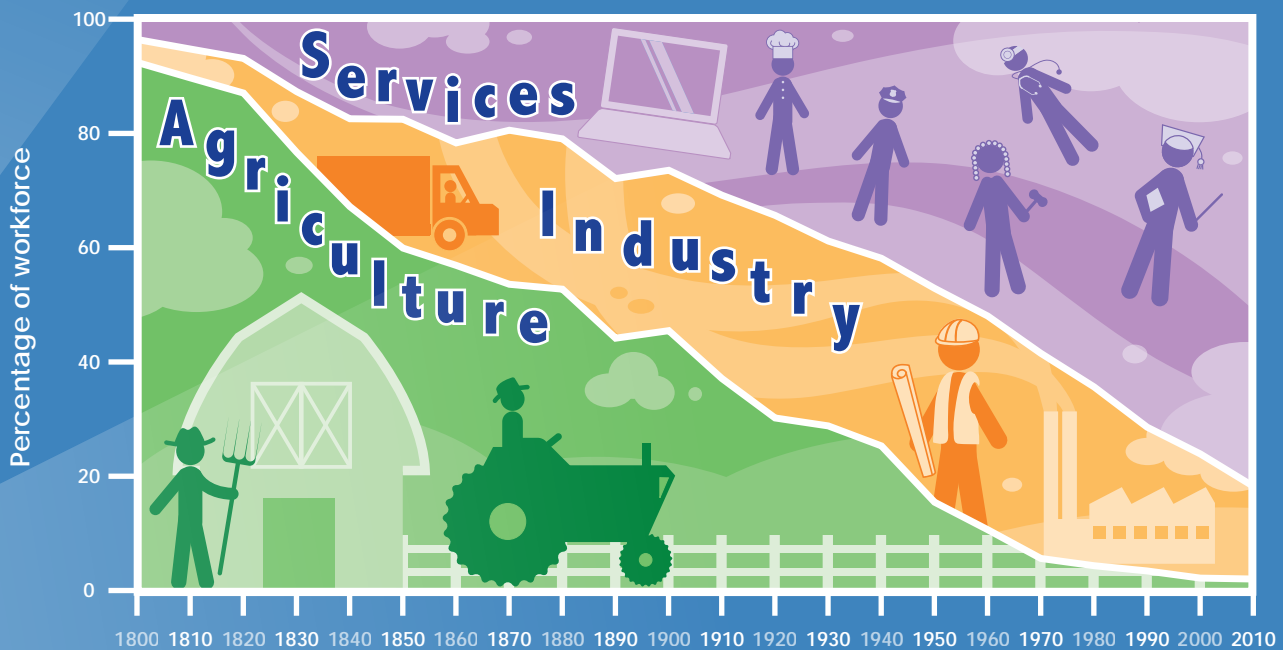
Innovation, Productivity and Economic Growth

If an entrepreneur introduces innovative goods or services or organizes resources in innovative ways, the efforts of that entrepreneur can have enormous economic impact. Innovation allows the economy to grow. It also allows the society as a whole to enjoy a higher standard of living by increasing labor productivity, which means workers produce more in a given amount of time. In the United States, innovation and increased productivity have transformed the labor force, along with the entire economy.

In the early days of the new republic, America was primarily an agrarian nation. More than 90 percent of the population worked on farms. But the 1800s saw a number of new tools that transformed the lives of farmers. Cyrus McCormick introduced the mechanical reaper, and John Deere began to mass produce the steel plow. In fact, John Deere's business grew so rapidly that he went from making 10 plows in 1839 to producing more than 2,100 in 1849. These tools, along with new developments in irrigation, seeds and farming techniques, made

From Farms to Factories to Facebook

As innovation eliminated jobs in agriculture, workers switched to occupations in industry and services. By 2010, farm jobs employed only 2 percent of the workforce, while services jobs had grown to 82 percent.



SOURCE: Bureau of Labor Statistics



individual farmers significantly more productive and allowed the United States to feed itself with far fewer agricultural workers.

