

Economic Development: Changing the Policy to Support Entrepreneurship

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ABSTRACT

This article explores the traditional approach to economic development which embodied the battle cry, "*What's good for General Motors is good for America.*" The authors explore and explain the changes in the world economy which have made the traditional approach passé. They explore the impact of entrepreneurship on employment and the U.S. economy, and demonstrate that the greatest impact on the economy during the decade of the 1990s, as well as the greatest potential for future economic development, is vested in those firms with less than 20 employees. The authors propose specific economic development policy changes which can result in creating an atmosphere which is more conducive to entrepreneurial activity, and suggest that the battle cry should be changed to, "*What's good for Entrepreneurship is good for America.*"

INTRODUCTION

The local television news broadcast last night opened with the announcement of the closing of a factory which employed 500 people in the county. The factory is closing its doors and all of the workers will be unemployed within three months. Like most people in the United States, the authors have heard this or a similar story many times in the last few years. This is, indeed, a dismal story, and yet, one which was completely predictable. In fact, had one cared to look into the future 20 years ago when that factory was first built and first began operations, one would have known that it would close some day; the only unknown factor was when it would close. Since all factories are subject to declining efficiencies, all of them will eventually close. When they do, the effects are likely to be devastating. In the opinion of the authors, economic development which is based upon wooing large manufacturing firms is not sustainable. What is sustainable? In the opinion of the authors, economic development based upon entrepreneurial activity is sustainable. In the following pages we will demonstrate the bases for both of these conclusions.

ECONOMIC EVOLUTION

Schumpeter (1942) predicted the managed economies which emerged after World War II with their emphases on giant corporations practicing economies of scale. These managed economies performed well for western nations for more than 40 years, fostering a period of economic prosperity, jobs growth, stability and security (Audretsch & Thurik, 1997; Wennekers & Thurik, 1999). However, the end of the Cold War ushered in a new economic era and a true global economy which made maintaining jobs in high wage nations problematic (Audretsch & Thurik, 2000).

This “new economy” which emerged in response to the new economic era, or which likely caused the evolution of the new era, functions differently and the effects of entrepreneurship are more dramatic. For example, IBM faced 2,500 competitors for its products in 1965; in 1992, it faced 50,000 competitors (Atkinson & Court, 1998). The turbulence and competitive intensity which emerged during the 1980s and continue today is accelerating. The number of firms being born and dying each year is growing and this undermines the stability of old economic arrangements. As less innovative and less efficient companies die or contract, more innovative and more efficient companies take their place (Atkinson & Court, 1998). In the 1950s and 1960s, it took 20 years for one third of the Fortune 500 to be replaced by other firms; another one third was replaced in the following 10 years; but it only took 5 years to accomplish the same replacement during the 1980s (Audretsch, 1995). Consumer choices are exploding with more than 50,000 new products appearing each year, in comparison to a few thousand annually in 1970 (Atkinson & Court, 1998). Innovation and intellectual capital are soaring. Consider that 80,000 trademark applications were filed in 1989, a record year, but 180,000 were filed in 1995 (Atkinson & Court, 1998). In the new economy of the 1990s and 2000s, entrepreneurial effort and innovation emerged as the dominant factors of employment growth and economic development. Large corporations had to downsize to survive, while new firms in new industries created the jobs (Davis, Haltiwanger & Schuh, 1996a; 1996b; Carree & Klomp, 1996). In fact, in manufacturing, employment grew by 21.25% in firms with less than 20 employees and decreased by 8.47% in firms with more than 500 employees between 1990 and 1995 (Audretsch & Thurik, 2000; Acs & Armington, 1998).

These changes were occurring planet wide. Konings (1995), Hughes (1993), and Robson and Gallagher (1994) found that small firms became the key to employment growth in the United Kingdom during the 1980s. Baldwin and Picot (1995) found the same pattern in Canada; and, Bais, Bangma and Verhoeven (1997) reported on the importance of small firms in the Netherlands in the early 1990s. This was apparently not the case in Germany (Wagner, 1995), but aside from its experience, small firms have created most of the new jobs in Europe and North America (Audretsch & Thurik, 2000).

