



## Small Firms, Employment, and Federal Policy

Although the most recent recession ended more than two years ago, the recovery has been slow and the economy remains in a severe slump. From December 2007 (when the recession began) to February 2010 (when the number of people on business payrolls was at a low point), the U.S. economy lost 8.7 million jobs, on net, on a seasonally adjusted basis. From February 2010 to February 2012, only 3.5 million jobs were created, on net, on a seasonally adjusted basis. The Congressional Budget Office (CBO) projects that, under current law, employment will grow at an average rate of about 2 million jobs per year over the next few years.<sup>1</sup> At that rate, employment will not reach its prerecession peak until the middle of the decade. Against that backdrop, policymakers, analysts, and the public continue to express concern about the prospects for job creation.

It is widely believed that small firms promote job growth. In fact, small firms both create and eliminate far more jobs than large firms do. On balance, they account for a disproportionate share of net job growth—however, that greater net growth is driven primarily by the creation of *new* small firms, frequently referred to as start-ups, rather than by the expansion of mature small firms.

The greater net job-creation rates associated with new small firms could motivate lawmakers to consider supporting such firms through various policy initiatives. However, policies specifically favoring small firms have both advantages and disadvantages. For instance, policies designed to prevent discrimination or reduce pollution would probably have smaller adverse effects on employment if they exempted small firms in those cases where compliance was particularly costly for small firms. Conversely, some policies CBO has examined that

would increase employment, such as reducing payroll taxes for firms that hire additional workers, would be less cost-effective if they were restricted to small firms.

Under current federal laws and regulations, small firms already receive more favorable treatment than large firms do in many areas. For example, certain provisions of the tax code relating to capital gains and the expensing of capital investments favor small firms. The Small Business Administration (SBA) helps small firms obtain loans. And many regulatory policies, such as those prescribed by the Family and Medical Leave Act of 1993, include exemptions for small firms. Because further efforts to favor small firms may shift employment away from large firms in an inefficient manner, broadly targeted policies may spur total employment more effectively.

### The Role of Small Firms in the Labor Market

Small firms employ a substantial share of all workers and are among the most dynamic employers in the economy. That very dynamism, however, leads small firms to both create and eliminate jobs at higher rates than larger firms do, in part because small firms come in to and go out of existence at much higher rates than their larger counterparts—a pattern that persisted through the most recent recession. Although small firms do generate jobs at higher rates, on net, than larger firms do, that relationship arises primarily because new firms, which typically start out small, create a comparatively large share of net new jobs. Conversely, older, more established small firms create a comparatively small share of net new jobs. Thus, even though observers sometimes cite small firms as the engine of job growth, the more accurate view is that *new* firms are a particularly important source of job growth.

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1. See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2012 to 2022* (January 2012).

**Table 1.****Distribution of Private-Sector Firms and Employment, by Firm Size, 2011**

Firm Size, by Employee Count	Firms		Employees	
	Number in Thousands	Percentage of All Firms	Number in Millions	Percentage of All Employees
1 to 4	2,704	56.0	5.5	5.2
5 to 9	944	19.6	6.2	5.9
10 to 19	574	11.9	7.7	7.3
20 to 49	369	7.6	11.1	10.6
50 to 99	122	2.5	8.4	8.0
100 to 249	72	1.5	10.9	10.3
250 to 499	22	0.5	7.5	7.1
500 to 999	11	0.2	7.4	7.0
1,000 or More	10	0.2	40.7	38.6
<b>Total</b>	<b>4,828</b>	<b>100.0</b>	<b>105.4</b>	<b>100.0</b>

Source: Bureau of Labor Statistics, Business Employment Dynamics database, first quarter of 2011.

### Differences in Employment at Small and Large Firms

Analysts measure the size of a business in a variety of ways, including using financial measures and market shares. In this analysis, CBO measures size primarily on the basis of the number of employees working for a firm. A firm may consist of only one establishment—such as a factory or store that conducts business in a single location—or multiple establishments. This analysis focuses on firm size because current size-related federal policies generally focus on firms rather than establishments. No uniform employee threshold has been adopted to define “small,” either in federal legislation or in published research, so this analysis considers various thresholds.

