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What Makes America Great? Entrepreneurship

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This chapter discusses the remarkable exceptionalism of American entrepreneurship and how entrepreneurship has been so critical in forging our nearly 250-year record of economic success. I will also discuss some policy options that can promote and foster entrepreneurship in the future.

America's vigorous entrepreneurial spirit predates the birth of our country by over a century and in fact goes back to 1607, which is the date of the first settlement in what became the thirteen colonies. One hundred and nine brave individuals from England set sail and came to the New World and settled in what is now known as Jamestown, Virginia. Contrary to popular belief, these settlers were not escaping religious persecution. Rather, this group represented 109 budding entrepreneurs. They were people who were undertaking the risk of a business and who came to Virginia with the idea that they were going to make a better life for themselves, with the hope of becoming successful.

Like most new businesses, the Virginia Company, which was the name of the Jamestown enterprise, failed miserably. The Virginia Company confronted the same challenges that any new business faces. These included difficulties in developing and implementing a business plan. In particular, the Virginia Company couldn't figure out which crops would flourish in Virginia. They also faced the more critical problems of trying to survive in environs so different from England.

As with many other new-business failures, the substantial risk of making a profit could not be overcome. But this failure also promoted future economic success. Subsequent settlers in Virginia learned from the miscues of the Virginia Company and found out through trial and error that tobacco would flourish in the Virginia climate. The demand for tobacco, and the rich soils of Virginia, made the new Virginians wealthy beyond their dreams. More broadly, the colonies grew from a few hundred settlers in the early 1600s to two million people—two million of the world's wealthiest people—just prior to the American Revolution. Entrepreneurship is part of America's DNA, and that same entrepreneurial spirit continues today.

To get a sense of the importance of entrepreneurship in the US economy, note that twenty-two American companies that began in 1976 or later are now among the five hundred largest corporations in the world, including Apple Computer, Microsoft, Google, and Costco. In contrast, continental Europe, which has a larger population than the United States, does not have a single company that began in 1976 or later among the largest five hundred in the world. Not surprisingly, it has enjoyed much less economic success over this period than the United States has.

Entrepreneurial continuity is critical for our future economic success, and entrepreneurs are the single most important force in driving economic growth and innovation. Just a few of our important entrepreneurs and their innovations and enterprises include Henry Ford and assembly-line production; the Wright brothers and the airplane; George Eastman and the camera; Bill Gates and Paul Allen of Microsoft; Steve Jobs of Apple Computer; Fred Smith of FedEx; Jeff Bezos of Amazon; and Howard Schultz of Starbucks.

These American entrepreneurs not only succeeded individually, but their success in turn created enormous wealth for society by way of creating new job and investment opportunities as well as new goods and services. In the process of developing and implementing their innovations, entrepreneurs transform the economy and the world that we live in. They are truly a gift to society. The wealth that they create for themselves is just a grain of sand on the beachfront that they create for the rest of us.

Today, the United States faces a crisis in entrepreneurship. The entrepreneurship rate, which is the number of new businesses started each year divided by the number of existing businesses, has declined by about 35 percent since the 1980s, and much of that decline has occurred since 2009.

To understand the importance of the current entrepreneurship deficit, I note that economic growth has change markedly in the United States since 2009. In particular, the United States is the only country that until recently enjoyed a largely uninterrupted and stable record of economic growth for over two hundred years. The historical average growth rate in per capita real gross domestic product, which is the most frequently used measure of a country's standard of living, is about 2 percent per year. This means that living standards in our country double about every thirty-five years.

However, America's remarkable record of stable economic growth is now in jeopardy. Figure 1 illustrates this problem by showing two lines.

