

THE ILLUSIONS OF ENTREPRENEURSHIP: LESSONS FROM US PUBLIC POLICY

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Prevailing view of entrepreneurship

Creating more start-ups will:

- ① Generate innovation
- ① Create jobs
- ① Produce wealth
- ① Transform depressed economic regions

Public policy toward entrepreneurship

This view leads to a variety of mechanisms to stimulate new business formation:

- ① Loans
- ① Subsidies
- ① Regulatory exemptions
- ① Tax benefits

The reality is different...

The typical start-up:

- Is not innovative
- Creates few jobs
- Generates little wealth

How can this be?

- ⦿ All major business success stories (SAP, Apple, Google, Virgin) once start-ups
- ⦿ Surely, these companies have created jobs and contributed to economic growth?
- ⦿ Of, course, but these were not typical start-ups

Most start-ups shouldn't be started

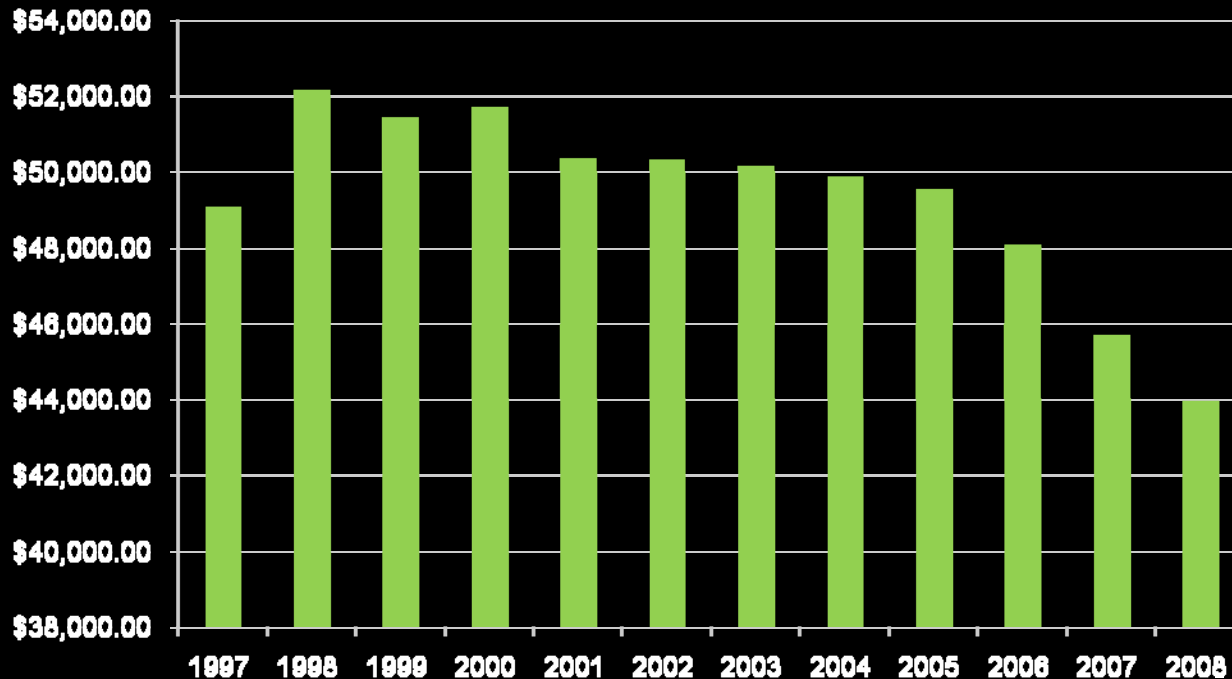
- Most entrepreneurs start companies that are easy to start, not the ones that will do well
- In the U.S., the correlation across industries between start-up rates and failure rates is 0.77
- 37-41 percent of US entrepreneurs don't think they have a competitive advantage
- 61 percent of new businesses serve the same customers as their previous employer

