Is America Encouraging the Wrong Kind of Entrepreneurship?

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Last month economist William Baumol passed away at the age of 95. His death was universally mourned by members of the economics community, many of whom shared the view that he had passed before receiving a much-deserved Nobel Prize. One of us (Robert) had the great privilege of working with him, befriending him, and being able to regularly witness his economic wisdom, even in his later years.

Of Baumol's many contributions to economics, the most famous is cost disease, which explains why high-productivity industries raise costs and therefore prices in low-productivity industries. The insight is particularly relevant now, as economic activity has shifted into low-productivity services like health care and education, where price increases are devouring public and household budgets, and whose continued low productivity has weighed down U.S. productivity growth overall.

But there's a lesser-known idea of Baumol's that is equally relevant today and that may help explain America's productivity slump. Baumol's writing raises the possibility that U.S. productivity is low because would-be entrepreneurs are focused on the wrong kind of work.

In a 1990 paper, "Entrepreneurship: Productive, Unproductive, and Destructive," Baumol argued that the level of entrepreneurial ambition in a country is essentially fixed over time, and that what determines a nation's entrepreneurial output is the incentive structure that governs and directs entrepreneurial efforts between "productive" and "unproductive" endeavors.

Most people think of entrepreneurship as being the "productive" kind, as Baumol referred to it, where the companies that founders launch commercialize something new or better, benefiting society and themselves in the process. A sizable body of research establishes that these "Schumpeterian" entrepreneurs, those that are "creatively destroying" the old in favor of the new, are critical for breakthrough innovations and rapid advances in productivity and standards of living.

Baumol was worried, however, by a very different sort of entrepreneur: the "unproductive" ones, who exploit special relationships with the government to construct regulatory moats, secure public spending for their own benefit, or bend specific rules to their will, in the process stifling competition to create advantage for their firms. Economists call this *rent-seeking behavior*. As Baumol wrote:

> …entrepreneurs are always with us and always play some substantial role. But there are a variety of roles among which the entrepreneur's efforts can be reallocated, and some of those roles do not follow the constructive and innovative script that is conventionally attributed to that person. Indeed, at times the entrepreneur may even lead a parasitical existence that is actually damaging to the economy. How the entrepreneur acts at a given time and place depends heavily on the rules of the game—the reward structure in the economy—that happen to prevail.

In Baumol's theoretical framework, depressed rates of entrepreneurship aren't the culprit for periods of slow economic growth; rather, a change in the *mix* of entrepreneurial effort between the two kinds of entrepreneurship is to blame — specifically, a decline in productive entrepreneurship and a coincident rise in unproductive entrepreneurship. But is this what's actually happening in the U.S.?

Well, for starters, we and others have documented a pervasive decline in the rate of new firm formation during the last three decades and an acceleration in that decline since 2000. In fact, we found that by 2009 the rate of business closures exceeded the rate of business births for the first time in the three-decades-plus history of our data. This decline in startup formation has occurred in each state and nearly all metropolitan areas, and in each broad industrial sector, including high tech. There has also been a slowdown in activity ofhigh-growth firms, the relatively small number of businesses that account for the lion's share of net job gains. All of this points to a slowdown in the growth of productive entrepreneurship.

What about the other kind of entrepreneurship? Do we also see a rise in unproductive entrepreneurship, as Baumol theorized?

We don't have a smoking gun to confirm this hypothesis, but there surely is smoke, and it comes in two forms: rising profits, especially those earned by the largest businesses in the economy, and suggestive evidence of an increase in efforts to shape the rules of the game. This pattern is consistent with the rise of economic rents and rent-seeking behavior.

For example, Jason Furman and Peter Orszag, both former economic advisers to President Obama, wrote an influential 2016 paper that argued that economic rents are on the rise, particularly since 2000, and were a central factor in increasing wage inequality observed during this period. Similarly, a group of economists from MIT, Harvard, and Zurich found that industries where top firms' share of the market had most increased had experienced the largest declines in the share of income going to workers.

Perhaps most convincing, University of Chicago economist Simcha Barkai carefully tabulated the share of industry income distributed to labor, capital, and “profits.” (Normally, capital and profits are included together in one broad, residual “returns to shareholders” category.) He found that the share of income earned by workers has been falling, as others have pointed out, but also that the share earned by capital has, too. Indeed, both have been declining while the share of income going to “markups,” or rents, has been increasing.

To be clear, the presence of economic rents by itself doesn’t establish that there’s been an increase in unproductive entrepreneurship. For that to be true, there must be be evidence of an increase in *rent-seeking* — that is, concerted efforts to stifle competition by influencing the reward structure or rules of the game in a market.

James Bessen of Boston University has provided suggestive evidence that rent-seeking behavior has been increasing. In a 2016 paper Bessen demonstrates that, since 2000, “political factors” account for a substantial part of the increase in corporate profits. This occurs through expanded regulation that favors incumbent firms. Similarly, economists Jeffrey Brown and Jiekun Huang of the University of Illinois have found that companies that have executives with close ties to key policy makers have abnormally high stock returns.

In short, Baumol may have been ahead of his time in warning that economies can suffer not only from a cost disease but also from its entrepreneurial counterpart — a change in the rules that shifts the distribution of entrepreneurial effort from activity that helps the economy toward activity that hurts it. Unfortunately, there is strong suggestive evidence that Baumol’s warnings have come to pass. If the U.S. is going to tackle its many problems, we are going to have to find ways to encourage would-be entrepreneurs to start innovative, productive businesses, rather than dedicating their efforts to co-opting government in order to secure economic advantage.