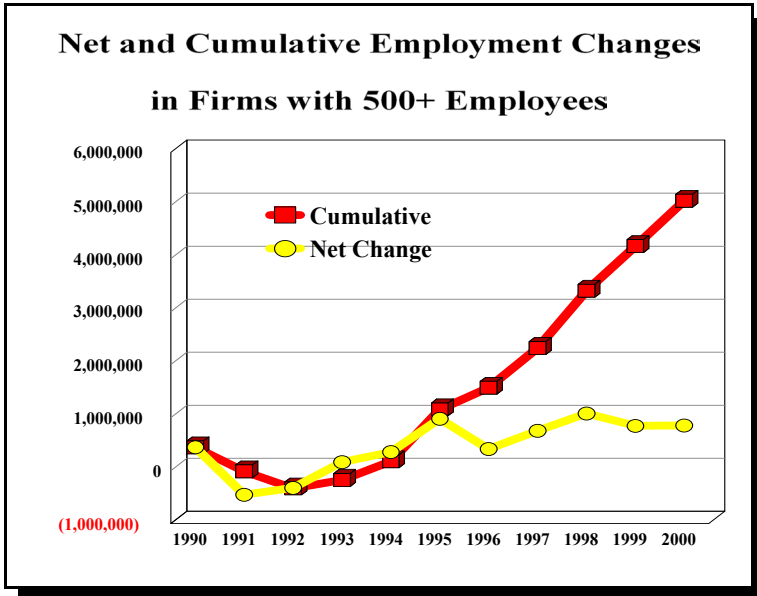
At the same time that the “new economy” was emerging, a focus on economic value-added evolved during the mid 1990s (Roberts & Cohen, 2002), and the concepts of social and natural capital began to be used to explain differences in regional economic performance (Grootaert, 1997; Helliwell & Putman, 2000). Social capital, in this perspective, represents the combined knowledge, cultural assets, skills, competencies and networks of civic society (Nelson, 1998). Natural capital represents the environmental attributes of a region and its natural resources (Hawken, Lovins & Lovins, 1999). Mohapatra (1998) presented evidence that economic development is not sustainable if it fails to replenish and develop these other forms of capital. Hawken, Lovins and Lovins (1999) suggest that traditional economic development is not sustainable because it depletes the stock of natural capital and limits the potential to increase social capital.

PATTERNS IN EMPLOYMENT CHANGES

The Office of Advocacy, U.S. Small Business Administration, maintains records on employer firm births, deaths, expansions and contractions. These data, drawn from the U.S. Bureau of the Census track employment changes in firms which actually have employees. In other words, firms without employees are excluded. Further, a firm must survive for at least 5 years in order to be counted in the data. This information is now complete for the decade 1990 through 2000, and it forms a fantastic basis for evaluation of the patterns in employment in the United States. It is

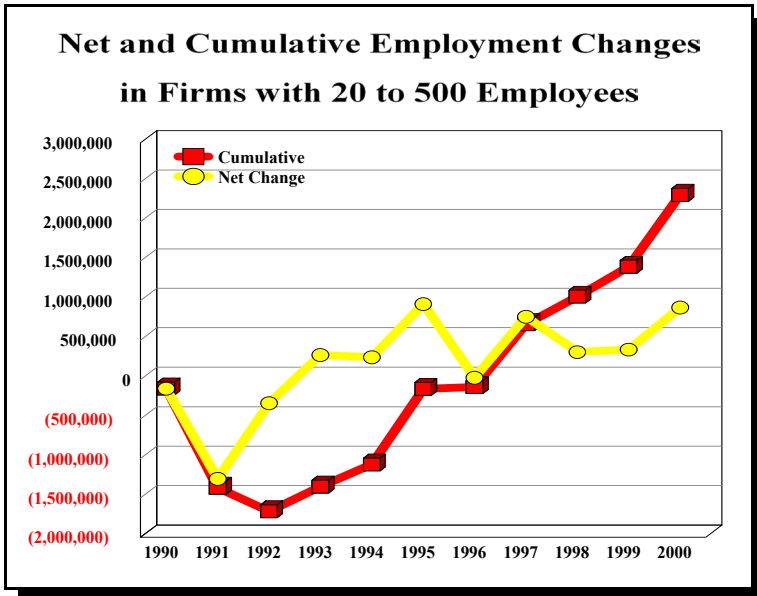
available on the SBA web page (www.sba.gov/advo/stats/dyn_b_d8900.pdf). Data in the following graphs were drawn from the SBA statistics.

The figure to the right presents a graph of the net effect on U.S. employment each year of births, deaths, expansions and contractions of firms with 500 or more employees for each year during the decade, 1990 through 2000. In addition, the graph plots the cumulative effect on employment of the large firm sector. To put the data into perspective, of the 5,074,000 employer firms in existence in 1990, 14,000 had 500 or more employees; and, of the total 1990 labor pool of 93,470,000, these large firms employed 43,302,000 (www.sba.gov/advo/research/rs190tot.pdf). As the graph shows, in aggregate, firms with 500 or more employees produced an increase in employment between 1990 and 2000 of five million jobs. That represents a total increase in employment over the decade of 5.4%, or an increase in the large firm work force of 11.8%.



