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SOME THOUGHTS ON ENTREPRENEURS AND ENTREPRENEURIAL BUSINESSES

What is an entrepreneur? The term has been variously translated from the French to mean “merchant,” “adventurer,” or “employer,” although a more literal translation is “to undertake.” Most people recognize an entrepreneur as someone who organizes, operates and assumes the risk for a business, in return for prospective profit and, perhaps, a measure of personal satisfaction. Entrepreneurs are typically viewed as individuals who are highly motivated, enjoy taking risks, and relish the creative process. This description, while illuminating, does not fully capture the contributions that entrepreneurs make in a broader economic sense, nor their pivotal role in driving economic growth, technological innovation, and prosperity.

A more interesting and complete definition was provided by the great economist Joseph Schumpeter, in his seminal interwar work on economic development.¹ Schumpeter depicted entrepreneurs as individuals who change the existing economic structure from within, by developing new products and introducing better methods of production. In his famous phrase, the actions of successful entrepreneurs lead to “creative destruction,” as current products, processes and ways of doing business become obsolete and are replaced with more innovative and value-enhancing alternatives.

Schumpeter made an important distinction between innovation and invention. The latter refers to the original development of an idea or product prototype, whereas innovation has to do with putting the invention to work in a way that creates economic value. According to Schumpeter, the entrepreneurial function is primarily realized in innovation – that is, by introducing the invention into the marketplace.

In Schumpeter’s formulation, entrepreneurs wield great influence by changing the economy’s allocation of resources over time. “Creative destruction,” he maintained, is what ultimately allows for economic progress and a rising standard of living.

Some economists have criticized Schumpeter’s approach because he separates the entrepreneur from the firm. As he uses the term, the label “entrepreneur” best fits an individual innovator who establishes a company, which then goes on to disrupt an existing

¹ Joseph Schumpeter, The Theory of Economic Development (1934).



market or way of doing business. Schumpeter's innovative entrepreneur effectively remains responsible for all or at least most of the enterprise's key decisions.

Of course, every successful enterprise begins life as an entrepreneurial start-up. But as companies grow and become more complex, owners generally delegate decision-making and even strategy development to salaried managers. Should salaried managers, at least those with a flair for identifying opportunities and introducing change, be considered "entrepreneurs"? This is a difficult question. However, as with entrepreneurs, excellent managers possess a knack for good judgment and try to stimulate entrepreneurship within their organizations. Indeed, top managers of some big companies have established internal start-up ventures within their organizations in an effort to spur innovation and new product development (this is often called "intrapreneurship"). So in some sense, creators of the firm (owners) and stewards of the firm (managers) may both be seen as embodying entrepreneurial talent.

Two Types of Entrepreneurs: Innovative and Replicative

Although Schumpeter never made the distinction, there are really two different types of entrepreneur.

Innovative entrepreneurs are the kind Schumpeter had in mind. As already suggested, they are often destabilizing influences and pave the way for the introduction of new products, technologies and even industries. Innovative entrepreneurs, as recently emphasized by US economist William Baumol, are fundamental to growth and wealth creation in a market-based economy.² Among other things, the businesses built by innovative entrepreneurs look beyond local markets and seek to export their products or services to external customers. Entrepreneurial innovators have played a significant role in introducing important technical inventions to the market; a few examples include the dial telephone, the turbojet engine, radio telephony, and the sound motion picture.³

Empirically, innovative entrepreneurial firms are most likely to emerge in regions characterized by strong post-secondary education systems, a well-educated work force, and research-intensive universities. Innovative entrepreneurial companies, while relatively small in number, produce substantial economic benefits because of their outsized contributions to job creation and to the reallocation of economic resources from stagnant/declining sectors to expanding ones. In the United States, research has shown that companies which have experienced annual growth rates of at least 20% for four or more years are responsible for a disproportionate share of new private sector jobs, especially in industry sectors with above-average wages/salaries (such as many advanced technology industries).

² William J. Baumol, The Free Market Innovation Machine (2002).

³ F.M. Sherer, Industrial Market Structure and Economic Performance, 2nd ed., Rand McNally (1980), pp. 438—39.



Replicative entrepreneurs occupy a different position in the economy. Essentially, they function as efficient coordinators of resources to meet the demands of a growing population and domestic market. Unlike innovative businesses, replicative entrepreneurial firms concentrate on servicing local markets, generally don't export, and rarely engage in research and development activity. But this is not to downplay their economic significance. Successful replicative entrepreneurial firms are a critical and often highly visible part of a growing local economy. They supply needed products and services, support large numbers of jobs, and drive efficiencies within competitive markets. They are most likely to flourish in regions with expanding populations. Replicative entrepreneurs may be highly innovative in terms of how they organize and conduct business (e.g., by adopting a novel marketing strategy), but seldom do they spearhead the development of new products or technologies or reshape the structure of entire industries.

Entrepreneurs and Mainstream Economics

While both economic history and casual observation attest that entrepreneurs and the businesses they spawn are pivotal to a successful market economy, the modern discipline of economics actually has surprisingly little to say about them. Indeed, in many leading universities today it is possible to study economics all the way up to the doctoral level without even encountering the topic of entrepreneurship. In part this is because neoclassical economic theory is built from models that utilize the simplifying assumptions that all people ("economic agents") are rational and possess perfect information. This leaves no room for entrepreneurs, one of whose defining functions is to make judgment calls and predict the direction of markets/technologies without having complete information. In a world of perfect information, there would be little role for risk-taking and "entrepreneurial intuition" in building successful enterprises.