What the typical U.S. start-up looks like

- ⦿ Almost 80 percent of all US small businesses have no employees
- ⦿ These non-employer businesses only account for 3 percent of US sales
- ⦿ Annual sales average \$44,000 (in 2007 dollars)

Non-employers' sales are shrinking

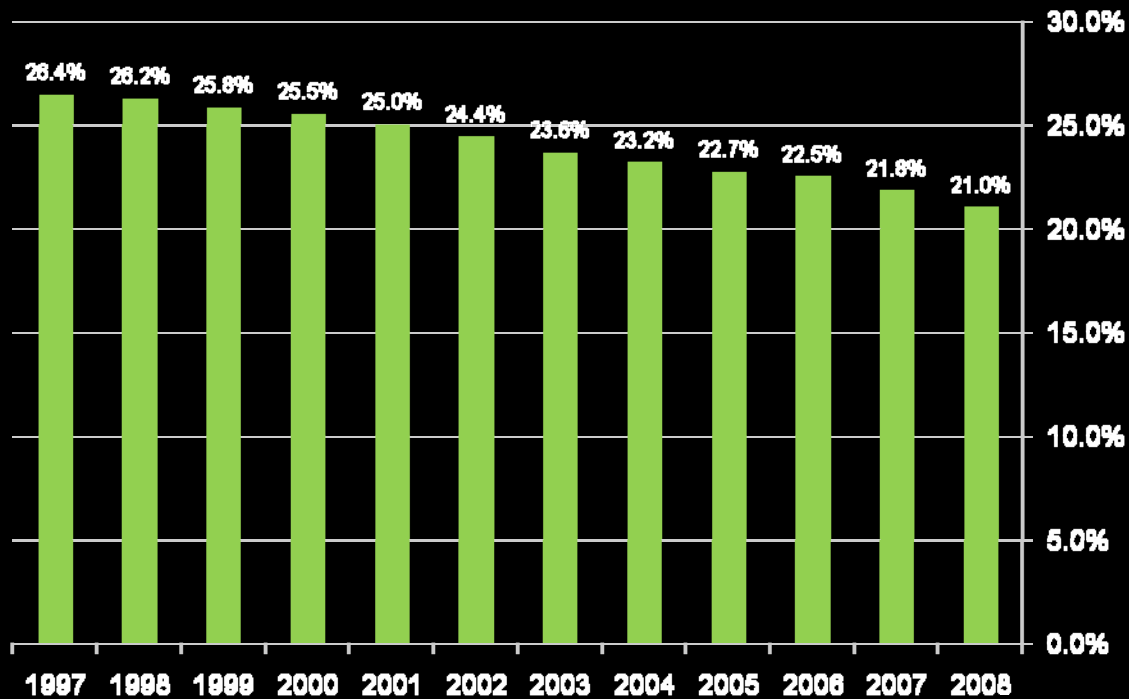
Real Average Annual Sales of Non-Employer Businesses