Those displaced farmhands flocked to cities and found new work such as building houses, generating electricity and making an abundance of consumer goods. The Industrial Revolution was under way. Technology advanced even further, and eventually machines began taking over more factory chores. Workers had to make another transition, from assembly lines to jobs in retailing, medical care, finance, management and services. America entered the information age, and the emergence of computer, telecommunications and satellite technologies dramatically changed the way Americans work once again. It now takes only a few employees to accomplish what once required dozens.

But the story of innovation and increased productivity is not only about changing the types of tasks that workers perform. The American labor force has increased its productivity over the past 200-plus years, and that allows the economy to produce more goods and services. Economists measure the production of a society by calculating the gross domestic product, the GDP. The GDP is defined as the market value of all the final goods and services produced within the country's borders in a given year.

Another important measure of the production of an economy is the per capita GDP. This is found by dividing the GDP by the population. This measures the average production of every person who lives in the country. Both GDP and per capita GDP can rise and fall over short periods of time. The United States, throughout its history, has experienced remarkable growth in both measures.

Innovation is a significant cause of the increased productivity seen in today's economy, and that productivity allows labor, along with other scarce resources, to produce more goods and services. This new production can begin to fulfill wants that had been unmet or maybe even unknown.

Modeling Economic Growth

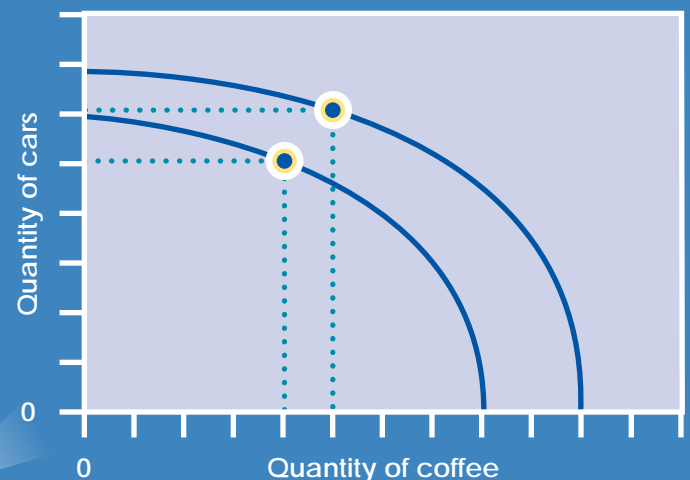
One way that economists show the productive capacity of a country is by using a model called the production possibility curve (or production possibility frontier). The PPC simplifies the economy by imagining a society that produces only two goods, for example cars and coffee. Both require all four types of resources—land, labor, capital and entrepreneurial ability. All of these resources are scarce, so production is limited to some combination of cars and coffee that falls on the production possibility curve. As long as the curve is fixed, the society cannot produce combinations outside the curve.

But higher productivity allows the curve to shift outward. A society becomes more productive in three main ways:

- Building its **capital stock**—adding more machinery, factories, offices and research facilities;
- Upgrading workers' **skills** through education, experience or retraining;
- **Innovating** and introducing new technologies that increase output and improve efficiency.

As the curve shifts outward, the society is able to produce and consume more of both goods.

Production Possibility Curve



When entrepreneurs weigh the possible risks and potential rewards of starting a business, a variety of government policies can impact that decision. As cities, states and nations make decisions about tax policy and spending levels, those choices have an important impact on the costs and benefits of operating a business. High taxes can discourage entrepreneurial activity by making it less profitable, but businesses benefit from roads and highways, police protection and other services provided by various levels of government. Some cities and states provide incentives, such as tax exemptions, to attract new businesses to the area.