The vast majority of firms in the United States are small, but large firms employ a disproportionately high share of all private-sector workers. For instance, in 2011, 98 percent of all firms had fewer than 100 employees, whereas 0.2 percent of firms had 1,000 or more employees, according to the Business Employment Dynamics (BED) database compiled by the Bureau of Labor Statistics (see Table 1).<sup>2</sup> However, those small and large firms employed about the same share of workers—37 percent and 39 percent, respectively. Similarly, more than 95 percent of all firms had fewer than 50 employees, but firms with 50 or more employees accounted for more than 70 percent of overall employment.

Small and large firms operate in all major industries, but the proportion of each industry’s firms that are large varies. Manufacturing firms tend to be larger than firms in other industries. In 2009—the latest year for which industry-level data on firm size are available—13 percent of manufacturing firms had 50 or more employees (see Table 2). Construction firms, by contrast, are generally smaller: Only 4 percent of firms in that industry had 50 or more employees in 2009.

Small firms tend to pay lower wages and provide less generous nonwage benefits (such as health insurance, pension plans, and paid time off) than do larger firms.<sup>3</sup> For example, CBO estimates that, in 2005, the average hourly wages paid to full-time workers in firms with

2. The data on employer size that CBO used in this analysis are derived from records kept on employers covered by unemployment insurance. Some large, multistate firms have multiple federal employer identification numbers and, thus, appear in the BED as several different and somewhat smaller firms. As a result, BED data may slightly overstate employment at small firms and understate employment at large firms.
3. See Jean Marie Abraham, Thomas DeLeire, and Anne Beeson Royalty, “Access to Health Insurance at Small Establishments: What Can We Learn from Analyzing Other Fringe Benefits,” *Inquiry*, vol. 46, no. 3 (September 2009), pp. 253–273; Charles Brown, James Hamilton, and James Medoff, *Employers Large and Small* (Cambridge, Mass.: Harvard University Press, 1990); and Walter Oi and Todd Idson, “Firm Size and Wages,” in Orley C. Ashenfelter and David Card, eds., *Handbook of Labor Economics*, vol. 3B (Amsterdam: Elsevier B.V., 1999), pp. 2165–2214.

**Table 2.**  
**Distribution of Private-Sector Firms, by Industry and Firm Size, 2009**

Industry	Share of Firms with 50 or More Employees (Percent)	Total Number of Firms (Thousands)
Agriculture	2	118
Construction	4	435
Finance, Insurance, and Real Estate	4	446
Services	4	2,325
Retail Trade	5	952
Transportation and Public Utilities	6	186
Wholesale Trade	7	321
Mining	9	20
Manufacturing	13	250
<b>Total</b>	<b>5</b>	<b>5,054</b>

Source: Census Bureau, Business Dynamics Statistics database.

100 or more employees were almost 40 percent higher than the wages earned by full-time workers in firms with fewer than 25 employees.<sup>4</sup> Further, 93 percent of full-time workers in those larger firms were offered and eligible for employer-sponsored health insurance as compared with 58 percent of workers in firms with fewer than 25 employees. The variations in average wages and benefits by firm size largely reflect differences in the industry and other characteristics of the firms themselves as well as differences in the education, skills, and other characteristics of the workers they employ.

### Employment at Small and Large Firms During the Recent Recession

During the recent recession and the following 18 months (that is, between December 2007 and December 2010), the number of private-sector jobs declined by 6.6 percent, on net, with declines occurring in all categories of firm size. Assessing whether the declines occurred at

4. CBO's tabulations are based on wave 5 of the 2004 Survey of Income and Program Participation (SIPP), which reflects the status of workers in 2005 when data on employers' offers of health insurance were collected. SIPP survey questions allow for three categories of firm size: 1 to 24 employees, 25 to 99 employees, and 100-plus employees. Thus, those data do not allow CBO to calculate statistics separately for firms with fewer or more than 50 employees.

different rates across large and small firms is much less straightforward than it might seem. The challenge arises because a firm's size can change over time—this year's large firm may be next year's small firm, and vice versa. The instability of firms' sizes leads unavoidably to some arbitrariness in how changes in employment are assigned to different categories of firm size. There are various methods for doing so, but no consensus exists as to which one is most useful (see Box 1).

