

# Economic SYNOPSES

short essays and reports on the economic issues of the day

2004 ■ Number 12



## Entrepreneurship

Rubén Hernández-Murillo

The U.S. economy's remarkable resilience in the face of shocks arguably owes to an array of institutions and policies that reward entrepreneurial activity. A competitive market system, a sound legal framework that secures property rights, a robust financial system, monetary stability, low inflation, and generally flexible labor markets encourage new business start-ups. Together these ingredients act as an engine for sustainable long-run economic growth. In such an environment, entrepreneurs have strong incentives to develop new products and new technologies and to discover profit opportunities that ultimately direct society's resources toward the most productive activities.

In the United States, entrepreneurship fosters small business growth. Firms with fewer than 500 employees represent about 99.7 percent of all firms and account for about half of all private nonfarm output and employment. As one would expect, the turnover among small firms is very high. In 2002, for example, 550,100 new firms were created and 584,500 firms closed down. Between 1999 and 2000, job creation by new or expanding establishments of small firms amounted to about 10.8 million employees, while job destruction at establishments that downsized or closed totaled about 8.3 million employees. The net change of 2.5 million employees in small firms, however, represented 75 percent of the net nonfarm employment change in the United States.<sup>1</sup>

Economists Steven Kreft and Russell Sobel argue that the key link between economic freedom—the combination of favorable legal institutions and tax and regulatory policies—and economic growth is entrepreneurial activity.<sup>2</sup> While several studies have found that nations with higher economic freedom tend to have larger per capita income and higher rates of economic growth, Kreft and Sobel analyze entrepreneurial activity across the 50 U.S. states as a function of political, legal, and regulatory factors. They find a statistically significant and positive relationship between the growth of entrepreneurial activity—measured by the annual growth rate of sole proprietorships—and states' scores on an index of economic freedom.

Their results suggest that a state's economic freedom is an essential factor in the state's ability to create and attract entrepreneurial activity. The economic freedom index is a composite measure of three areas of state policies: size of government,

discriminatory taxation, and labor-market flexibility.<sup>3</sup> The table illustrates the positive relationship between the economic freedom score in 1996 and the growth in entrepreneurial activity in the period 1996-2001. The five states with the highest freedom scores experienced, on average, higher growth in the rate of entrepreneurship—measured as the number of nonfarm sole proprietors divided by the population between 25 and 64 years of age—than did the five states with the lowest freedom scores.

These analyses, Kreft and Sobel insist, strongly suggest that political and economic liberties do not work individually to promote economic growth, but rather they exert influence as a complementary group through their incentive effect on entrepreneurial activity. ■

<sup>1</sup>United States Small Business Administration, <http://www.sba.gov/advo/stats/>.

<sup>2</sup>Kreft, Steven F. and Sobel, Russell S. "Public Policy, Entrepreneurship, and Economic Growth." Unpublished manuscript, West Virginia University, 2003.

<sup>3</sup>Karabegović, Amela; McMahon, Fred; Samida, Dexter; with Mitchell, Glenn. "Economic Freedom of North America 2004 Annual Report." The Fraser Institute (Canada), 2004.

	Economic Freedom Score 1996 (0-10)	Growth of Entrepreneurship 1996-2001 (%)
<b>Five highest scores</b>		
Delaware	7.7	12.2
Colorado	7.4	7.9
Wyoming	7.4	4.6
South Dakota	7.3	5.5
Georgia	7.2	7.2
Average	7.4	7.5
<b>Five lowest scores</b>		
Washington	6.0	0.5
Maine	5.7	6.8
Rhode Island	5.7	6.0
West Virginia	5.7	8.2
Montana	5.6	5.0
Average	5.7	5.3

SOURCES: Sole proprietorships: Bureau of Economic Analysis. Population: intercensal estimates of population, Bureau of the Census. Economic Freedom Index: The Fraser Institute.

*Views expressed do not necessarily reflect official positions of the Federal Reserve System.*