Government at every level can also affect business through regulations. Consumer, environmental and

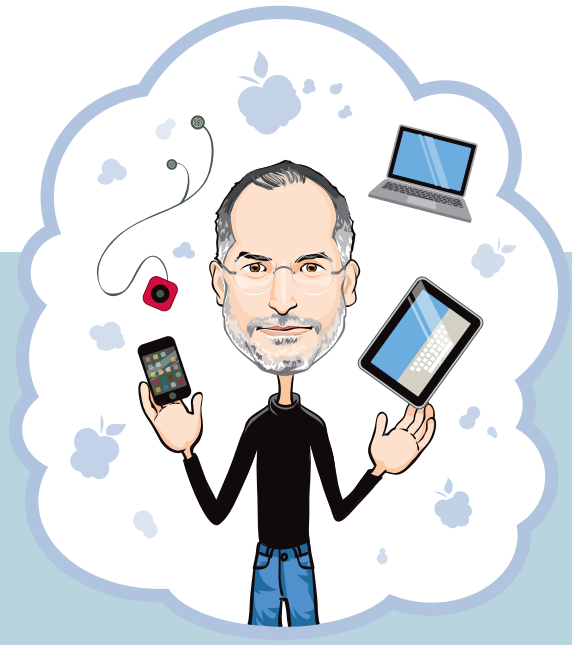
safety regulations, along with labor laws such as the minimum wage, affect the cost of opening and running a business. Just as elected officials must consider the potential costs and benefits of new regulatory measures, entrepreneurs have to anticipate the impact of those measures on business profits.

In a free enterprise system, one of the government's important roles is to protect the rights of the owners of productive resources. Laws prevent resources from being taken from the owner without payment. Strong institutions, such as courts, equitably enforce those laws. These property rights ensure that people can own resources and ideas and can make decisions regarding how they will use them.

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Bill Gates began programming computers at age 13. While he was a Harvard undergraduate, he developed a version of a new programming language called BASIC. He left Harvard as a junior to work on a new software company called Microsoft that he had founded with his friend Paul Allen in 1975. Gates believed that the personal computer would eventually be used in every office and in every home, and his new company began to develop software for those personal computers. By licensing the software to PC manufacturers, Microsoft retained control of the code and was able to work with a wide variety of hardware suppliers.



Steve Jobs became fascinated with computers and electronics growing up in Silicon Valley. In 1976, he cofounded Apple Computer with the goal of producing a personal computer at a time when most computers were the size of a room. The company grew rapidly with the sales of the Apple II and the Macintosh. Jobs left Apple in 1985. Over the next few years, he founded and ran NeXT, a software company, and Pixar Animation Studios. He returned to Apple when it bought NeXT in 1996. After his return, Apple continued to develop new products like the iPod, iPhone and iPad. Apple's online music store, iTunes, has revolutionized many different forms of media.

Intellectual Property Protection

What if you design a new video game that is about to hit the market? If the game becomes popular, you would not want someone else to use your ideas to create a competing game. Your work can be protected by a variety of laws.

Copyrights

Copyrights prevent someone from copying your original work. The characters you created, the worlds they inhabit and the tools they use can all be copyrighted. No one else can reproduce your creative work in a different video game, a movie or any other form without your permission. Copyrights protect many types of original work, including literary, dramatic, musical and artistic works. The original author or artist is allowed to control the reproduction, distribution, performance and display of the original creation.



Trademarks

Trademarks are words, names or symbols that identify the maker of a particular good. So after you name your game and design the logo, that name and design can be trademarked to distinguish your brand. The makers of similar games and products might try to confuse consumers who want to buy your game, but a trademark protects your right to differentiate your product from similar products.

Patents

Patents will protect your inventions. If you design a unique game controller or even a toy based on one of your characters, no one else can produce a similar controller or toy without your permission. Patents give property rights to inventors by allowing them the sole right to manufacture, use or sell their invention, usually for 20 years.

Many familiar products are protected by a combination of copyrights, trademarks and patents. A fast food restaurant could copyright an advertising jingle, trademark the name of its signature sandwich and patent the design of a special oven that is used to keep the food warm. The formula for a new prescription drug could be covered by a patent to prevent the production of a generic version. Also, the name of the new drug can be registered as a trademark. Even the color and shape of the pill can be protected as part of the brand's identity in the marketplace.