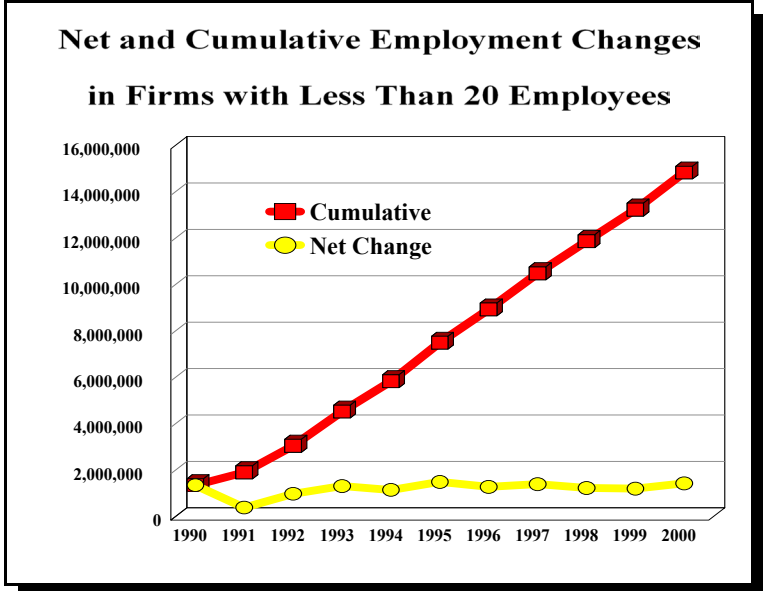
It appears that the downsizing, outsourcing, and reengineering that has been in vogue for the last decade has taken a toll on employment in large companies. Then, dare we say it? There is the malfeasance. Look at Enron and its gigantic failure, the 7th largest firm in the world at the time of its collapse. Not only were the employees of its worldwide reach out of work, hundreds of other smaller companies were impacted by its decline. Suppliers of various types lost their way as well as the accounting firm which allowed the malfeasance. The ripple effect of large company failure is far more dramatic than once thought.

To examine how that performance compares with middle sized firms, consider the data displayed on the graph to the right. As before, the graph shows the net effect on U.S. employment each year of births, deaths, expansions and contractions of firms. For this sector, the authors have isolated firms with more than 20 employees, but less than 500 employees. In 1990, there were 472,000 such firms, employing 31,255,000 people (www.sba.gov/advo/research/rs190tot.pdf). As the graph shows, these firms accounted for a net increase in U.S. employment over the decade of



2,342,000 jobs. That represents an increase in total employment of 2.5%, or an increase in the middle sized firm sector employment of 7.5%. Clearly, the middle sized firm sector contributed less to the U.S. economy during this decade than did the large firm sector. This was largely the result of the significant decrease in employment that occurred in 1991 and 1992.

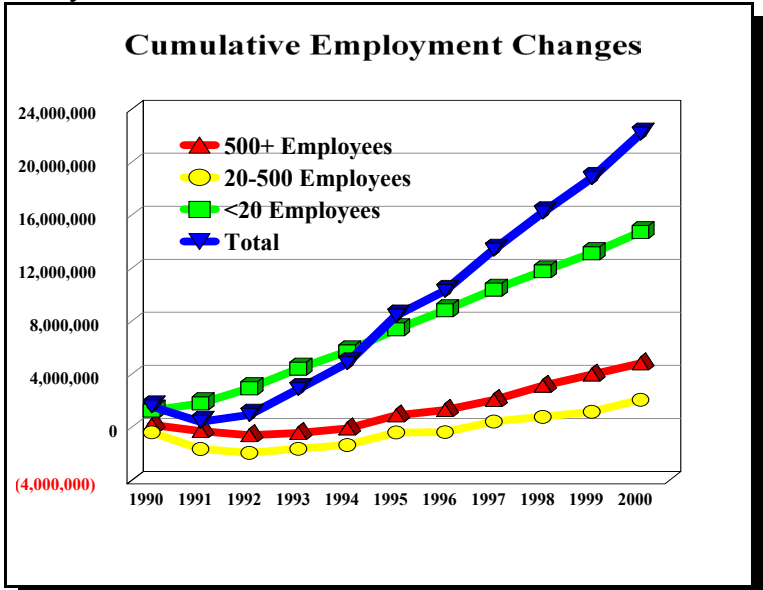
The impact of the smallest firms in the U.S., those employing less than 20 employees, is displayed in the figure to the right. There were 4,588,000 such firms in 1990, employing a total of 18,812,000 people. As the graph shows, the cumulative effect of this employer firm sector over the decade was an increase in total employment of 14,989,000 jobs. That represents an increase in the total U.S. employment of 16%, and an increase in the small business sector employment of 79.3%. Clearly, the impact of this sector on the economic development of the nation is dramatically superior



to the middle sized and large firm sectors. The impact is not just a function of the number of firms, as the total employment of the sector grew by almost 80% during the decade. The small firms increased significantly in number, and increased significantly in employment, and did so while both of the other sectors were growing at only modest rates.

