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Does Social Spending Discourage Entrepreneurship?

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The importance of entrepreneurship to the economy is well established. Entrepreneurship drives economic growth and helps to solve society's intractable problems, from curing disease to lowering pollution. For this reason, governments have a vested interest in crafting policy that helps entrepreneurs to thrive. Whether to spend less or more is a big part of that decision.

One of the most fundamental debates in economics is how government spending on entrepreneurial activity, business ownership, and the public's view of entrepreneurship as a career choice impacts the economy, entrepreneurship, and general wellbeing. Two broad camps have emerged: proponents of free markets and small government vs. those who favor a more robust government role in managing the economy. Is it better to regulate markets and redistribute society's profits, or to fully unbind the Invisible Hand?

When it comes to entrepreneurship, there is an argument for each approach. The Keynesian or "market failure" model says that free markets entail a lot of inefficacies that the government can help deal with. The Darwinian free market may discourage entrepreneurship because failure could mean destitution, encouraging people to stick with safer but less transformative jobs. On the other hand, if too much profit and capital are allowed to stay within one company, individual, or social group, the system becomes less dynamic and innovative, and more feudal.

The opposing view, known sometimes as the Austrian view for the economic school of thought that contributed to it, disagrees with these ideas. The "Austrians" assert that social spending only distorts optimal decision-making. Higher taxation needed to fund social programs makes business ownership more expensive. It also disincentivizes entrepreneurship by offering more attractive alternatives, such as a government job or simply enjoying the fruits of the welfare state.

We recently conducted a study to test these opposing assertions. Among other surprising findings, our results favored the Austrian camp, suggesting social spending has a negative effect on entrepreneurial activity, business ownership, and even how the public perceives entrepreneurship as a career.

Background

The relationship between government spending and economic activity is an interesting problem because it's been studied for a long time, yet it continues to yield conflicting conclusions. While relatively few, several studies have also directly investigated the link between social programs and entrepreneurship. They similarly find themselves at odds.

Some studies support the market failure theory: that social spending functions as a gymnastics mat, allowing entrepreneurs to take bigger risks and achieve greater victories, insured against a more painful fall. For example, studies of "food stamp entrepreneurs" (Olds, 2013) found that social spending reduces the economic barriers an entrepreneur may face.

Other studies have found just the opposite: social spending provides attractive alternatives to the risk and sweat of striking out alone, and the accompanying taxes reduce incentives even further (Cowling and Bygrave, 2006). Studies supporting the Austrian view find that freer markets have more robust levels of entrepreneurship and economic dynamism, while those with a more active government role tend to fall on measures of both.

The reason for such conflicting findings likely comes down to the fact that both ideas are partially true. A base level of social spending provides a social safety net against becoming destitute that likely does encourage entrepreneurship for some who may otherwise not have ventured out alone. However, if taken past providing basic support the higher taxes and more comfortable economic conditions lower the incentive and necessity to stake one's claim. The question is: have the world's developed nations that provide some degree of social support, surpassed the crucial base level or have they yet to meet it?

Our study

To study the effect of social spending on entrepreneurship, specifically SME's (small and medium enterprises) we took high-quality data from 31 countries, from 2004 to 2011. We focused on the effects of changes in social spending within each country during that time period. Most of the countries studied are considered developed and democratic, with a couple middle-income exceptions like Mexico. We got our data from three highly reputable sources: the GEM (Global Entrepreneurship Monitor), The World Bank, and the Organization for Economic Co-Operation and Development (OECD).

Our fundamental research question was whether social spending, putting a floor on the income of all citizens and taxing those that are higher above that floor, hurts or harms entrepreneurship at the country level. Specifically, we looked at social spending on entrepreneurial activity, business ownership, and the public's view of entrepreneurship as a career choice and defined it as the percentage of GDP that each country spent in each year (data was from the World Bank). We measured across time at the country level, studying how a change in social spending drove three key indicators of entrepreneurial vigor.

Then, for each country in each year, we measured social spending's impact on three key variables: (1) Total Early-stage Entrepreneurial Activity (the percentage of working-age adults, age 18-64, starting out as entrepreneurs), (2) business ownership (the percentage of working-age adults who own a business that employs other people), and (3) public perception of entrepreneurship (the percentage of working-age adults who think entrepreneurship is a good career.

Within each country, and for every year, we related social spending to those three markers of entrepreneurial health, in order to tease out the impact that social spending had on them. For business ownership and entrepreneurial activity, we lagged the impact of social spending by one year -- for example, measuring 2005's spending against 2006's level of business ownership -- in recognition that it takes some time for changes in social spending to impact rates of business ownership and new ventures.

A number of variables can muddy the relationship between social spending and our three measures of business dynamism, and we wanted to be sure to tease out the effect of "welfare state" spending, so theoretically-appropriate control variables were also factored in (e.g., GDP per capita, public programs assisting SMEs, financing availability for entrepreneurs, etc.).

Our Findings: A Point for the Austrian Model

Our results support the Austrian narrative: from 2004 to 2011, social spending reduced all three measures of entrepreneurial health. At the country level, an increase in social spending led to a decrease in small business ownership as well as entrepreneurial activity: fewer people owned employing businesses or worked for themselves. Additionally, an increase in social spending predicted a decrease in the public's perception of entrepreneurship as a positive career choice.

The impact of social spending was dramatic and statistically significant, meaning it is extremely unlikely that no relationship exists, for all three variables. If an additional percent of GDP went to social spending, for example from 42% to 43%, the rate of early entrepreneurs and business ownership fell by about a quarter to a third of a percent, respectively. Although this may sound like a small number in percent change, GEM estimates in 2023 there are 31 million entrepreneurs in the US, and a reduction in one third of a percent means a loss of over 100,000 businesses. The impact on perception was even more dramatic; there was an almost a one-to-one negative relationship (-0.88) between a change in social spending and the public perception of entrepreneurship as a good career choice. Furthermore, these relationship imply increases in social spending above the base level equate to

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paying to discourage and lose entrepreneurs.

Two theories might explain this. One is that social spending, including the creation of attractive government jobs, makes the opportunity cost of entrepreneurship higher. Entrepreneurship, a risky and stressful endeavor, now has to compete with the alternatives of a well-paying job in the public sector or to simply enjoy the fruits of the welfare state.

The cost of entrepreneurship is also more directly raised by the taxes necessary to finance greater social spending. Higher public spending entails higher taxes, which can lower what an entrepreneur might expect to earn by striking out alone, especially at the upper bound of that expectation. The result is that people are more comfortable near the middle of the economic income pyramid, spared the discomfort of the bottom and with less perceived access to the top.

Conclusion

There are two widely held beliefs about how social spending affects entrepreneurship: it encourages it by providing a safety net to encourage experimentation, or it discourages it by making it easier not to undergo the difficult and perilous founder's Journey. This study suggests that the latter effect is stronger than the former.

With this in mind, governments crafting a pro-entrepreneurial policy may be best off leaning toward free markets, and cautioned against expecting social spending to boost a public spirit of entrepreneurial adventure. Of course, these decisions should be weighed in the bigger picture of what is best for society, which of course goes beyond just entrepreneurship.

Explore the Research

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