Types of Firms

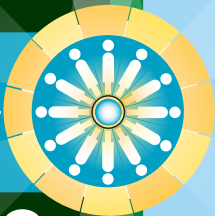
When starting a new business, an entrepreneur must make many decisions. But one of the most important is the legal form or structure of the business. In the U.S., there are three main ways to organize a business. Each one offers advantages and disadvantages.



A **sole proprietorship** is an unincorporated business owned by one person. It may be large or small, with many or few employees. The owner receives the profit from the business but also bears the responsibilities for the debts and the risk of loss if the business fails.



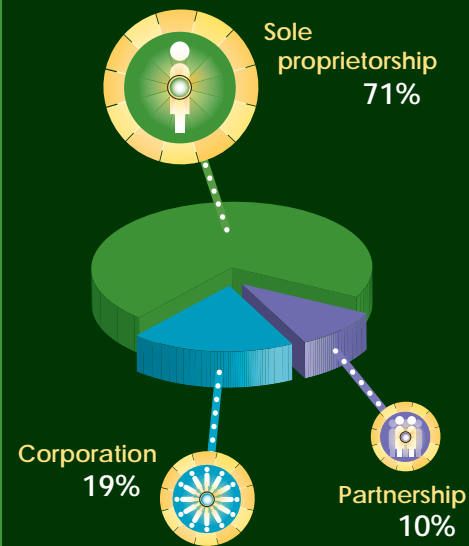
A **partnership** is an unincorporated business owned by two or more persons. Each one has a financial interest in the business. The owners share the potential for profit and the risk of loss.



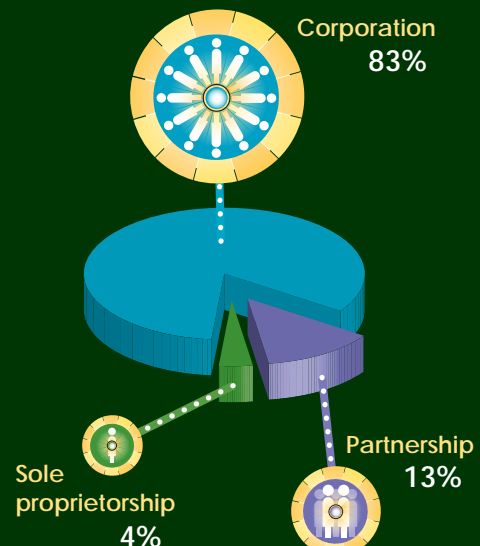
A **corporation** is a business that exists as a separate legal entity. When a business is incorporated under state laws, the new entity has the right to buy and sell, incur debt and sign contracts. The owners of the corporation, called the shareholders, have limits on their liability for the debts or losses of the business but also may have less ability to affect the actions or direction of the company.

Sole proprietorships make up the vast majority of firms in the U.S., but many of these businesses are relatively small. While only 19 percent of firms in the U.S. are corporations, their sales make up 83 percent of the total receipts of all businesses in the country.

Number of Firms



Sales



What if privately owned land could be taken away arbitrarily, without cause? In a market system, landowners decide who can use their property or extract the resources under the soil. Would a business invest in new tools, equipment and machinery if those capital resources were not protected as private property? If entrepreneurs cannot expect to keep the profits from a new business venture, they are unlikely to take the risk or put in the hard work to open for business.

The protection of private property also provides an incentive for entrepreneurs to create because they are allowed to sell and profit from their intellectual property – their ideas and inventions. What would happen if books could be reprinted and sold without payment to the author? Would anyone be willing to write the next best-seller? If a business creates a new product design or cutting-edge technology, should its competitors be able to copy the innovation and sell it as their own?

Today, a wide range of patent, copyright and trademark laws protect people from having their intellectual property copied, used or stolen by others. A screenplay or a song, a recipe or a computer program can form the basis of a new business. But if the idea can be copied and used by someone else without payment, the new venture and all the potential jobs and profit that it might create will likely never appear.

Without these intellectual property rights, favorable legal and regulatory systems, and reasonable governance and tax codes, innovation is stifled. A strong entrepreneurial society is one in which these supportive conditions exist. They lay the groundwork for the innovation and growth that entrepreneurs can bring to an economy.