The use of different methods has led some analysts to assert that small firms have borne the brunt of the economic downturn and others to claim that losses have been broadly similar across all categories of firm size.<sup>5</sup> According to CBO's methodology—which relied on BED data—the number of employees at firms with fewer than 50 workers fell by 7.1 percent from December 2007 to December 2010, the number at firms with 50 to 499 workers fell by 8.1 percent, and the number at firms with 500 or more workers fell by 5.4 percent. Thus, CBO's assessment is that small and medium-sized firms suffered disproportionately greater job losses than large firms did over the past few years. That difference in employment growth by firm size is consistent with the trend observed over the preceding decade and a half, during which the share of private-sector employment at large employers edged up gradually (see Figure 1).

Whether the recent recession has been unusually difficult for small firms is unclear because historical data are not sufficient to establish a typical pattern for job losses during recessions. In contrast with the recent recession, large firms experienced substantially more net job losses than small firms did during the 2001 recession. However, during the recession of 1991, there were disproportionately greater net job losses in small firms than in large ones.<sup>6</sup>

5. See Jessica Helfand, "All Firm Sizes Hit Hard During the Current Recession," *Issues in Labor Statistics*, Summary 10-02 (Department of Labor, Bureau of Labor Statistics, March 2010), [www.bls.gov/opub/ils/summary\\_10\\_02/all\\_firm\\_sizes\\_hit\\_hard.htm](http://www.bls.gov/opub/ils/summary_10_02/all_firm_sizes_hit_hard.htm); Giuseppe Moscarini and Fabien Postel-Vinay, "The Contribution of Large and Small Employers to Job Creation in Times of High and Low Unemployment" (draft, June 2011), [www.econ.yale.edu/~gm76/large\\_employers.pdf](http://www.econ.yale.edu/~gm76/large_employers.pdf); and Aysegül Sahin and others, "Why Small Businesses Were Hit Harder by the Recent Recession," *Current Issues in Economics and Finance*, vol. 17, no. 4 (New York: Federal Reserve Bank of New York, July 2011), [www.newyorkfed.org/research/current\\_issues/ci17-4.pdf](http://www.newyorkfed.org/research/current_issues/ci17-4.pdf).

6. See Helfand, "All Firm Sizes Hit Hard During the Current Recession."

**Box 1.****Assessing Changes in Employment at Firms of Different Sizes**

One reason that studies have come to different conclusions about the role of small firms in the labor market during the recent recession is that they have used different methods for measuring changes in employment. Those different methods have various strengths and weaknesses.

The method that CBO used to calculate the changes in employment reported in this analysis is based on comparisons of total employment within various firm-size categories at different points in time. A strength of this method is that it shows the relative importance of firms of different sizes in the labor market at a given point in time. As a simple example, if total employment at small firms was 1 million at the end of 2008 and 1.1 million at the end of 2009, the employment growth rate for small firms for 2009 would be 10 percent using this approach. However, because firms start, grow, shrink, and fail on a regular basis, the small firms whose employment is measured in 2008 may not be the same small firms measured in 2009. As a result, this approach does not estimate job losses or gains at any fixed set of small firms. In particular, when larger firms shrink and become small firms, the workers remaining in those firms are then reclassified as small-firm workers, offsetting some of the job losses experienced by firms that were small initially.

An alternative approach is to measure employment changes within specific firms whose size class is based on their employee count at the beginning of the period. A drawback of that approach, however, is that the number of people employed at a given firm fluctuates from year to year even in times of economic stability. If a firm has an unusually high number of employees one year, it will often see a drop in employment in the next, and vice versa. That phenomenon—sometimes known as regression to the mean—can lead to the incorrect impression that large firms are shrinking and small firms are growing even if the sizes of all firms are simply oscillating around stable long-run levels.