Source: Created From Data From U.S. Census Bureau, Non-Employer Statistics

Share of employer businesses is shrinking

Employer Business as a Percentage of Total Businesses



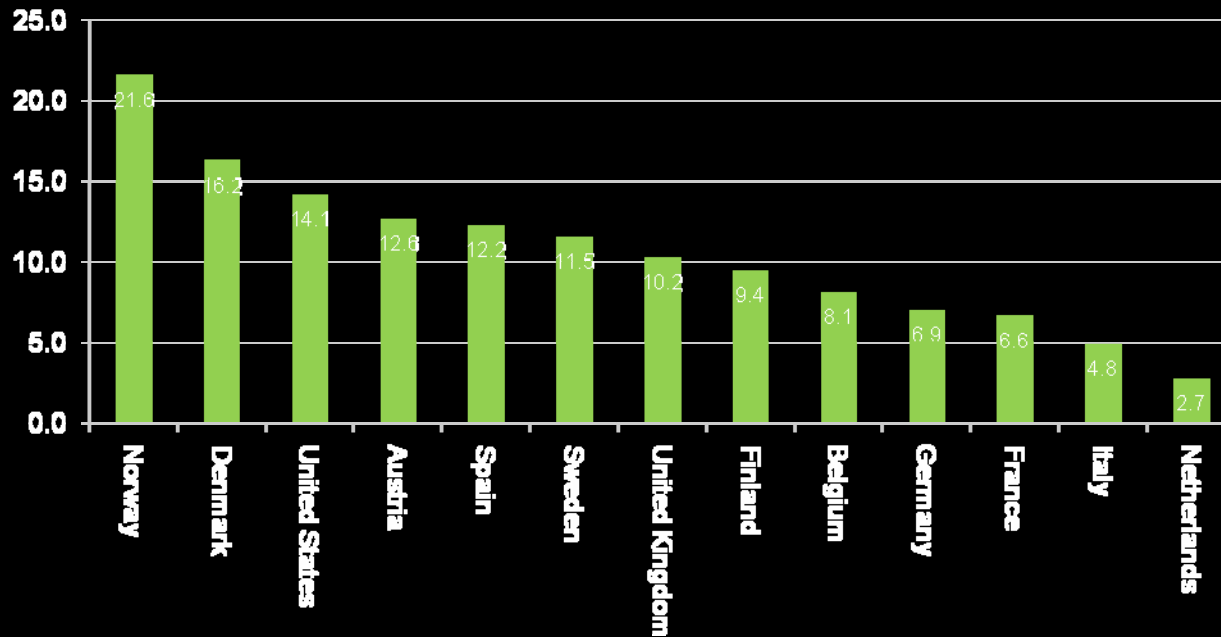
Source: Created From Data From U.S. Census Bureau, Non-Employer Statistics and Office of Advocacy, U.S. Small Business Administration

Most entrepreneurs have low aspirations

- The reason most people start businesses is to avoid having a boss
- Most entrepreneurs don't want to generate wealth or create jobs
 - Most entrepreneurs say they don't want sales or employment to grow
 - Half of US founders expect to generate \$100,000 in revenue in five years
- Only 10 percent of the Inc. 500 firms offer a product or service that other companies do not offer

New firms create only a small portion of new technology

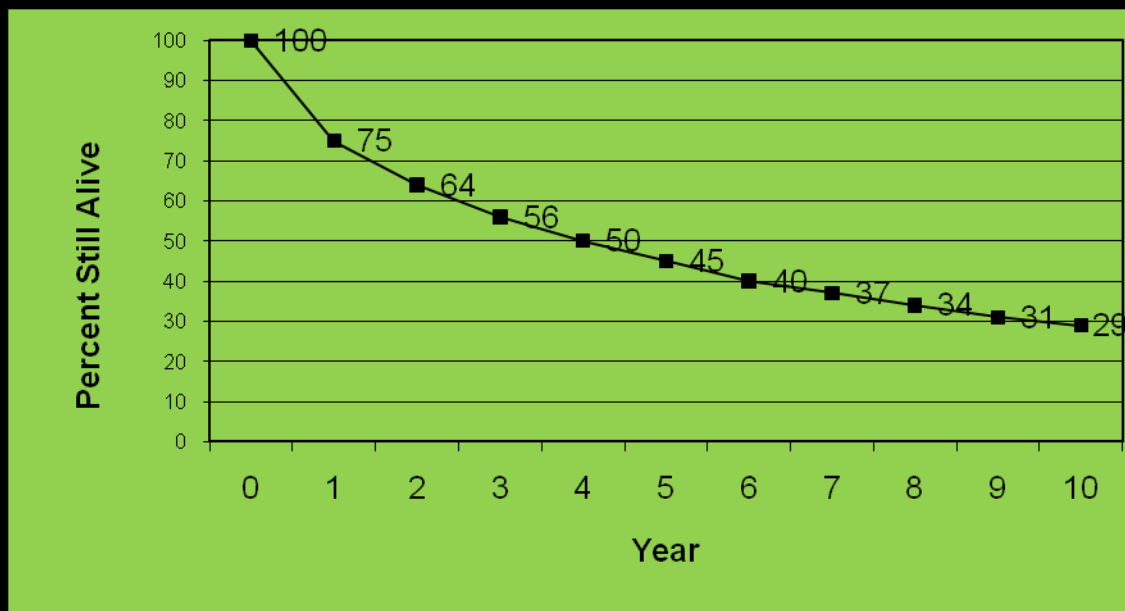
Percent of Patents Filed by Firms Under Five Years Old



