# Entrepreneurship and Growth

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**Introduction**

It is a pleasure to be here with you today to talk about the key role entrepreneurs play in the long-run performance of the United States economy. As one examines worldwide economic growth over the past decade, it is clear that the U.S. economy has surpassed most of the industrialized world both in its rate of growth and its ability to create wealth. Indeed, in our nation, growth in real output (GDP) averaged 3.2 percent during the last decade, compared to only 1.8 percent for all industrialized economies. Moreover, per capita income in the United States is among the highest in the world.

What accounts for the United States' extraordinary economic performance among nations? Perhaps the most important factor behind this success is the strong growth of productivity – the amount of output per worker. Most discussions of the recent surge in U.S. productivity have focused on the increased use of computers and advances in information technology. However, new ideas and new technology do not translate immediately into increased productivity and faster economic growth. Someone has to recognize the potential of new ideas, design applications, develop new products, and successfully bring these products to market. This is the critical role played by the entrepreneur, and the recognition of this importance has spurred increased research on the contribution of entrepreneurs to the long-run performance of the U.S. economy.

Today, I would like to share with you my thoughts on how entrepreneurship boosts economic performance and what elements are needed to support and maintain an entrepreneurial economy. I would also like to highlight the important part played by entrepreneurs in the economic history of Kansas City.

**How Does Entrepreneurship Boost Economic Performance?**

Consider, for example, that research from the *Global Entrepreneurship Monitor*, sponsored in part by the Kauffman Foundation right here in Kansas City, suggests that a third to a half of the differences in economic growth rates among industrialized countries can be attributed to differences in the level of entrepreneurship.[1] The same source shows that the level of entrepreneurial activity in the United States stands among the highest of all industrialized countries.

Low-income developing countries also tend to have relatively high levels of entrepreneurship, but their high levels arise mostly from necessity or from limited alternatives. The high level of entrepreneurship in the United States, on the other hand, is mostly opportunity based. Only 15 percent of Americans starting a new business do so because they lack other job opportunities.[2] Most do so to pursue opportunities that would boost their standard of living. In the United States, unlike most parts of the world, high wealth individuals are the ones more likely to switch into self-employment.[3]

But how does entrepreneurship boost economic growth rates? The conceptual link is clear; entrepreneurship fosters innovation. A half century ago, Joseph Schumpeter, a renown economist and market advocate, asserted that the hallmark of capitalism is innovation, "the sweeping out of old products, old enterprises, and old organizational forms by new ones," a process he called "creative destruction."[4]

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[1] Paul D. Reynolds, Michael Hay, and S. Michael Camp, 1999, *Global Entrepreneurship Monitor*, Kansas City, MO, Kauffman Center for Entrepreneurial Leadership; Andrew L. Zacharakis, William D. Bygrave, and Dean A. Shepherd, 2000, *Global Entrepreneurship Monitor*, Kansas City, MO, Kauffman Center for Entrepreneurial Leadership.
[2] Maria Minniti and William D. Bygrave, 2004, *Global Entrepreneurship Monitor, National Entrepreneurship Assessment, United States of America*, Wellesley, MA, Babson College.
[3] D. S. Evans and L. S. Leighton, 1989, "Some Empirical Aspects of Entrepreneurship," *American Economic Review*, 79(3), 519 – 535.
[4] Joseph A. Shumpeter, 1942, *Capitalism, Socialism, and Democracy*, New York, Harper & Row, 83.

More recent research by John Haltiwanger, an economist at the University of Maryland and the National Bureau of Economic Research and a visiting scholar at the Federal Reserve Bank of Kansas City, has focused on the rise and fall of businesses in the United States, seeking to understand the inner workings of Schumpeter's creative destruction.[5] Haltiwanger's research paints a picture of a churning business environment in which new firms are developing and growing at the same time older businesses are maturing, falling behind, and eventually shutting down. This noisy process, which involves a lot of trial and error, produces a continual and extensive reallocation of labor and capital from the old to the new. And a growing body of evidence indicates that the productivity of the new, entering businesses is higher than that of the older businesses they replace.