Globalization

It appears that entrepreneurs will face both opportunities and challenges throughout the 21st century. Globalization – which is the increasing integration of the world’s economies through the flow of goods, services, financial capital and people across national borders – will play a significant role. This phenomenon has presented entrepreneurs with opportunities by opening new markets where resources are available and goods and services can be sold. Small firms can access new technologies and methods of production, allowing them to compete with more established firms. Through globalization, information and knowledge are widely available and easy to share.

But challenges remain for entrepreneurs who seek to enter the marketplace. Financing new ventures has never been easy, and the period after the 2008

Linda Alvarado worked her way through college as a laborer with a landscaping company. After working in the construction industry, she founded Alvarado Construction in 1976. Some of her first projects involved building sidewalks and shelters for bus passengers, but as the company grew, the projects increased in scale to hotels, convention centers and sports arenas. When she joined a group of investors to buy the Colorado Rockies, she made history as the first Hispanic and the first woman to buy a Major League Baseball franchise.





Oprah Winfrey began her broadcasting career in Nashville while still in high school. She anchored television news in Nashville and Baltimore before moving to Chicago to host a morning talk show that was quickly expanded and renamed *The Oprah Winfrey Show*. It entered national syndication in 1986 and became the highest-rated talk show in television history.

In 1988, Winfrey established Harpo Studios, making her the third woman in the American entertainment industry (after Mary Pickford and Lucille Ball) to own her own studio. The company has produced movies and telefilms and has launched new television shows featuring Dr. Phil and Rachael Ray. With her partners, Winfrey has introduced a magazine, a website and an XM Satellite Radio station. Her newest venture is the Oprah Winfrey Network that premiered on Jan. 1, 2011.

financial crisis was particularly difficult. Access to credit for entrepreneurs, especially in the developed world, was disrupted by the turmoil that started in the U.S. financial markets and quickly spread throughout the world. The financial crisis and associated recession destroyed significant numbers of jobs worldwide. As the world's financial systems

gain strength, innovation is being identified as a key force to facilitate the recovery process. U.S. policymakers have been vocal in stressing the importance of entrepreneurship. Countries that have entrepreneurship as an integral part of their core values will have a comparative advantage in the 21st century economy.



The change that entrepreneurial activity brings is around every corner. No one knows what new company will be the next Facebook or Harpo Studios or Apple or Baby Einstein, but that is what keeps an economy vibrant. Throughout the world, scientists, writers, engineers, designers and a host of other creative people are dreaming up ideas that will be the seeds of future innovations. Entrepreneurs will continue to take the risks associated with starting new ventures. Thus, economies will grow and living standards will rise.



Great minds think about...

entrepreneurs

Richard Cantillon (1680–1734) introduced the French term *entrepreneur* and the English word *undertaker* to describe the people who assumed the risk of producing when the demand was not known. He discussed the competition among entrepreneurs and recognized that some were likely to go bankrupt.

Jean-Baptiste Say (1767–1832) described three types of producers: the scientists, the entrepreneurs and the workers. The scientists investigate the properties of the resource, the entrepreneurs apply the scientists' discovery to a useful purpose and the workers actually make the product. And any successful economy needs all three.

Joseph A. Schumpeter (1883–1950) saw that an entrepreneur could temporarily earn a profit greater than the one in perfect competition. He believed that economic growth is driven by innovations brought to the marketplace by entrepreneurs seeking those higher profits. As these new innovations enter the economy, they render old products obsolete, causing them to disappear in a process called creative destruction.

William J. Baumol (1922–) found evidence that entrepreneurs are present in every society but that different societies reward their efforts differently. So the rules and customs of a given culture will determine whether entrepreneurs are productive or destructive. In a market economy, successful production is rewarded with profit, leading to greater innovation and development.

Israel Kirzner (1930–) said that entrepreneurs discover markets where a profit potential exists because of poor allocation of resources and shortages or surpluses in the market. Entrepreneurs move into that market and earn higher profits until competition eliminates the opportunity for those higher profits.



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