Source: Created from data from the OECD's "Measuring Innovation: A New Perspective"

The life of a typical start-up is nasty, brutish and short

Percentage of Start-ups Still Alive by Years Since Founding



Source; Created from a special tabulation by the Bureau of the Census produced for the Office of Advocacy of the U.S. Small Business Administration.

Even most survivors do poorly

- ◎ The founder of the typical ten-year-old business earns 65 percent of what he earned working for someone else
- ◎ The average entrepreneur makes less money, works more hours, and has more variable income than the average employee
- ◎ The typical entrepreneur earns no extra return on invested capital

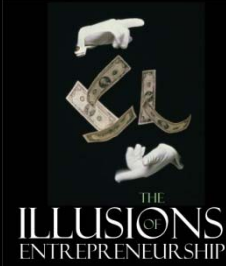
Start-ups are less productive than existing firms

- ⦿ Productivity increases with firm age.
- ⦿ In the U.S., the average new firm makes worse use of resources than the average existing firm

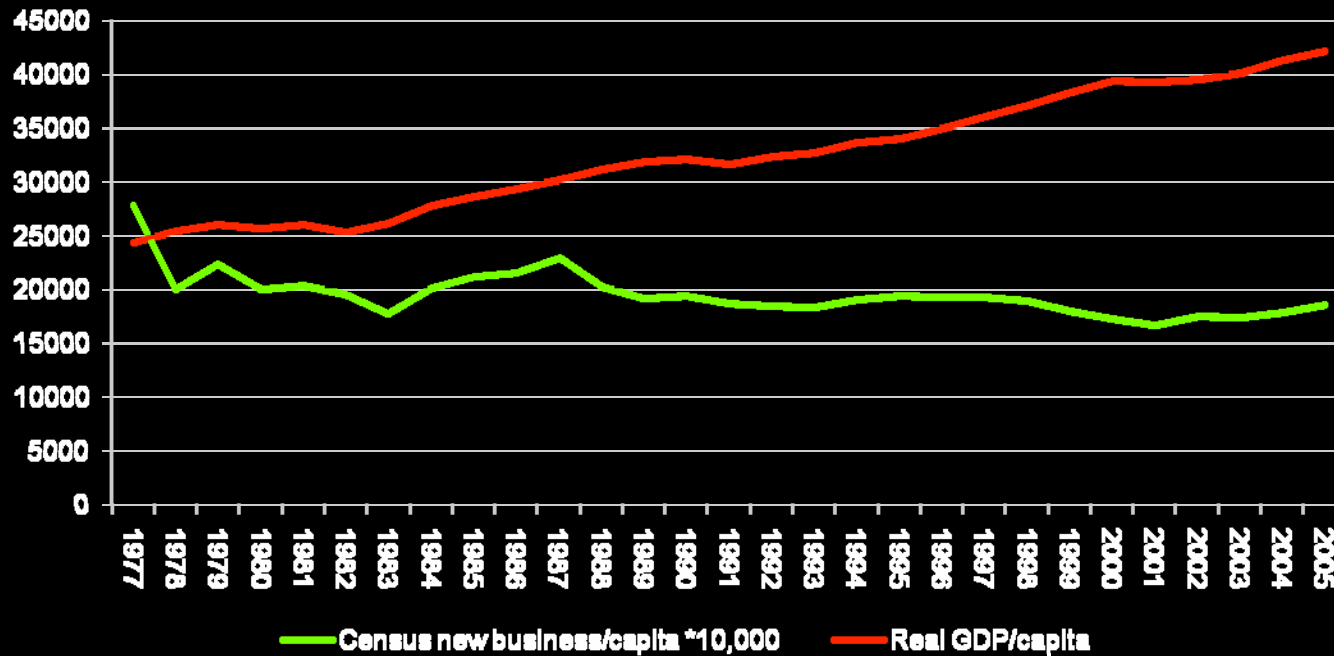
Having more start-ups won't cause economic growth