The dashed line is the 2 percent growth trend described above. This line measures the expected position of our economy based on our historical record. The solid line shows actual per capita real GDP. The figure

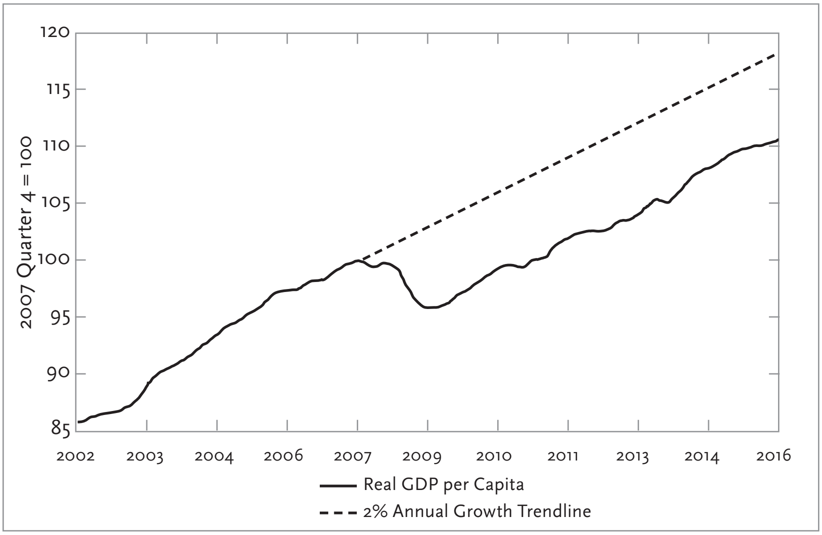

Figure 1. Real GDP per Capita

clearly shows the recession of 2008–9, and, more important, it shows that the economy has never recovered.

This is the first time in the history of the United States when the country did not recover from an economic downturn. To put this in perspective, the United States fully recovered from the Civil War and two world wars, from the Great Depression and the two major 1970s energy crises, from the savings and loan crisis, and from 12 percent inflation and nearly 20 percent interest rates of the early 1980s. But we haven't recovered from the 2008–9 recession, and this chart provides no evidence that we will. If the US economy had experienced a normal recovery after this recession, then the accumulated additional income over time, compared to our actual level of income, would nearly be enough to eliminate the US publicly held federal debt.

An important reason why we have not recovered is seen in the next graph (figure 2). I find this graph to be the most important and most depressing feature of our current economy, and it is one that you don't

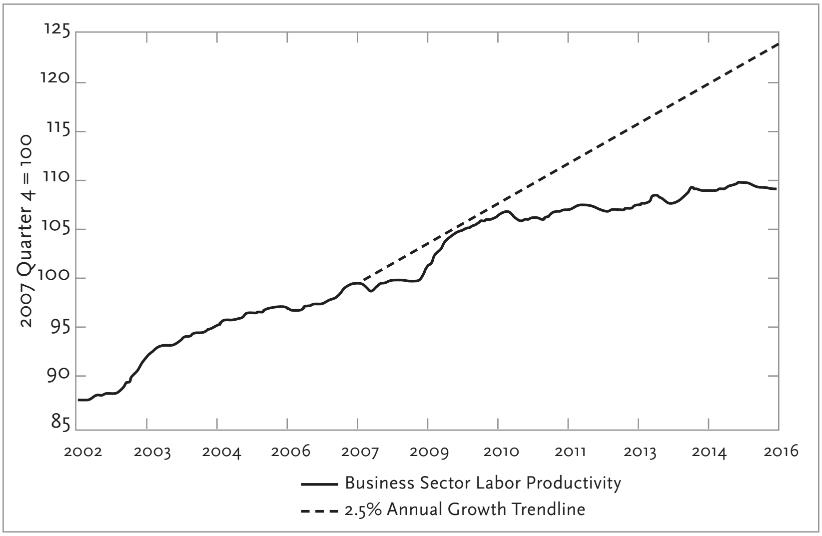

Figure 2. Productivity Is Well Below Trend

hear much about. It shows the enormous decline in the growth rate of worker productivity. American business sector productivity, which is the inflation-adjusted value added per worker, historically grew by about 2.5 percent per year. This means that it doubles every twenty-eight years. However, this growth rate has declined to about 0.9 percent per year. Consequently, you can see that there is now about a 14 percent gap between where our current productivity level is and where we should be. If productivity continues to grow at 0.9 percent per year, then it will double roughly every seventy-seven years, rather than its historical average of every twenty-eight years. This is a fundamental problem that we need to reverse to restore prosperity and growth.

