WHY DO ENTREPRENEURS APPEAR AND FLOURISH?

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Economists have spent a great deal of effort, beginning with Adam Smith in 1776, trying to understand economic growth. They have investigated technical causes (such as large gaps between the demand for and supply of investable funds—the "investment gap"),[1] the role of endogenous technological change,[2] culture,[3] a set of liberal economic policies (including privatization, freer markets, macroeconomic and monetary stability, and more openness to international trade—a set of policy prescriptions known as the "Washington Consensus"),[4] and, most recently, the role of institutions in fostering growth.[5]

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1. *See*, *e.g.*, WILLIAM EASTERLY, THE ELUSIVE QUEST FOR GROWTH: ECONOMISTS' ADVENTURES AND MISADVENTURES IN THE TROPICS (2001). Easterly's book is a first-rate history of the theories of economic growth and of how policymakers have used those theories in guiding their actions toward the developing countries.

2. *See* Paul M. Romer, *Increasing Returns and Long-Run Growth*, 94 J. POL. ECON. 1002 (1986). The early theories of economic growth—the Harrod-Domar and Solow models—had considered technological change as exogenous to the process of development. One of the implications of that assumption was that there would be convergence between the higher growth rates of the developed countries and the lower growth rates of the less-developed countries. When that convergence did not materialize over the 1960s, 1970s, and 1980s, economists began to look for amended models that might allow for nonconvergence and even for continued divergence. Romer's model allows for endogenous technological change and also for divergence in growth rates between developed and less-developed countries.

3. *See* DAVID S. LANDES, THE WEALTH AND POVERTY OF NATIONS: WHY SOME ARE SO RICH AND SOME SO POOR (1998), and David S. Landes, "Culture Makes Almost All the Difference," in LAWRENCE E. HARRISON & SAMUEL P. HUNTINGTON, EDS., CULTURE MATTERS (2001). *See also* Luigi Guiso, Paola Sapienza, & Luigi Zingales, *Does Culture Affect Economic Outcomes?*, 20 J. ECON. PERSP. 23 (2006), and FRANCIS FUKUYAMA, TRUST: THE SOCIAL VIRTUES AND THE CREATION OF PROSPERITY (1995).

4. An excellent summary is Dani Rodrik, *Goodbye Washington Consensus, Hello Washington Confusion?: A Review of the World Bank's* Economic Growth in the 1990s: Learning from a Decade of Reform, 44 J. ECON. LIT. 973 (2006).

5. *See*, *e.g.*, ELHANAN HELPMAN, THE MYSTERY OF ECONOMIC GROWTH (2004). Douglass C. North is justly famous for stressing the importance of institutions (by which he means "the rules of the game") in explaining economic growth. *See* DOUGLASS C. NORTH, UNDERSTANDING THE PROCESS OF ECONOMIC CHANGE (2005). *See also* Daron Acemoglu,

Despite the vigorous intellectual effort in this area, there is no consensus about how to foster economic growth. No one quite believes that there are a multitude of paths to a relatively well-to-do standard of living, that each country is a special case with a special set of explanations. All believe, rather, that there are some general lessons to be gleaned from the historical record—most notably, perhaps, that there are some policies (such as inattention to macroeconomic stability and isolation from competition in the international arena) to be avoided. On the affirmative policy side, there is less consensus about exactly what policies work most effectively.

Nonetheless, there is widespread belief that growth necessitates creating an environment in which entrepreneurs can prosper. Whatever else it is that entrepreneurs do, it is certain that they try new things—that they start new business enterprises that provide new products and services, that they provide new sources of employment, and that they frequently incorporate new technology into the production process or in the search for new or improved output. Sometimes entrepreneurs fail; other times—perhaps after failing several times—they prosper. For them to engage in their activities, there must be, among other things, tolerably good capital markets through which to raise funds for an initial investment, a tax system that allows them to realize and retain the profits of their success, a cultural disposition to value their activities with prestige in addition to material rewards, and a system of bankruptcy laws that cushion the shock of failure and allow for a "fresh start."[6] What people become entrepreneurs—whether they can be trained or are simply born—is still not entirely clear.[7] Nor is it entirely clear what surrounding societal, economic, and regulatory conditions fertilize entrepreneurs.