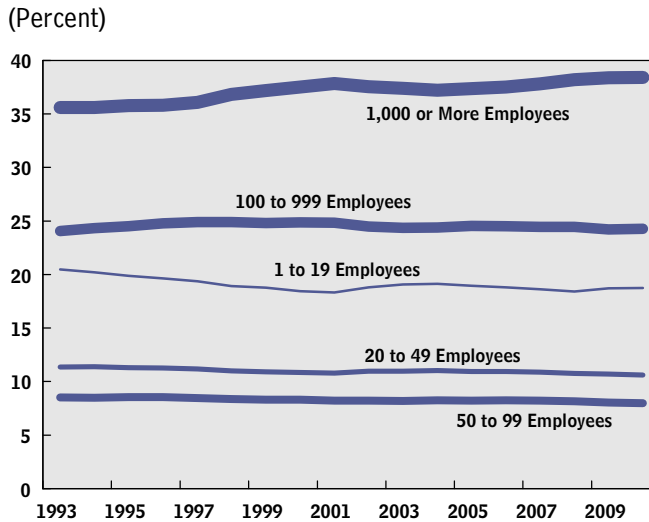
Yet another approach is the “dynamic sizing” method used by the Bureau of Labor Statistics in its Business Employment Dynamics program. Using that methodology, when a firm changes from one size category to another, losses and gains are allocated across categories. If, for example, a firm with 500 workers suddenly shut down, employment in the category of “500 or more workers” would show the loss of only a single job; the rest of the employment loss (499 jobs) would be allocated among smaller firm-size categories even though the firm in question never operated at those employment levels. Consequently, that approach tends to overstate job losses at small firms when the economy is contracting and firms are closing.

One factor contributing to the decline of small business employment over the past several years has received particular attention: small firms’ reduced access to credit. (A subsequent section of this brief discusses at greater length the availability of credit for small firms in recent years.) One recent study found that, in 2008 and 2009, workers in credit-sensitive industries, such as construction and real estate, were more likely to lose their jobs if they were employed by small rather than large firms; conversely, there was no appreciable difference in the probability of job loss across firm sizes in less credit-sensitive industries.<sup>7</sup>

However, responses to surveys indicate that access to credit has not been the main problem facing small businesses during the past several years; poor sales, taxes, government regulations, and economic uncertainty

7. See Burcu Duygan-Bump, Alexey Levkov, and Judit Montoriol-Garriga, *Financing Constraints and Unemployment: Evidence from the Great Recession*, Working Paper No. QAU10-6 (Boston: Federal Reserve Bank of Boston, December 14, 2011), [www.bos.frb.org/bankinfo/qau/wp](http://www.bos.frb.org/bankinfo/qau/wp). That study defines a small firm as having fewer than 500 workers.

**Figure 1.**  
**Share of Private-Sector Employment, by Firm Size, 1993 to 2010**



Source: Bureau of Labor Statistics, Business Employment Dynamics database.

have been mentioned more frequently as problems.<sup>8</sup> In addition, a recent survey of loan officers indicates that banks have not tightened lending standards, on net, during the past two years for small firms.<sup>9</sup> Among firms with less than \$50 million in annual sales, the share reporting that they received none of the credit they wanted in the preceding year declined from 23 percent in late 2009 to 16 percent in October 2010.<sup>10</sup>

### Job Creation and Firm Size

Across all size categories, firms are continually growing and shrinking. Thus, even in a period of stable overall employment, substantial “churning of labor”—the loss of jobs at some firms, the gain of jobs at others—occurs among shrinking and growing firms. Churning rates are

much higher for small firms than for large firms. Annual employment gains and losses each amount to more than 10 percent of employment among firms with fewer than 20 employees, whereas gains and losses are roughly 2 percent to 3 percent of employment among firms with more than 1,000 employees (see Figure 2). Employment shares at smaller firms stay roughly constant over time because their higher job-creation rates are offset by nearly equivalent rates of job destruction and because fast-growing small firms “graduate” into larger firm-size categories.

Job creation slowed and job destruction accelerated in firms of all sizes after the recession started in December 2007. Job-creation rates began to rise and job-destruction rates began to fall in 2009, halting further decreases in employment. For the most part, job-destruction rates returned to their prerecession levels by 2010, but job-creation rates did not.

Although studies often show that, on net, small firms create more jobs than large firms do, the strength of the relationship varies with the technical approach and data used.<sup>11</sup> Recent research, however, has found that it is young small firms, especially start-ups, that grow faster—and consequently create jobs at a higher rate—than either large firms or established small firms do. One study found that the smallest firms, those with between one and four employees, grew 4.7 percent faster than the largest firms, those with more than 10,000 employees.