- Studies show a negative correlation between real GNP growth rates and self-employment rate in 19 OECD countries
- In the U.S. measures of entrepreneurship per capita have been declining over time as the country gets richer.

Start-up rate is inversely related to wealth



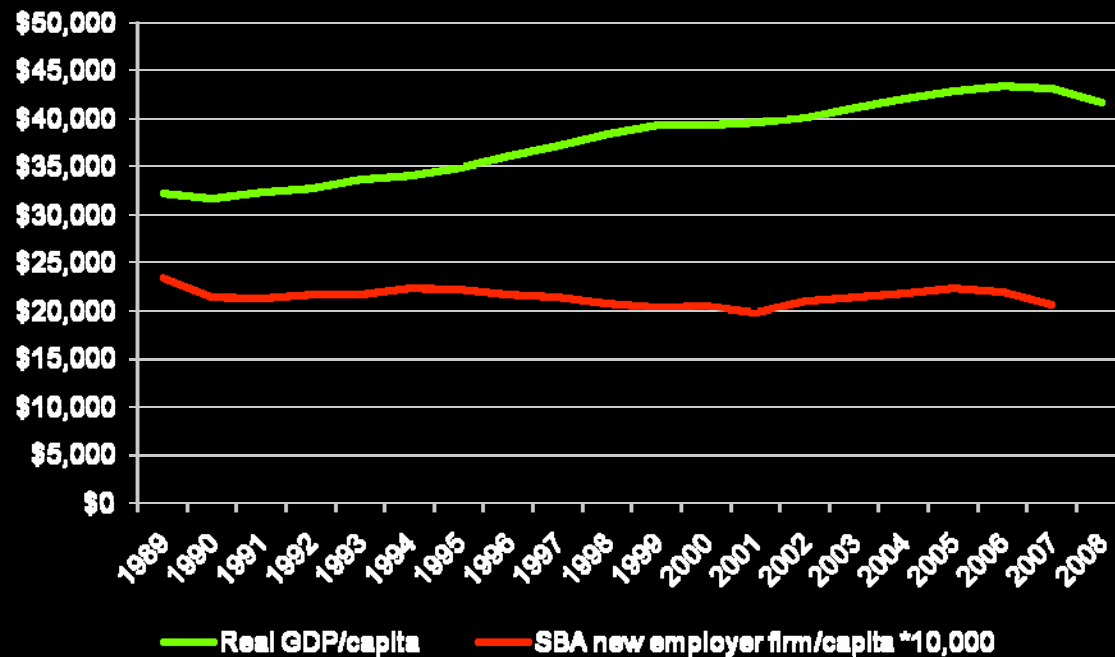
Real GDP Per Capita and Start-up Rate Per Capita Over Time



Source: Created from data from Bureau of Economic Analysis and the U.S. Census Bureau, Longitudinal Business Dynamics