Root Causes: A Historical Approach to Assessing the Role of Institutions in Economic Growth, FINANCE & DEVELOPMENT (June, 2003), 27-30, and Daron Acemoglu & Simon Johnson, *Unbundling Institutions*, 113 J. POL. ECON. 949 (2005).

6. The possibility of a causal relationship between these policies and successful entrepreneurship has been of particular interest in the economies that are making the transition from socialism or communism to capitalism. *See*, *e.g.*, John McMillan & Christopher Woodruff, *The Central Role of Entrepreneurs in Transition Economies*, 16 J. ECON. PERSP. 153 (2002) (summarizing the patterns and importance of entrepreneurial activity in Russia, China, Poland, and Vietnam) and Simon Johnson, John McMillan, & Christopher Woodruff, *Property Rights and Finance*, 92 AM. ECON. REV. 1335 (2002) (surveying new firms in post-communist economies to discover if secure property rights or easy availability of external finance is more important and finding that firms are more likely to reinvest their profits where property rights are more secure).

7. This was the subject of Amir Licht's fascinating paper in this symposium. *See* Amir Licht, *The Entrepreneurial Spirit and What the Law Can Do About It*, 28 COMP. LAB. L. & POL'Y J. 817 (2007). A recent paper by Edward P. Lazear, *Balanced Skills and Entrepreneurship*, 94 AM. ECON. REV. 205 (2004), suggests that "entrepreneurs are generalists," not technical

The papers presented at this conference explored these and other issues having to do with the appearance and flourishing of entrepreneurs. I shall begin my comments by looking at these two very strong and insightful papers. Then I'll turn to broader comments on both papers.

I. THE RELATIONSHIP BETWEEN SOCIAL INSURANCE AND ENTREPRENEURSHIP

Jolanda Hessels and her coauthors find a subtle but complicated relationship between societal arrangements to provide a safety net and the willingness to engage in entrepreneurial activity.[8] One might have hypothesized that the relationship was simple: the presence of a safety net might induce entrepreneurs to undertake more risky business ventures than they would without such a net to catch them if they fail. Hessels and her coauthors show, however, that both parts of this simple hypothesis—the one involving the safety net and the other involving the motivations of entrepreneurs—are inappropriately simple. As a result, they hold that the simple theoretical relationship between the presence of a safety net and the level of entrepreneurial activity is not so obviously true. And, they further argue, this theoretical uncertainty argues in favor of empirical analysis to clarify the relationships.

First, they note that there is an important distinction to be drawn between the safety net that catches one in the event of unemployment and the net that catches one in the event of illness. The possibility of devastating illness is, of course, one that risk-averse individuals are almost certain to insure against. And it may be true that for the general population there is a moral hazard issue that arises because of the presence of that form of insurance: some people might take health-threatening action (such as cigarette smoking or failure to pay attention to one's diet) because they have social insurance against

specialists, as some believe. Their innovations are not in a single dimension, such as in designing a new product, but in putting together and operating a business, which requires a wide spectrum of skills: "entrepreneurs must be jacks-of-all-trades to some extent." *Id.*

See also David G. Blanchflower & Andrew J. Oswald, *What Makes an Entrepreneur?*, 16 J. LAB. ECON. 26 (1998). The authors explore several data sets on entrepreneurs and follow up those statistical inquires with interviews. They find that the probability of self-employment as an entrepreneur is positively and strongly correlated with the individual's having received an inheritance or gift and that aspiring entrepreneurs believe that raising capital is the main problem they face. Finally, Blanchflower and Oswald explore the childhood psychology records of successful entrepreneurs and find nothing in those records that correlates with later success as an entrepreneur.