8. See William C. Dunkelberg and Holly Wade, *Small Business Economic Trends* (Washington, D.C.: NFIB Research Foundation, February 2012), [www.nfib.com/research-foundation/small-business-economic-trends-sbet-archive](http://www.nfib.com/research-foundation/small-business-economic-trends-sbet-archive); and John K. Paglia, *Private Capital Markets Project*, Survey Report No. 5 (Los Angeles, Calif.: Pepperdine University, Graziadio School of Business and Management, Summer 2011), Figure 7, [www.bs.school.pepperdine.edu/appliedresearch/research/pcmsurvey/content/PCMPsummer2011.pdf](http://www.bs.school.pepperdine.edu/appliedresearch/research/pcmsurvey/content/PCMPsummer2011.pdf).

9. See Board of Governors of the Federal Reserve System, *The January 2012 Senior Loan Officer Opinion Survey on Bank Lending Practices* (January 2012).

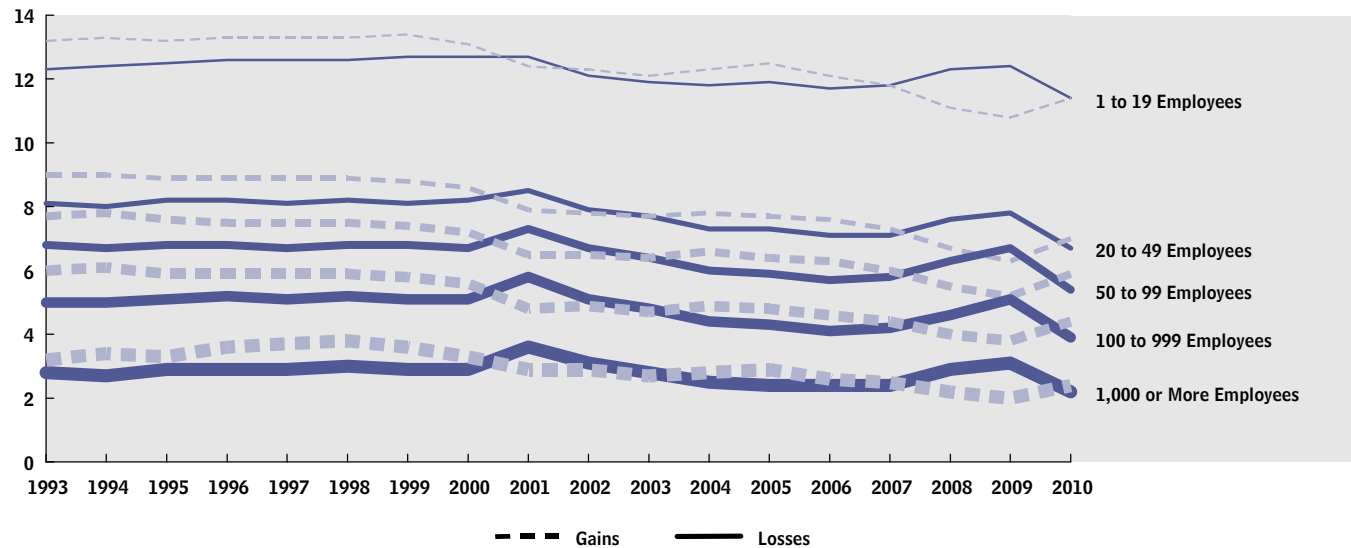
10. See William J. Dennis, Jr., *Small Business Credit in a Deep Recession* (Washington, D.C.: NFIB Research Foundation, February 2010), p. 31, [www.nfib.com/Portals/0/PDF/AllUsers/research/studies/Small-Business-Credit-In-a-Deep-Recession-February-2010-NFIB.pdf](http://www.nfib.com/Portals/0/PDF/AllUsers/research/studies/Small-Business-Credit-In-a-Deep-Recession-February-2010-NFIB.pdf); and William J. Dennis, Jr., *Financing Small Businesses: Small Business and Credit Access* (Washington, D.C.: NFIB Research Foundation, January 2011), p. 42, [www.nfib.com/Portals/0/PDF/AllUsers/research/studies/Small-Business-Credit-Access-NFIB.pdf](http://www.nfib.com/Portals/0/PDF/AllUsers/research/studies/Small-Business-Credit-Access-NFIB.pdf).