Our current entrepreneurship deficiency has important implications for our current productivity-growth deficiency. To see this, note that all businesses have a life cycle. A few start-ups grow dramatically, become big, and transform the society that we live in. But ultimately, those businesses mature and then decline. A few big businesses, such as

IBM, which left computer hardware and is now in business consulting, and General Electric—which left consumer appliances and now specializes in medical imaging hardware and jet aircraft engines—reinvent themselves.

However, most big businesses are not able to reverse old age and succeed in other product lines. Does anybody remember Cone Mills or Hines Lumber or Pacific Vegetable Oil? They were all Fortune 500 companies and were an important part of our economic record at one time. But their decline is an equally important part of our economic record as new and better ideas come along and replace the old ideas.

The United States is not like continental Europe or South America, where large stagnant companies prosper because they receive subsidies and political payoffs. In contrast, the United States is a country that reallocates capital and labor from mature, declining businesses to very young growing businesses. In that process, the young replace the old within the life cycle of private enterprise. At one time, J. C. Penney, Woolworth, Montgomery Ward, and Sears ruled the American retail landscape. They have been pushed aside by Costco, Walmart, and Target.

Just before the financial crisis in 2006, start-ups created three and a half million jobs, while all incumbent businesses lost one million jobs. This statistic gives you a sense of how important entrepreneurs are for our economy.

In my view, our historically successful entrepreneurship record reflects four factors: an efficient financial system that has allocated capital to start-ups; historically sensible regulations; an excellent education system, which provided a deep pool of talented workers; and a tax code that didn't penalize small businesses.

More broadly, all of these factors historically reflect the United States' deep tradition of economic freedom. But all measures of our economic freedom have declined substantially. Before the financial crisis, the United States was ranked third in the world in terms of economic freedom, just behind Singapore and Hong Kong. Today we have fallen to sixteenth place, just behind Estonia.

This decline in economic freedom has coincided with a substantial increase in regulation, including financial regulation, a much lower ranked education system, and an increasingly complicated tax code that penalizes small business. Not surprisingly, this is the first time in the history of the United States that we have more exiting businesses than new businesses being born.

The United States substantially reduced regulatory burdens in the 1970s, 1980s, and 1990s, and this occurred under Republican and Democratic leaders. But since then, regulation has skyrocketed. The Small Business Administration commissioned a study to measure the cost of regulation. They estimated regulatory costs of $1.75 trillion in 2008, which had doubled from 2001. After 2008, these costs almost certainly have increased, with the Dodd-Frank Act and Obamacare. More broadly, Congress has chosen to delegate enormous regulatory authority to unelected commissions with no accountability whatsoever. These regulations cause disproportional impact on small business, including small banks. Lending to small business today is 20 percent below what it was during the financial crisis. How could that have happened?

A key problem is that the regulatory costs of the Dodd-Frank Act have increased the cost of lending, particularly to small community banks that do so much of the small-business funding in this country. Community banks are disappearing through consolidation, which is negatively impacting the financial system's capacity to make small-business loans.

The decline in the American education system is also negatively affecting entrepreneurs, who frequently report that it is hard to find qualified workers. Not so long ago, the American K–12 education system was the best in the world. Today, the Organisation for Economic Co-operation and Development, which administers international assessment tests in math and science to students, ranks us number twenty-seven out of thirty-four countries in international mathematical assessment. Our scores are comparable to, or even lower than, developing countries that spend 50 percent less per pupil. Why aren't our students performing better? In my view, teacher unions that protect underperforming teachers with teacher tenure are an important factor in this decline. The teacher dismissal rate for cause in California is just 0.003 percent. This means that only 3 out of every 100,000 teachers are dismissed for cause.

The dismissal rate for cause among workers in the private economy, however, is about 2,500 times higher. This suggests that teacher unions are protecting many poorly performing teachers through teacher-tenure provisions. Research by Hoover fellow Rick Hanushek shows that protecting underperforming teachers has an enormous negative effect on student learning. In particular, he finds that if the bottom tenth percentile of public school K–12 teachers were replaced with a median performing teacher, then US school achievement would rise from its current position near the bottom of the rankings to near the top.

Teacher unions not only keep poorly performing teachers in the classroom, but they also reduce the number of better performing teachers by blocking merit-based pay, which means that exceptional teachers are not paid what they are worth. In contrast, teacher union contracts typically link pay to tenure and training program certifications that are largely uncorrelated with teacher performance.