Thus, innovation is the critical link between entrepreneurship and economic growth. Innovation boosts productivity which leads to higher growth rates for our economy and a rising standard of living for our citizens. In part as a result of the innovations of entrepreneurs and others, gains in productivity have been greater in the United States during the last decade than in nearly every other industrial nation.

Around the globe, the action of entrepreneurs creates jobs and boosts local incomes and wealth. In the United States, small businesses are an important contributor to job growth. A substantial majority of business start-ups in the United States employ at least one person in addition to the proprietor, and almost a quarter of them plan to employ 20 or more people within their first five years. Data from the U.S. Department of Labor show that the earnings of successful self-employed entrepreneurs are typically a third higher than the earnings of the

[5] John Haltiwanger, 2002, "Understanding Aggregate Growth: The Need for Microeconomic Evidence," New Zealand Economic Papers, 36(1), 33 – 58.

typical wage-and-salary worker, and the earnings of entrepreneurs who have incorporated their businesses are considerably higher.

Whether the lone individual starting from a garage or a corporate executive starting a new division, the entrepreneur initiates change and improvement and keeps our nation's economy dynamic and vibrant.

**What Elements Support an Entrepreneurial Economy?**

A number of elements are critical for a successful entrepreneurial economy. Surely a unique entrepreneurial spirit is a part of the mix, but a supportive environment is crucial. In brief, entrepreneurship flourishes in an environment where ideas can bubble up and become productive and marketable and where business start-ups can readily grow and mature.

Many individuals in every society likely match the characteristics of historically successful entrepreneurs, such as self-confidence, perseverance, insight, and the willingness to bear risk and cope with uncertainty. Whether or not enough of these prospective entrepreneurs thrive, however, depends on the institutional environment in which they operate. A number of criteria define a supportive entrepreneurial environment.

Chief among these criteria are the security of property rights and the rule of law, which are critical to the existence of well-functioning markets.

Well-defined legal entitlements and the absence of bribery and other forms of corruption by those in power reduce the risk of losing assets, lower the costs of business transactions, and speed the transfer of research and development and technology.

We often take property rights and the rule of law for granted in the United States. In many places, however, these are not so assured, and U.S. companies are by no means guaranteed protection abroad. For example, infringement of intellectual property rights is a major problem around the globe. The World Customs Organization estimates that 5 to 7 percent of global merchandise trade involves counterfeit goods, which is equivalent to lost sales of half a trillion dollars a year.[6] Perhaps nowhere is this a bigger problem than in China. Fortunately, the Chinese government is beginning to crackdown on these infringements. The impetus for change seems to be that Chinese companies themselves are beginning to become hampered by counterfeits of their own products.

In contrast, the United States provides stronger patent protection than most of its trading partners, and the strengthening of intellectual property rights since the early 1980s has been accompanied by an expansion in research and development and a surge in patents.[7]

A second key criterion for a high-growth, entrepreneurial economy is an open market that encourages competition without artificially protecting one group of producers from another. This is particularly important for entrepreneurs because they are introducing new goods and services or new processes, thereby challenging the status quo. Without open and flexible markets, new ideas would be more difficult to introduce.

To be sure, the keen competition that accompanies an open marketplace leads to the failure of some businesses. Free and flexible markets enable the closing of businesses that have run their course, rather than artificially propping them up at high cost. Such failure is a critical part of Schumpeter's creative destruction, clearing a path for more efficient, more innovative businesses. The result is a dynamic and vibrant business environment that rewards innovation, efficiency, and continual improvement.

[6] "Fakes!" *BusinessWeek*, Feb. 7, 2005.
[7] OECD, 2004, "OECD Economic Surveys United States: Product Market Competition and Economic Performance," *OECD Economic Surveys*, vol. I, no. 76, 168 – 229.

The global marketplace provides a strong illustration of the importance of open markets. Some years ago, noted economist Jeffrey Sachs and his colleague Andrew Warner studied the experience of dozens of countries, contrasting those with more open markets against those which attempt to protect their markets.[8] Sachs is a respected economist and was recently named one of the world's 100 most influential people by *Time* magazine. Among the developed countries reviewed, he and Warner found that those with open economies grew more than three times faster from 1970 to 1990 than those with closed economies (about 2 ¼ percent versus 0.7 percent). The contrast was even starker among developing nations, with open economies growing more than 4 ½ times faster than closed economies (about 4 ½ percent a year versus less than 1 percent).