11. For studies that show that small firms create a disproportionate share of new jobs, see David Neumark, Brandon Wall, and Junfu Zhang, *Do Small Businesses Create More Jobs? New Evidence from the National Establishment Time Series*, Working Paper No. 13818 (Cambridge, Mass.: National Bureau of Economic Research, 2008), [www.nber.org/papers/w13818](http://www.nber.org/papers/w13818); Bruce A. Kirchoff and Bruce D. Phillips, “The Effect of Firm Formation and Growth on Job Creation in the United States,” *Journal of Business Venturing*, vol. 3, no. 4 (1988), pp. 261–272; and David L. Birch, *Job Creation in America: How Our Smallest Companies Put the Most People to Work* (New York: Free Press, 1987). For a study that finds no relationship, see Steven J. Davis, John C. Haltiwanger, and Scott Schuh, *Job Creation and Destruction* (Cambridge, Mass.: MIT Press, 1996).

**Figure 2.**

## Total Job Creation and Destruction as a Share of Private-Sector Employment, by Firm Size, 1993 to 2010

(Percent)



Source: Bureau of Labor Statistics, Business Employment Dynamics database.

However, when the comparison is made between firms of the same age, small firms grow more *slowly* than large firms do.<sup>12</sup>

Almost all firms start small. Many fail and, of those that do survive, most have no desire to expand beyond “small firm” status.<sup>13</sup> Only a few grow substantially and become large firms. Thus, the faster average growth of young small firms is driven by the ambitions and successes of a fairly narrow set of start-up employers.

### Advantages and Disadvantages That Varying Policies by Firm Size Could Have for Overall Job Growth

For the purpose of promoting job growth, policies favoring small firms can have both advantages and disadvantages.

12. See John C. Haltiwanger, Ron S. Jarmin, and Javier Miranda, *Who Creates Jobs? Small vs. Large vs. Young*, Working Paper No. 16300 (Cambridge, Mass.: National Bureau of Economic Research, August 2010), [www.nber.org/papers/w16300](http://www.nber.org/papers/w16300).

13. See Erik Hurst and Benjamin Wild Pugsley, “What Do Small Businesses Do?” (draft, University of Chicago, September 2011), <http://faculty.chicagobooth.edu/erik.hurst/research/>.

One advantage relates to the cost of complying with federal regulations, which may be especially burdensome for small firms. For example, compliance with federal regulations—such as those aiming to prevent discrimination or reduce pollution—often requires that firms develop internal systems or procedures that have a fixed cost per firm in addition to costs that vary with the size of the firm. In that case, achieving the goal of the regulation at small firms will be relatively more costly than achieving it at large firms. Therefore, policymakers may reasonably decide to apply certain regulations in modified form at small firms or to exempt small firms from some regulations altogether.<sup>14</sup> Such an approach could promote employment growth.

In contrast, a disadvantage of policies favoring small firms is that such policies may inadvertently discourage certain firms from increasing in size and losing that preferential treatment. Moreover, exempting small firms from certain regulations, or modifying regulations applied to small firms, may allow more of certain problems—such as

14. See Dhammika Dharmapala, Joel Slemrod, and John Douglas Wilson, “Tax Policy and the Missing Middle: Optimal Tax Remittance with Firm-Level Administrative Costs,” *Journal of Public Economics*, vol. 95 nos. 9-10, (October 2011), pp. 1036–1047.

discrimination or pollution—to persist than would be the case if regulations were applied uniformly across firms of different sizes.

More generally, the effectiveness of achieving job growth by targeting policies at small firms depends on how the details of the policies relate to the various ways that small and large firms differ. In some cases, targeting policies at small firms might be more effective than using broader policies, but in other cases, the opposite is true. For example, CBO has analyzed options for spurring employment by temporarily reducing employers' payroll taxes when their firms hire additional workers. Because jobs provided by small firms are less "durable" (that is, such jobs are more likely to be later eliminated), the economic benefits of each subsidized job are lower if the payroll tax cut is restricted to small firms. In addition, because of the higher volatility of employment at small firms, a larger share of a tax reduction targeted at small firms would pay for employment growth that would have occurred without the policy, thereby reducing the policy's cost-effectiveness relative to a comparable tax reduction offered to all firms.<sup>15</sup>

Note also that projecting policy effectiveness based on historical rates of job growth at small firms or other measures of past performance may not be appropriate. For example, a study of high-growth firms conducted in 2007 would have concluded that the construction of residential housing—which involves a disproportionate number of small firms—was a large source of net job growth during the previous decade. However, a policy implemented in 2007 to support employment in that industry probably would not have had much effect on employment over the next several years because the conditions that previously generated growth in that industry were not sustainable.