This discussion suggests that reforming teacher union contracts, particularly teacher tenure rules, and developing merit-based pay could have substantial positive effects on K–12 educational performance.

I now turn to what I call the dangerous "war on success" and how that's impacting entrepreneurship. Witness phenomena ranging from populist statements by former president Obama and Senator Elizabeth Warren, who have dismissed the importance of entrepreneurs, to policy proposals by former presidential candidates Hillary Clinton and Bernie Sanders, who have proposed raising tax rates substantially on the most productive earners. These increases include an investment surtax, a minimum tax rate that is referred to as the "Buffett Rule," much higher tax rates on capital gains, and a higher estate tax.

While these federal proposals will not become law under the current administration and the current Congress, there are similar proposals being made at the state and local government levels. This includes California's Proposition 55, which was passed in November. This proposition continues the 13.3 percent tax rate on the highest earners to 2030. This is particularly egregious because the 13.3 percent tax was explicitly marketed to voters by Governor Jerry Brown as a temporary tax to help restore California's fiscal stability following the recession. Voters approved the proposition with the view that "the rich can afford to pay, and the state needs the money."

A key to the passage of Proposition 55 was a populist strategy of allowing the higher state sales tax rate that was part of the original tax increase, and which impacted all Californians, to sunset. Not surprisingly, the proposition passed with over 63 percent of voters choosing to penalize the most productive workers in the state. Moreover, this clearly indicates that politicians will blatantly break promises if it means increasing revenue. Of course, this strategy, both with regard to breaking promises and with continuing to penalize success, may ultimately backfire if more high-earning Californians choose to leave the state. A study conducted by Spectrum Location Solutions, a firm that helps businesses determine where to locate, estimates that more than 10,000 businesses either left the state, substantially reduced operations, or chose not to locate in California between 2008 and 2015.

The war on success also takes place in the regulatory arena, particularly through the Dodd-Frank Act. The consumer protection bureau of the Dodd-Frank Act has been given almost an unconstrained ability to prosecute lenders. It has, for instance, prosecuted auto lenders for discrimination against minorities without any direct evidence of discrimination.

The consumer protection bureau guesses whether an individual is a minority based on their last name and address. Given such skimpy proof of discrimination, it is reasonable to wonder why a defendant would not fight this vigorously. It turns out, based on consumer protection bureau records, that the defendants in this lawsuit were chosen based on the expectation they would simply settle the suit. Is this consumer protection, which of course is the purpose of regulation, or is this a political shakedown of deep-pocketed lenders? It seems to me that this is a violation of our rule of law.

There has also been a substantial increase in regulatory intrusion in housing, including what are known as disparate impact lawsuits against business practices that are not discriminatory in terms of treating people differently but unintentionally harm a protected group. Typically, plaintiffs don't need to show that the practices intended to be discriminatory; they just need to show that the practice created a different outcome for a protected group.

Recently, a nonprofit organization promoting neighborhood integration sued the Texas Department of Housing for providing tax credits for new housing construction in minority neighborhoods. New investment within a neighborhood sounds like a welcome development, but not to the plaintiffs. Their logic is that new housing in a minority neighborhood improves the neighborhood, which in turn suggests that more families will remain in the neighborhood rather than move to other neighborhoods.

The lawsuit, and the pretzel logic defining the government's position, went to the Supreme Court in 2013. The plaintiff's case was argued by the US solicitor general, who adopted the view that improving minority neighborhoods interferes with the goal of integration. In questioning the solicitor general, Chief Justice John Roberts asked, "What is the bad thing, to build new housing in a minority neighborhood, or to build housing in an affluent neighborhood with the goal of increasing integration?" The solicitor general had no reasonable alternative but to agree with Roberts that both proposals would be regarded as positive developments for minorities. But despite Roberts's ridicule of the disparate-impact theory, the Supreme Court decided in favor, five to four, of the plaintiffs.

The examples described here show how policies have evolved over time to sharply restrict economic and personal freedom. Restoring prosperity requires restoring economic freedom, which in turn will promote entrepreneurship. Following the November 2016 elections, the country has a terrific opportunity to make policy changes in the areas of regulation, taxation, and education that could substantially improve the climate for entrepreneurs.