Testimony before the Committee on Small Business, Subcommittee on Contracting and Workforce
Hearing Title:
"The Decline in Business Formation: Implications for Entrepreneurship and the Economy"
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Mr. Chairman and Members of the Committee, I am John Deskins, and I serve as Director of the Bureau of Business & Economic Research and as Associate Professor of Economics at West Virginia University. Thank you for inviting me to appear before you today to discuss the role of small business in the United States economy.

Numerous statistics from the U.S. Small Business Administration and other sources suggest that small businesses play a vital role in our economy. For instance, statistics based on standard SBA definitions indicate that small firms represent the large majority of firms in the nation; small firms employ around half of the total U.S. private sector workforce; and small firms have historically accounted for more than half of net job creation in the U.S.[1]

Further, academic research has demonstrated the importance of small business to economic growth using advanced statistical methods. Recent research has rigorously demonstrated that new business formation is not simply correlated with a growing economy, but is indeed a key driver of economic growth.[2]

My own co-authored research has found that small business establishment births are the single largest determinant of output and employment growth at the US state level.[3] This research suggests that fostering an environment that is fertile for small business formation and growth is likely to be more fruitful than manipulating many of the simpler policy levers that officials often look toward.

Research has found that new firms are more likely to promote economic growth as a result of innovation, compared to existing firms. Research has also shown that new firms often increase competitive pressures for existing firms, forcing existing firms to be more competitive, thereby creating a broader economic benefit for society.[4]

As the terms "small business" and "entrepreneurship" are somewhat vague notions, research has also refined our understanding of the specific types of small business that are most effective in promoting

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[1] United States Small Business Administration, Office of Advocacy. "Frequently Asked Questions." 2014.
[2] See Acs, Zoltan, and Catherine Armington. "Employment Growth and Entrepreneurial Activity in Cities." *Regional Studies*, 38(8), 2004.
[3] Bruce, Donald, John A. Deskins, Brian C. Hill, and Jonathan C. Rork. "(Small) Business Activity and State Economic Growth: Does Size Matter?" *Regional Studies*, 43(2).
[4] Disney, R., J. Haskel, and Y. Heden. "Restructuring and productivity growth in UK manufacturing." *Economic Journal,* 113, 2003.

economic growth. Here a key finding is that *young* firms are most important for long-run economic prosperity, not necessarily *small* firms.[5]

However, new business formation rates in the U.S. have suffered during recent years[6] and it stands to reason that this decline is a significant concern as it relates to innovation and long-run economic growth.

It is imperative that public policy is structured to be conducive to small business formation to help ensure that our economy remains innovative and as healthy as possible in the long-run.

Fortunately a large literature has developed that examines the ways in which public policy affects small business activity. I will use the remainder of my remarks to comment on the findings of this literature.

This research has investigated the question using a variety of data – survey data, tax return data, and aggregated data – and at multiple levels – national, state, local. The literature has investigated a variety of tax and expenditure policies, such as various income tax rate measures and tax credits, as well as non-rate policies, such as depreciation policy or health insurance deductibility.

Some important findings from the more recent literature relating to how public policy affects small business are as follows:

- Federal income tax rates and credits do matter. Research has convincingly shown that relatively more favorable tax policy toward the self-employed, compared to wage and salary workers, increases self-employment. A sample of findings is as follows:
    - A lower average tax rate for self-employment income, relative to that of wage and salary income, has been shown to encourage the transition to self-employment.[7]
    - Higher expected marginal income tax rates faced by the self-employed have been shown to shorten spells of self-employment. Correspondingly, increases in expected marginal income tax rates for wage and salary income lengthen spells of self-employment.[8]
    - Spending on research and development is positively influenced by tax credits toward small business.[9]

- Other tax policies are also found to matter in recent research. For instance, research has shown that greater deductibility of health insurance premiums for federal income tax purposes likely reduces exits from self-employment.[10]

[5] See Haltiwanger, John C., Ron S. Jarmin, and Javier Miranda. “Who Creates Jobs? Small vs. Large vs. Young.” National Bureau of Economic Research, August 2010.
[6] United States Small Business Administration, Office of Advocacy. “Frequently Asked Questions.” 2014.
[7] Bruce, Donald. ”Effects of the United States tax system on transitions into self-employment.” *Labour Economics*, 7, 2000: 545-574.
[8] Gurley-Calvez, Tami, and Donald Bruce. “Do Tax Cuts Promote Entrepreneurial Longevity?” *National Tax Journal*, 61(2), 2008.
[9] See Gale, William, and Samuel Brown, “Small Business, Innovations, and Tax Policy: A Review,” *Tax Policy Center*, April, 2013, for a discussion of this issue.
[10] Gurley, Calvez, Tami. “Tax-Based Health Insurance Reforms.” Contemporary Economic Policy, 29(3), 2011.

- It is believed that tax avoidance and evasion opportunities are often more pronounced for the self-employed. Research has shown that evasion and avoidance are likely drivers of the transition into self-employment. Indeed, entry into self-employment may actually be high when marginal rates in general are high, driven by the potential to evade or avoid taxes.[11] Overall this implies that policymakers should be mindful of the potential for inefficient tax avoidance activities and illegal tax evasion when crafting tax policy toward small business.

- Policymakers must also be mindful, however, that some of the identified behavioral effects, while readily apparent, are considered small in magnitude.

- In contrast to these findings, some research has failed to identify any relationship between other elements of policy. For instance, recent research has failed to identify any evidence that more favorable depreciation rules and capital expensing policies promote small business activity.[12]

- Several elements of U.S. state tax policy have also been identified to affect small business activity in states.[13] Although magnitudes here are often small as well.

There are many important questions that remain in the literature. Even the most basic question of what is a “small business” is not met with universal agreement. Additionally, research needs to investigate further how much of the apparent change in small business activity in response to tax policy is a real behavioral response versus a change in less economically substantive tax reporting behavior.

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[11] See Bruce, Donald. ”Effects of the United States tax system on transitions into self-employment.” *Labour Economics*, 7, 2000: 545-574, for suggestive evidence to this effect.

[12] Bruce, Donald, John Deskins, and Tami Gurley-Calvez. “Depreciation Rules and Small Business Longevity.” *Journal of Entrepreneurship and Public Policy*, 3(1), 2014.

[13] Bruce, Donald, and John Deskins. “Can state tax policies be used to promote entrepreneurial activity?” Small Business Economics, 38(4), 2012.