More recent evidence provides a convenient rule of thumb for translating the "openness" of an economy into gains in per capita income. Specifically, each percentage point increase in the share of GDP that is derived from international trade boosts annual per capita income by two percent.[9]

In the end, consumers enjoy access to a wider variety of goods at lower prices, and the rest of the world can invest freely in our markets, hold our debt, and buy our products, many of which come from our nation's army of entrepreneurs and small businesses.

Indeed, small entrepreneurial firms are our nation's fastest growing group of exporters. In recent years both the number of small entrepreneurial businesses and the volume of their exports has more than tripled. Growth in the number of exporting firms and the value of exports

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[8] Jeffrey D. Sachs and Andrew Warner, 1995, "Economic Reform and the Process of Global Integration," *Brookings Papers on Economic Activity*, 1 – 118.
[9] Jeffrey A. Frankel and David Romer, 1999, "Does Trade Cause Growth?" *American Economic Review*, 89(3), 379 – 399.

has been greatest in the smallest of these businesses, those with fewer than 20 employees. Clearly, open markets are good for business and good for consumers.

Another criterion for robust entrepreneurship is access to financial capital. In the United States, financial markets are the most efficient and fluid in the world. As a testament, nearly half of all the world's equity shares (by market capitalization) are traded in the United States, and foreign investors hold approximately $4.5 trillion in U.S. equities. Our financial markets are as broad as they are deep, spanning a broad array of equity and debt investments—including banks and other lenders, stock and bond markets, and venture capital providers. Overall, these markets perform an extraordinary service connecting entrepreneurs with investors and lenders who are willing and able to measure business risks, accepting the most promising and rejecting the less worthy.

Nevertheless, entrepreneurs often relate the challenges they face in financing their business start ups. Some begin humbly by borrowing to the limit on a collection of credit cards. Some find a start in the "believer" capital market, accepting investments or loans from family members or friends with confidence in their ideas and abilities. Some find a start with individual "angel" investors who eagerly seek high rewards from funding new businesses that more traditional capital providers deem too risky. At the Federal Reserve Bank of Kansas City, we recognize the importance of these informal markets, and we have research underway to gain a better understanding of them.

The fourth criterion for an effective entrepreneurial environment is a strong education system. Successful entrepreneurs need a variety of skills, including technical skills, financial acumen, and the ability to recognize market opportunities, synthesize information from a variety of sources, and organize and manage operations. Along with practical experiences, a good general education and life-long learning opportunities are imperative for entrepreneurial success.

A strong general and advanced education system not only builds up the skills of existing and would-be entrepreneurs, but also develops the skill level of workers, promotes research and development and technology transfer, and helps attract well-educated and highly skilled people and their families.

The support of a great university can be key to the development of entrepreneurship, as evidenced in California's Silicon Valley, Massachusetts' Route 128 corridor, and North Carolina's Research Triangle.

This is an area in which considerable room for improvement exists in both the nation as a whole and in Kansas City.

Finally, the cultural and social norms in the United States that encourage citizens to seek new opportunities and take risks cannot be overestimated.

**What Role Has Entrepreneurship Played in Kansas City?**

We don't have to look far from home to find striking evidence of a vibrant entrepreneurial spirit and a fruitful entrepreneurial environment.

The City of Kansas City was itself the product of innovation and entrepreneurship. Traditionally, settlers traveled along the Missouri river and disembarked in Independence, to acquire the supplies needed for the long overland trip west. John Calvin McCoy, owner of a general store 22 miles west of Independence, found a rock ledge on the south shore of the Missouri River that formed a natural landing for river boats. Travel by water was faster and easier than shipping by land, and McCoy reasoned that if supplies could be floated to his landing, even with the four-mile trip overland to Westport, the land haul would be cut by 18 miles. He cut a road from his dock on the Missouri to Westport and the town that would become Kansas City was born.

Since those early days, numerous Kansas City area entrepreneurs have built companies that remain cornerstones of our region's economy.