Real GDP has gone up while employer starts per capita has declined

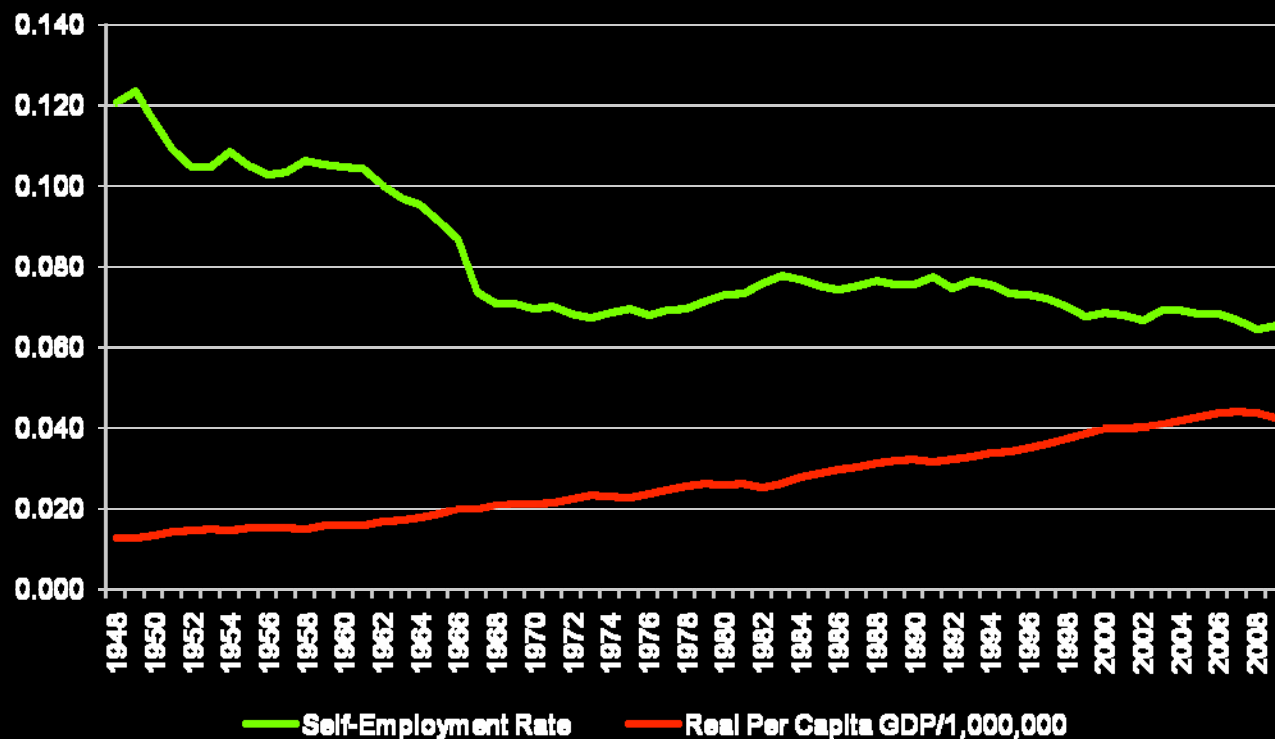
Real GDP Per Capita and New Employer Firms Per Capita Over Time



Created from data from the Office of Advocacy, U.S. Small Business Administration

Self-employment rate has fallen while real per capita GDP has risen

Real GDP Per Capita and Self-Employment Rate Over Time



Source: Created From Data From Bureau of Labor Statistics

Places with more start-ups have fewer high growth companies

- Anniston, Alabama and Laramie, Wyoming are top MSAs for rate of company formation in the US; San Francisco and San Jose – the poles of Silicon Valley – score poorly
- The correlation between rate at which firms growing at 20 percent or more per year and the rate of new firm formation in an MSA is negative

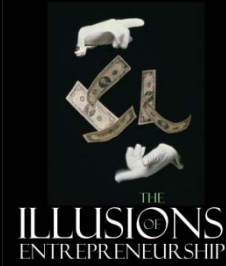
The wrong people respond to the incentives to start companies

- People with few alternatives are most likely to respond to incentives to start businesses because their opportunity cost is lower
- But they start worse businesses because their hurdle for what kind of business is worth starting is much lower.
- So policies designed to increase the total number of new businesses disproportionately attract the worst entrepreneurs.