One should keep in mind that the foregoing data represents only employer firms. Proprietorships and small businesses without payrolls are not included in the data. There are 16 million more such firms in the U.S., and although their impact is on a single person, they represent a formidable sector of the nation's economy.

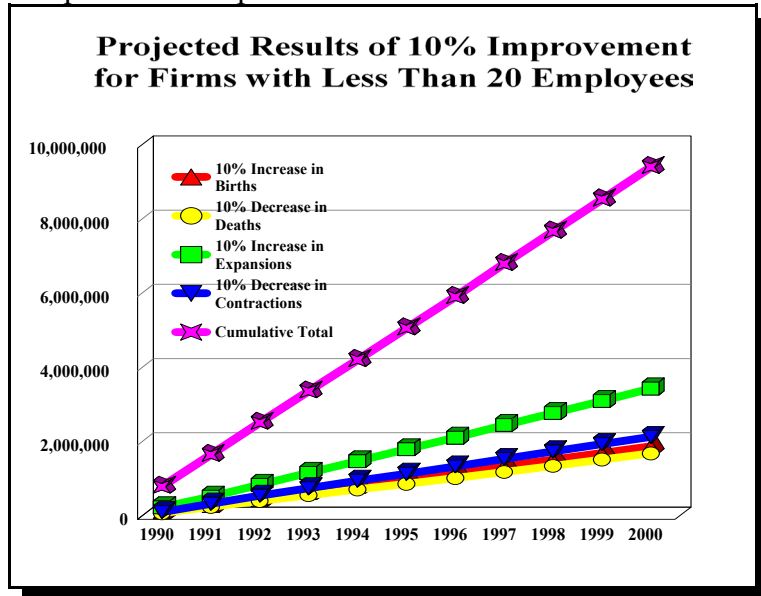
The graph to the right recaps the total growth in jobs over the decade, and shows the source. In total, U.S. employment rose by 22,420,000. The smallest employer firms in the nation, those with less than 20 employees, accounted for 67% of this growth; firms with 20 to 500 employees accounted for 10% of the growth, and firms with more than 500 employees contributed 23% of the growth. This suggests that our economic development emphasis has been misplaced.



THE NEED FOR CHANGE IN ECONOMIC DEVELOPMENT POLICIES

Traditional economic development activity has involved local government and state employees actively soliciting and recruiting large employers through offers of tax moratoriums, training and relocation assistance, infrastructure development or enhancement, or any of a host of other incentive programs or proposals. These efforts are expensive and have been highly lauded in the past as major sources of job growth in a state or county. What would be the effect of expending a portion of the cost of these programs in efforts aimed at improving the success of the smallest firms in the nation? To answer that question, the authors undertook an examination of the data reported above from the perspective of a speculative impact.

The graph to the right displays the net effect, and the aggregate cumulative impact, of a 10% increase in the birth rate of firms with less than 20 employees, a 10% decrease in the death rate of such firms, a 10% decrease in the employment contraction of such firms, and a 10% increase in the expansion rate for such firms, over the decade of the 1990s. As the graph shows, the cumulative total effect would have been dramatic, to say the least. Had our economic development efforts targeted this smallest firm sector, and had they only had an average of a 10% improvement in performance, the nation would have experienced an increase in employment of 9,494,000 jobs; or a 42% increase in employment growth.



Could economic development efforts have impacted this sector? The battle cry of economic development people 30 years ago, “*What’s good for General Motors is good for America,*” might have made sense then, but it certainly does not today in a climate dominated by entrepreneurship. Consider the difference in perspective which a change in target embraces. If one wishes to focus on supporting large ventures, then economic development efforts should focus on natural resources, labor and capital, but if one wishes to focus on entrepreneurial development, then economic development policies must shift to creation of an environment which facilitates the creation and commercialization of knowledge (Audretsch & Thurik, 2000).