8. Jolanda Hessels, André van Stel, Peter Brouwer & Sander Wennekers, *Social Security Arrangements and Early-State Entrepreneurial Activity*, 28 COMP. LAB. L. & POL'Y J. 743 (2007).

catastrophic health care expenses. But it seems to stretch credulity to imagine that there is a moral-hazard issue regarding entrepreneurial business decisions that arises from the health insurance safety net.

So, if the presence of a social insurance safety net induces morally hazardous behavior by entrepreneurs, then it is the unemployment insurance part of the net that is responsible. A careful investigation of that moral-hazard effect must, therefore, net out the medical-insurance part of the safety net. An implication is that the moral-hazard effects of social insurance vary depending on variations across jurisdictions in the proportion of the safety net that is unemployment-related and the proportion that is catastrophic illness-related. Thus, a system that is extremely generous in its unemployment benefits but not in its medical benefits may be one that has a greater adverse effect on entrepreneurs than a system that is generous with respect to medical expenditures but not generous with respect to unemployment.

Second, Hessels and her coauthors note that all social insurance systems require contributions by both the employer and the employee. Why is this significant? I was not persuaded that the authors had adequately fleshed out this relationship; so, here is an attempt to recast what I think that they mean to say. If employers had to pay *all* of the social insurance contributions of their employees, then one might expect an adverse relationship between the presence of a social safety net and entrepreneurial activity. The high cost to the entrepreneur of his or her labor force might discourage the formation of new enterprises or the expansion of existing firms.[9] If so, then having the employee contribute something toward their social insurance will reduce the entrepreneur's disincentive to engage in new business activity.[10]

There is another possibility here that I did not find in the authors' paper but that may bear further thought and testing. If employees are expensive (either because of social security payments or wages), employers may seek to economize on labor expenses by substituting capital for labor. This possibility suggests a further hypothesis that Hessels and her coauthors may seek to test: where social insurance payments are particularly burdensome to the entrepreneur, one might

9. It might also induce moral hazard and adverse selection issues with respect to employees' behavior. To the extent that those concerns would increase the costs to entrepreneurs (or the government) of monitoring employees more closely (either to keep his costs down or to avoid a special governmental surcharge), this might lower the profits of the entrepreneur, further discouraging the creation of new firms.

10. Hessels et al. articulate these relationships in their hypotheses 1A, 1B, and 2. *See* Hessels et al., *supra* note 8, at 748.

expect the entrepreneur to enter a business (or adopt a production function) that has, all other things equal, a higher capital-labor ratio.

Third, the authors note that a simple relationship between the presence of a social safety net and entrepreneurship may be far less likely because of categorical differences in the administration of the social security system. For example, there may be one set of benefits and policies for those who are employed by others, and an entirely different system for those who are self-employed. If that were the case, then one could not draw conclusions about the effect of the safety net on entrepreneurial decisions without focusing on the regulations as they apply to the self-employed, not to employees. The authors claim that previous researchers have made this mistake.

Fourth, the authors distinguish between opportunity- and necessity-based entrepreneurship and how those forms of entrepreneurship might be differently affected by the presence of social security. The difference between the two forms of entrepreneurship comes from two starkly different motivations of entrepreneurs. The entrepreneur who wants to be his or her own boss, to start his or her own company, to create something new is said to be engaged in "opportunity-based entrepreneurship."[11] In contrast, the entrepreneur who starts a new business only because all her other options for employment or gaining legitimate income are gone may be said to be engaged in "necessity-based entrepreneurship."[12]

The authors posit a weak relationship between opportunity-based entrepreneurship and the presence (or generosity) of the safety net and a stronger relationship between necessity-based entrepreneurship and a safety net.[13]

The authors confront these hypotheses with data from the Global Entrepreneurship Monitor and other sources. They find general support for their hypotheses. For instance, they find the expected negative relationship between the level of both the employer's and employees' social insurance contribution and the level of entrepreneurial activity—particularly for the early stages.