The reality of entrepreneurial job creation

- ⦿ Companies less than two years old with at least one employee account for only 1 percent of US employment (Acs and Armington, 2004)
- ⦿ New firms are responsible for about 7 percent of the gross jobs created annually
- ⦿ Yield from firm formation efforts is poor; only 1/3 of people who start the firm formation process manage to create a firm, only 1/4 of them employ anyone, yielding 0.33 jobs/start-up effort

For a cohort, there is no net job creation over time



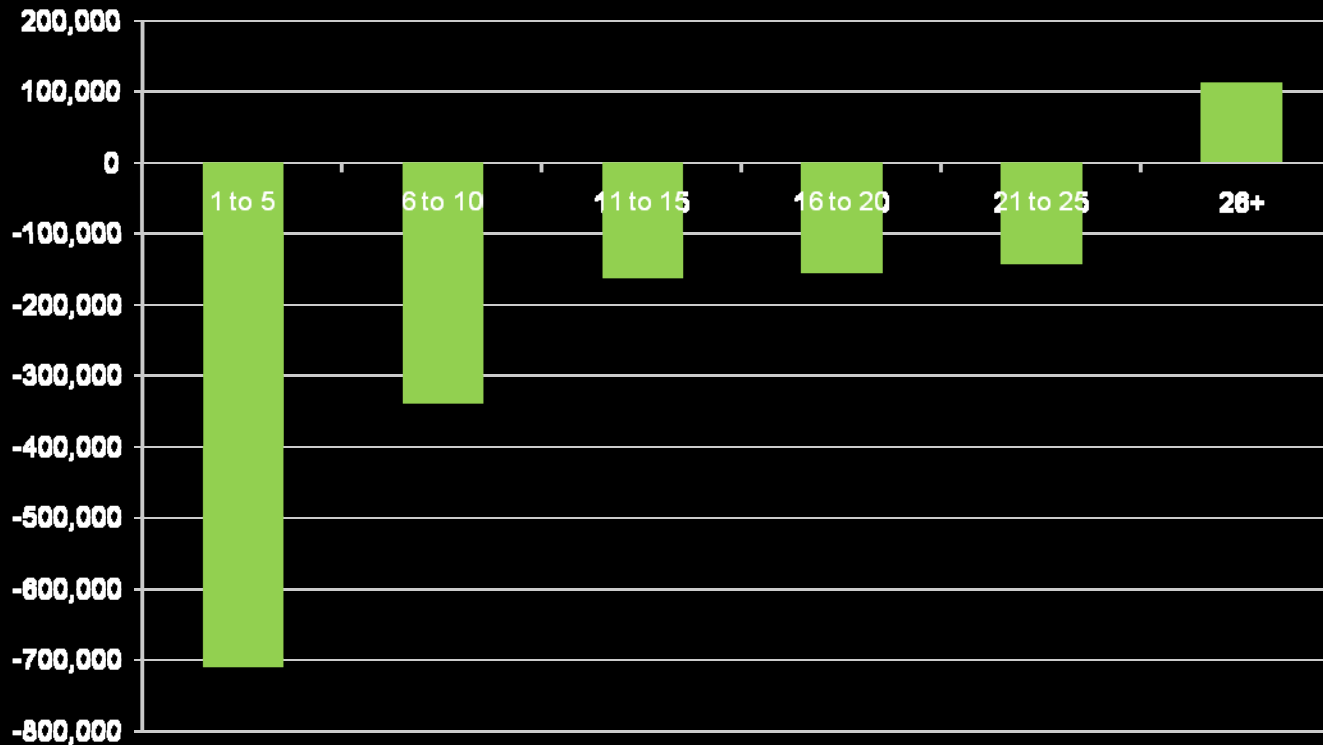
Employment of 1998 Cohort of New Businesses Over Time

	1998	1999	2000	2001	2002
Overall	798,066	792,131	781,506	721,103	670,111

Source: Created from data from A. Knaup, "Survival and Longevity in the Business Employment Dynamics Data," *Monthly Labor Review*, May 2005, 50–56.