For example, the Brown Telephone company was founded in 1899 by Cleyson L. Brown as an alternative to the Bells. Nearly a century later, the Sprint Corporation evolved to revolutionize the telecommunications industry with the first all fiber optic network in the United States. Today Sprint, with a market capitalization of over $30 billion, employs roughly 17,000 area residents and is the largest employer in the State of Kansas.

Joyce Clyde Hall arrived in Kansas City a decade later (1910) with a couple shoeboxes of post cards and a reservation at the YMCA. He sent bundles of the cards along with invoices to Midwestern vendors, a third of which responded with orders for more. Thus was born Hallmark, then Hall Brothers Company, as a partnership between Joyce Hall and his brother Rollie. Future years would bring innovations like mass-marketed Christmas and Valentine's Day cards and modern gift wrap. Today Hallmark racks up $4.5 billion in annual sales and employs 18,000 fulltime workers nationwide, including 4,500 in its headquarters office in Kansas City. Crown Center, which houses the headquarters office, was developed as an effort to thwart decay in the downtown area. The company funds the Hallmark Corporate Foundation, which supports human service, education, health and arts organizations in the communities in which it operates.

A half century ago, the Bloch brothers recognized a golden opportunity when the IRS stopped filling out tax returns in Kansas City. Seizing the opportunity, they launched a new industry in mass market tax preparation services. Today H&R Block has a market capitalization of over $8 billion and employs over 15,000 full-time associates and about 100,000 seasonal associates nationwide. In 2004, Block completed almost 16 million U.S. tax returns, originated over $23 billion in mortgage loans, and serviced over 850,000 brokerage accounts. The H&R Block Foundation awards approximately $2 million annually in the Kansas City metropolitan area for arts, education, health and human services, neighborhood development, and volunteerism.

About the time H&R Block was getting off the ground (1950), Ewing Kauffman founded a global pharmaceutical company from a humble start in his basement. By the time it merged with Merrell Dow in 1989, Marion Laboratories was worth $6 billion in market capitalization, sales were close to $1 billion, and the company employed 3,400. It also had the highest sales and profits per employee among all companies on the NYSE. Today the foundation that bears Kauffman's name uses its $1.7 billion in net assets to encourage entrepreneurship across the country and improve the education of children and youth.

A few years later (1958), Jim Stowers and his 20$^{th}$ Century Investments revolutionized the investment community by integrating computer technology and common stock investing. Not surprisingly, American Century Investments, as the firm is known today, also was one of the first mutual fund companies to make transactions available over the Internet. Later, Mr. Stowers and his wife Virginia founded the Stowers Institute, bringing cutting edge cellular-level medical research to Kansas City.

And today we are meeting in another entrepreneurial enterprise that created its own industry revolution in healthcare information technology, replacing paper medical records with innovative software programs, eliminating errors, and significantly reducing costs. Today, Cerner employs well over 5,000 metro area residents and has a market capitalization of over $2 billion.

**Conclusions**

To sum up, entrepreneurs in Kansas City and elsewhere in the United States have created businesses that have grown, sometimes very quickly, to employ millions of citizens, to generate billions in income and wealth, and to create trillions in market value. These businesses were not founded by government planners, but rather by individuals with a vision and a persistent desire to succeed. The government played its part by providing a stable environment, a rule of law, the infrastructure necessary to succeed, and fiscal and monetary policies that facilitated markets and price signals. We should remember the importance of each institution's role as we think about our future.

On that note, let me end as I began, looking at the strength of our nation's economy and our role in the world. During the past decade, economic growth in the United States has by far outpaced much of Europe and Japan. We have a system not so different from theirs; but still enough different, enough more innovative, and enough less burdened by government to enable our greater success. Today, less developed nations that are beginning to generate economic success—especially China and India—are doing so by adopting our model to promote innovation and growth.

In the year ahead, the U.S. economy should continue its solid performance, growing nearly 4 percent with productivity growing more than 2.5 percent. Taking a longer view, we will continue to achieve such strong levels of performance if we provide fiscal, monetary, and regulatory policies that encourage an open, competitive, progressive, and noninflationary economy—an economy in which the entrepreneur and the American worker can thrive.