Specific recommendations for local, state, and federal policies which contribute to the development of a supportive environment for entrepreneurship include:

- Policies that channel formal and informal financing to prospective, nascent and established entrepreneurs;
- Policies that decrease the regulatory and compliance burden of small, and start-up ventures;
- Policies that encourage and support private investment in start-up and growing ventures;

- Policies that support and expand research and development activities in public and private institutions and organizations;
- Policies that improve and expand education and training opportunities and access; and,
- Policies which support the development of clusters of entrepreneurial interest and emphasis.

Could diversion of a portion of the local, state, and federal expenditures for economic development over the last decade have impacted small businesses? The authors believe so, and the potential gains from such diversion are so great that they cry out for change. Reynolds, Bygrave, Autio, Cox and Hay (2002) conducted a study of entrepreneurship in 37 nations, funded by the Kauffman Foundation. Their study, published as the *Global Entrepreneurship Monitor*, which included data from 1999, 2000, and 2001, clearly established direct linkages throughout the world between entrepreneurial activity, and both gross domestic product and employment. The United States ranked eleventh in entrepreneurial activity behind Thailand, India, Chile, Korea, Argentina, New Zealand, Brazil, Mexico, China, and Iceland. Further, the U.S. reported declines in the growth rate of its entrepreneurial activity during the period of study and these were reflected in declines in the growth rate of its gross domestic product (Reynolds, Bygrave, Autio, Cox & Hay, 2002). What stronger wake-up call could exist? It's time to change the battle cry to, "*What's good for Entrepreneurship is good for America.*"

ENTREPRENEURSHIP AND WAGES

One concern which seems to impede economic development policy change is that job creation by small firms is associated with low wages. A number of empirical studies have demonstrated that small firms pay lower wages (i.e., Brown, Hamilton & Medoff, 1990; Oosterbeek & Van Praag, 1995). These studies employed static, cross sectional methodologies. That is, the researchers measured aggregate wages by firm size (Audretsch & Thurik, 2000). That approach includes small firms which will not survive. A more dynamic view of entrepreneurship suggests that people start firms to pursue new and untested ideas, and market reaction determines the viability of those ideas (Jovanovic, 1982). If the idea is not viable, the firm will stagnate and may ultimately die, but if the idea is a good one, the firm will grow and flourish (Geroski, 1995). Using longitudinal data, Baily, Bartelsman and Haltiwanger (1996) showed that the wages and productivity of new firms increase as the firm matures and ages. In other words, some of the low wage firms of today will become the high wage firms of tomorrow, and many of those that do not, will not ultimately survive. Looking at firm size and wages in isolation at a single point in time distorts the data because it does not reflect the potential impact of those firms that will grow, but are still in the throes of establishing themselves in the marketplace. It also includes static firms which will ultimately exit the marketplace because they are not really viable. Consequently, abandoning a static, cross sectional methodology leads to a conclusion that entrepreneurship creates not only greater employment, but higher wages, as well (Audretsch & Thurik, 2000).

CONCLUSION

From a global perspective, entrepreneurship is the backbone of our economies and the mandate for the wealth of our nations. It is at the very core of our existence. It is, at once the source of economic stability and the well spring of innovation. It is this uniqueness of entrepreneurship

which the authors find so fascinating: its ability to provide economic stability at the same time that it propels innovation. All this from the dreams of people.

The authors' favorite expression comes from the movie, *Tucker: The Man and his Dream*. In one sequence, Abe is trying to express how much Tucker has meant to him when faced with dire consequences for the company. He says: "My Mom told me when I was little to stay away from people or you'll catch their dreams. Years later I realized I misunderstood her, germs, she said, not dreams. I got too close to you, Tucker, and I caught your dreams." Entrepreneurs can do that: they can infect other people with their dreams. When we change economic development policy to encourage and support entrepreneurship, we will see the potential for such contagion in action. Simply reflect on what we have seen in the world to date. All around this shrinking globe we have seen the power of entrepreneurship, the true wealth of a nation. In tiny, developing nations we have seen entrepreneurship taking on the role of Prometheus and bringing fire to fuel economic growth. In formerly Communist countries we have seen entrepreneurship taking on the role of the Phoenix, rising reborn from its fiery nest to rekindle economic well-being. In our own history, we have seen a tiny band of refugees fleeing economic and religious persecution build a wilderness into a nation which covered the world with Yankee trader ships and which grew into a leader of the Western World. We have seen the war torn, repressed peoples of Europe drive their nations back from the brink of economic disaster to become dynamic, vibrant members of a new world order. In all of these stories which we have witnessed upon the stage of history, one thread appears in every weave, one constant appears in every function, one aspect appears in every population: the entrepreneurial dream. Let's remove the barriers to that dream and watch it carry our world into a vibrant future.

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