Young firms are net job destroyers

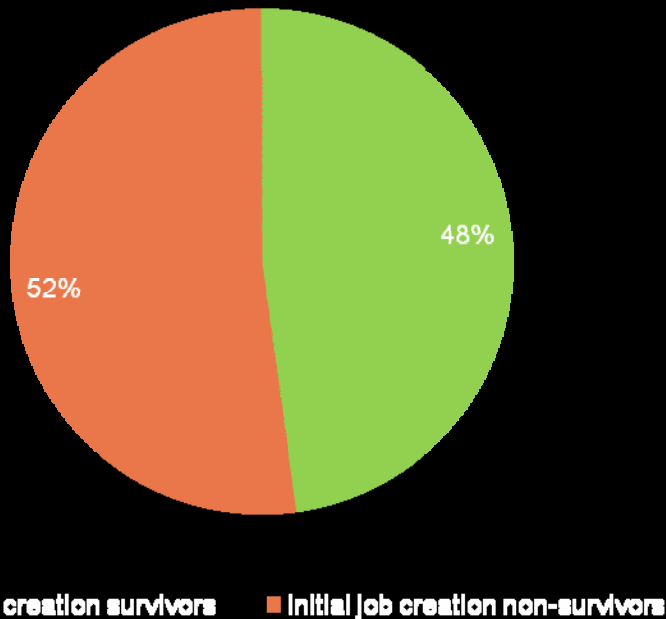
Net Job Creation Post Founding by Firm Age in 2005.



Source: Created from Data from Longitudinal Business Dynamics U.S. Census Bureau;

Soon-to-fail entrepreneurs are big job creators

Jobs Created at Start by New Firms That Survive and do not Survive Five Years



Source: Created from Data from Longitudinal Business Dynamics U.S. Census Bureau;

Which entrepreneurs should be encouraged?

- ◉ Skewed distribution - a tiny sliver of companies accounts for the vast majority of job creation and economic growth from entrepreneurship
- ◉ Many gazelles are fairly old at the time that they become major wealth and job creators

The venture capital numbers

- Since 1970, U.S. venture capitalists have funded an average of 820 new companies per year
- These 820 start-ups – out of the more than 1.5 million companies started every year - employ 9.4 percent of the private sector labor force and generate 9.6 percent of business sales

Implications

- ⦿ Getting economic growth and jobs creation from entrepreneurs is not a numbers game
- ⦿ It is about encouraging the formation of high quality, high growth companies

Can't pick winners? Then avoid losers

- ◎ Some argue that we can't choose companies to back because don't know which start-ups will become high growth businesses
- ◎ But we can identify start-ups with a low probability of generating jobs and enhancing economic growth
- ◎ By reducing the rate of creation of these companies, we can improve the average performance of new businesses

Which company would you invest your money in?

- A personal cleaning business that is started by an unemployed high school drop out, that is pursuing the customers of another personal cleaning business, and is capitalized with \$10,000 of the founder's savings
- An Internet company that is started by a former SAP employee with fifteen years of experience in the software industry, an MBA and a master's degree in computer science, that is pursuing the next generation of Internet search, and is capitalized with \$250,000 in money from the founder and a group of business angels

Think like a venture capitalist...

Look at:

- ① Human capital of the founder
- ① The industry in which the company was founded
- ① The business idea and strategy
- ① The legal form and capital structure

All predict the performance of start-ups

Change the approach

- ⦿ Stop encouraging the formation of typical start-ups by reducing the transfer payments, loans, subsidies, regulatory exemptions, and tax benefits that encourage more and more people to start businesses
- ⦿ Reallocate the resources to policies that support high growth companies program

There may be reasons to encourage start-ups

- ◎ Entrepreneurship has many benefits
 - Can reduce social unrest by giving people something to do
 - Makes people happier
- ◎ But don't say A and do B
 - Telling people we subsidize your neighbor's venture so you will get a job is disingenuous
 - Tell people that we subsidize your neighbor's venture because it gives her something to do and makes her happier

Questions and comments

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