These are significant findings for which the authors are to be commended. And these findings spur me to suggest that the authors look at their hypotheses in two radically different contexts—

11. Hessels et al., *supra* note 8, at 751.

12. *Id.* Even though the authors cast these two forms of entrepreneurship as being dichotomous, it seems obvious to me that the forms of entrepreneurial activity lie upon a spectrum and that, as a result, many instances of new business activity have mixed motivations as between opportunity and necessity.

13. *Id.*, in Hypotheses 4A and 4B.

developing economies and transition economies. The social security arrangements in those two categories of society are very different both from one another and from the social security arrangements in the developed economies on which the authors focused in this paper. With respect to the developing countries, social security is clearly at a lower level—but perhaps not a lower relative level—than in the developed countries. And such social security as there is is likely to be provided privately—perhaps by families, clans, and religious organizations—not by the state. How, if at all, might this change the results that the authors have found between social security and entrepreneurship in the developed countries? Could it be the case, for example, that the disincentive effects that they discovered flowing from the social security system to entrepreneurial activity do not exist in the developing economies (where social security is much less or privately provided)?

The transition economies may be very different from both the developed and the developing economies. There, my sense is that before the downfall of socialism and communism there was significant social security, in the sense that the many risks of life—of losing one's job, of having bad health, of leaving one's family destitute after death, of a failing business—had been minimized. To the extent that entrepreneurial activity involves, at its core, risky activity, I wonder if the authors were to look for a connection between social security and entrepreneurs in the transition economies, whether they might find something very different from what they found in the developed countries or might find in the developing countries.

II. GENERAL COMMENTS: SOCIOECONOMIC VARIABLES AND THE LAW AS DETERMINANTS OF ENTREPRENEURIAL ACTIVITY

Finally, I have three broad, general comments. First, I am struck by the fact this paper focuses exclusively on economic variables to explain variations in the amount and vigor of entrepreneurial activity. But what about other, noneconomic determinants of entrepreneurial activity? Consider Richard Florida's work on the presence of a creative class.[14] Florida, who has a significant following among policy-makers, argues that cities prosper to the extent that they make themselves attractive to particular subgroups in the population—high-

14. *See* RICHARD FLORIDA, THE RISE OF THE CREATIVE CLASS: AND HOW IT'S TRANSFORMING WORK, LEISURE COMMUNITY, AND EVERYDAY LIFE (2003); RICHARD FLORIDA, THE FLIGHT OF THE CREATIVE CLASS: THE NEW GLOBAL COMPETITION FOR TALENT (2006).

tech workers, creative artists such as musicians and writers, gay men, and a group that Florida calls "high tech bohemians." There have been numerous criticisms of Florida's hypothesis,[15] but its currency among policy-makers and the relative ease of incorporating Florida's creative class, as an independent variable or variables argues in favor of paying attention to it in future research. But there are other socioeconomic variables that may well have effects on entrepreneurial activity that are at least as strong as those identified by the papers in this symposium. Consider, for instance, education. There might well be a connection between the average amount of schooling (or, possibly, of particular kinds of schooling, such as degrees in business administration) and its accessibility to women and minorities (so as, for example, to broaden the group of potential entrepreneurs or of skilled labor). There are also issues of demographic composition: there may be ethnic, racial, or religious strife that make it difficult for entrepreneurs to operate.[16]

Second, this paper considers entrepreneurial ability within a single national jurisdiction. That may, in fact, be the appropriate scale of investigation, but it assumes that entrepreneurs do not cross national boundaries in order to pursue new business activities. As I say, this national-centric assumption regarding entrepreneurs may be appropriate, but it is worth investigating whether national boundaries are an impediment to entrepreneurs and whether, if they are, the impediment effect is demonstrably growing less constraining. We clearly live in an increasingly globalized economy in which resources are relatively freer than they have ever been before to move to any part of the world in which they perceive a profitable opportunity. Might that free movement of resources apply to entrepreneurs just as much as it applies to products, services, capital, and, increasingly, labor?[17]

Third, and finally, I was struck by the fact that this paper did not give sufficient attention, for my money, to the effectiveness of the legal system as an explanatory variable for entrepreneurship. I'm

15. *See*, *e.g.*, Jamie Peck, *Struggling with the Creative Class*, 29 INT'L. J. URB. & REG. RES. 740 (2005).