Modern microeconomic theory focuses on the determination of prices, output and costs, with marginal analysis and optimization employed as the fundamental tools of analysis. Economists trained in this tradition have difficulty explaining discrete and disruptive change. But innovation is just that.⁴ As a result, microeconomics is necessarily concerned with the prices and quantities of yesterday's inventions, rather than with how they came into being in the first place. Still less is it interested in tomorrow's innovative products, disruptive technologies, or fundamentally different ways of organizing business. By their very nature, entrepreneurial activities do not lend themselves to the formal optimization analysis that dominates microeconomic theory.

The fact that much of economic theory is composed of equilibrium models in which, structurally, nothing is changing, also reinforces the tendency to exclude entrepreneurs from economic analysis and teaching.⁵ One of Shumpeter's insights is that the entrepreneur seeks

⁴ William J. Baumol, "Return of the Invisible Men: The Microeconomic Value Theory of Inventors and Entrepreneurs," paper presented at the American Economics Association 2006 Conference http://www.aeaweb.org/annual_mtg_papers/2006papers.html.

⁵ Ibid.



out profitable opportunities that will upset any established equilibrium. Contemporary microeconomic theory has been unable to incorporate this kind of disruptive economic actor.

The good news is that leading scholars who are interested in the forces shaping economic growth have come to recognize that entrepreneurs – specifically, the innovative kind – are important to understanding how growth occurs. That said, there is still no generally accepted economic model of entrepreneurship. Modern research, however, has shifted from examining the traits of entrepreneurs to developing an understanding of 1) how entrepreneurs are able to sustain and create organizations, and 2) the broader consequences of entrepreneurial activity. Given the numerous pitfalls that await the novice entrepreneur and the high failure rate of new business ventures, it would be helpful to have a better understanding of how entrepreneurs use existing resources, business and personal networks, and their own knowledge to go from idea to innovation to the establishment of a viable and growing business.

Entrepreneurs and the Canadian Economy

In light of the complexities of defining what an entrepreneur is and does, it is not surprising that estimating their numbers is not straightforward. One thing we can be confident about is that the number of truly “innovative” entrepreneurs and entrepreneurial firms is small – the vast majority of firms fit the category of “replicative” entrepreneurial businesses.

As a starting point, the number of self-employed provides a general sense of how many individuals have at least some entrepreneurial spirit. To refine the figure a bit further, we look only at the self-employed who also have paid help. This is not to suggest that self-employed individuals without paid help are never entrepreneurial. But they are excluded here because the evidence suggests that most of them are running part-time “cottage” businesses, or else fall into the category of consultants or contractors who have an ongoing business arrangement with outside companies to which they sell their services and expertise. Moreover, few self-employed individuals working from home evolve into sizable, rapidly growing enterprises.

In 2005, there were approximately 864,000 self-employed with paid help in Canada. While this sounds like a large number, it represents just 5% of the Canadian workforce. And this proportion has fallen over the past several years as the Canadian job market has rebounded. Within Canada, the western provinces are more entrepreneurial, with BC leading the way with the highest share (6.5%) of self-employed, followed by Alberta (6.2%), and Saskatchewan (6.1%). At the other end of the scale, Ontario and New Brunswick have the lowest proportions of self-employed persons measured as a share of the work force.

Another, and perhaps more suitable, indicator of entrepreneurial activity comes from Statistics Canada’s *Employment Dynamics* database, which tracks the annual number of new business ventures. This source suggests that between 1% and 1.5% of the Canadian



population aged 18-64 starts a new business in any given year. The database also confirms that the western provinces have a higher rate of entrepreneurial activity. In BC, Alberta and Saskatchewan, between 1.4% and 1.5% of the working aged population starts a new venture each year, compared to just 1% in the rest of Canada.⁶

Most people believe entrepreneurship is a high risk undertaking. This perception reflects the fact that new businesses have a high failure rate. The evidence indicates that in the four western provinces, the first year failure rate for new businesses ranges between 23% (in BC) and 31% (in Manitoba). And while the death rate of new ventures tends to decline after the first year, at the end of six years only one-third of new businesses are still in existence.

A key challenge facing all new business ventures as well as established companies seeking to grow is access to capital. For the new entrepreneur, start up capital requires an equity stake such as personal investment, money from family and friends or angel investors. As a firm grows, other financing options, including debt, venture capital, or even a public listing, may be considered. Note, however, that most small companies in Canada remain small or disappear; only a tiny fraction ever grow to the point where they become mid-sized (let alone) large enterprises.⁷

Most small businesses are found in a handful of sectors: business services, retail and wholesale trade, accommodation and food-services, and construction. Replicative entrepreneurs are very common in these parts of the economy. Innovative entrepreneurs are most likely to emerge in high technology and other knowledge-intensive sectors that are involved in selling to external and not simply local markets.

Entrepreneurial motivation is complex - no one mould applies. There are numerous reasons why people decide to go into business - an interest in finding an alternative to paid employment, a desire to be one's own boss, the expectation of increased earnings, a drive to create a new firm or product, or the potential to exploit a perceived opportunity. Motivations differ among start-up entrepreneurs and small businesses. This is one reason why so many surviving small companies stay small: their owners prefer it that way. An odd feature of the Canadian tax system is that it actually encourages entrepreneurial firms to remain small by providing preferential tax treatment for businesses that fail to grow.⁸

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⁶ Edward Chambers and Stuart Shaw, "A Primer on Western Canadian Entrepreneurship," Information Bulletin number 76 (April 2004), Western Centre for Economic Research, University of Alberta, p. 7.

⁷ In Canada, mid-sized companies are usually defined as those with 100-499 employees, while large enterprises have 500 or more.

⁸ This point is emphasized in a new OECD report on Canada. See Organization for Economic Cooperation and Development, OECD Economic Surveys: Canada (June 2006), pp. 51-52.