16. *See* AMY CHUA, WORLD ON FIRE: HOW EXPORTING FREE MARKET DEMOCRACY BREEDS ETHNIC HATRED AND GLOBAL INSTABILITY (2002). But see Tom Ginsburg, *Democracy, Markets, and Doomsaying: Is Ethnic Conflict Inevitable?*: *A Review of Amy Chua's* World on Fire, 22 BERKELEY J. INTERNAT'L L. 310 (2004).

17. On globalization, see generally JAGDISH BHAGWATI, IN DEFENSE OF GLOBALIZATION (2004), and MARTIN WOLF, WHY GLOBALIZATION WORKS (2005). On labor mobility issues and globalization, see LANT PRITCHETT, LET THEIR PEOPLE COME: BREAKING THE DEADLOCK ON GLOBAL LABOR MOBILITY (2006).

particularly interested in learning about the possibly salutary role of lawyers. Let me briefly elaborate.

For example, Hessels and her coauthors could have included such factors as the stability and strength of property and contract law, the access to and effectiveness of the judicial system, or the number of lawyers. The first two of those three factors are, in the study of developing and transition economies, almost always deemed to be important.[18] Perhaps because the jurisdictions under consideration in this paper are all highly developed, those factors are working at an efficient level, and so the authors felt that there was no point in including variables to capture their effect. Fair enough.

But even in the developed countries, why not take account of the number of lawyers or the number of lawyers per capita? Why might that be an important addition? Because lawyers—transactional lawyers—can assist people, such as entrepreneurs, in getting things done. Ron Gilson once spoke—marvelously, I think—of lawyers as being "transaction cost engineers."[19] Gilson's contention is not that regulations alone create transaction costs. Lots of things create transaction costs. Bargaining is a costly activity in which the skill and experience of the bargainers can lower the costs of striking an enforceable agreement. Transactional lawyers are, among other things, experts in helping parties bargain—in anticipating and forestalling problems, allocating risk, and getting parties to surmount problems of asymmetric information. I am hypothesizing that the greater the number of lawyers per capita in a society, the greater the ease with which regulations and other transaction-cost impediments (many of them private) to entrepreneurial activity can be surmounted.[20] Moreover, recognize the very simple point that the larger the number of lawyers per capita, the lower—all other things equal—the cost of using a lawyer.

The possible applications of this hypothesis to the issues of this symposium are many. I will leave to another day the articulation of those applications and merely mention one: educating more lawyers may be an important aspect of fostering entrepreneurial activity. I cannot resist saying that this is a counterintuitive notion. I know that the vast majority of business people and many economists believe that

18. See the sources mentioned in *supra* notes 5–6.

19. *See* Ron Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 301-302 (1984).

20. For some evidence on this socially beneficial role of lawyers, see Frank B. Cross, *The First Thing We Do, Let's Kill All the Lawyers: An Empirical Evaluation of the Effect of Lawyers on the United States Economy and Political System*, 70 TEX. L. REV. 645 (1992), and Frank B. Cross, *Law and Economic Growth*, 80 TEX. L. REV. 1771 (2002).

lawyers do not lubricate transactions; they prevent them or, at the very least, increase the costs of transactions. And many business people are convinced that lawyers are so cautious that they are constantly preventing entrepreneurs from doing what they would like to do. Take the example of Google's famous book copying project.[21] If Google were to wait for the legal issues to be clarified, they could wait for years. But Google is not doing that. They are forging ahead.

Even though this paper has advanced our understanding of the effects of certain government policies on entrepreneurial decision-making, there is much more scholarship to be done on these matters. I hope that these authors will take these excellent beginnings and push them across national borders and across the disciplinary borders that seem to confine us all.

21. *See* Google Book Search at http://books.google.com/intl/en/googlebooks/about.html.