## The Federal Policy Environment Faced by Small Firms

The ability of all firms to expand or become more efficient—that is, to produce goods and services in a more cost-effective way—is influenced by federal policies that determine the taxes those firms pay, the availability of credit, the regulations with which they must comply,

and other factors. In many cases, the current federal policy environment is more favorable to small businesses than to large ones; in other cases, the reverse is true.

### Tax Policies

Tax policies can significantly affect decisions about whether to start a new business or to expand an existing firm. Some provisions of the tax code explicitly distinguish between large and small firms on the basis of employee count. For example, under the Affordable Care Act enacted in 2010, tax credits are available to businesses with 25 or fewer full-time-equivalent employees to help cover the costs of providing those employees with health insurance; and, beginning in 2014, penalties will be imposed on certain businesses with 50 or more employees that do not offer health insurance.<sup>16</sup>

Because the Internal Revenue Service cannot easily verify the number of a firm's full-time employees, the tax code typically uses other criteria—such as the amount of a firm's investments or its assets or income—to differentiate between large and small businesses. For example, firms with relatively small amounts of qualifying capital investment (primarily, tangible resources such as equipment) benefit from an "expensing" provision that allows them to fully deduct such costs in the year those assets are placed into service rather than over time as their value depreciates. The maximum amount a firm can expense in 2012 is \$139,000; that amount phases out dollar for dollar for purchase amounts above \$560,000, so that provision does not provide benefits to firms purchasing \$699,000 or more of equipment. The provision implicitly favors smaller firms because they tend to make smaller capital investments than larger firms. Under current law, the maximum expensing amounts and phaseout thresholds will fall to \$25,000 and \$200,000 in 2013 and beyond, so the provisions will be increasingly targeted to smaller firms in the future.

Another tax-code provision helps small and mostly young firms attract capital by reducing the capital gains tax that investors pay upon sale of the firms' stock. The tax is reduced by allowing investors to exclude from taxation half or more of the gains on such investments (although the remaining gains are taxed at regular income tax rates,

15. For additional discussion, see Congressional Budget Office, [letter to the Honorable Robert P. Casey, Jr.](#), providing information on reducing payroll taxes to encourage employment (February 3, 2010).

16. The maximum credit for small firms is available only to firms with 10 or fewer full-time-equivalent employees with average taxable wages of \$25,000 or less. The credit phases out as employment and average wages rise.

up to a maximum of 28 percent). To qualify for such favorable treatment, a firm's assets cannot exceed \$50 million at the time stock is issued and the firm cannot be in certain lines of business, such as law, finance, or the restaurant industry; in addition, the investor must purchase the stock at the time it is issued and hold it for more than five years. Among those benefiting from the provision are venture capital funds and start-up firms making their initial public offerings of stock.

Other provisions of the tax code do not explicitly treat large and small firms differently but, by their nature, may have that effect. For example, the tax code implicitly favors small businesses in that statutory tax rates increase with net business income. Businesses with lower gross receipts, therefore, are typically taxed at lower rates.

In addition, large and small businesses tend to choose different organizational structures—a choice that has tax consequences that may or not be advantageous to small businesses. Large businesses are more likely to incorporate and become subject to the corporate income tax. Those corporations may choose to retain their after-tax profits for future investment, which tends to increase the value of corporate stock, or they may distribute them as dividends to shareholders. Shareholders pay individual income tax on corporate dividends at rates up to 15 percent, and they pay tax on capital gains at rates up to 15 percent when they sell their shares of stock.<sup>17</sup> Either way, profits of such corporations are taxed once at the corporate level and again at the shareholder level. Small businesses are more likely to be organized as “pass-through entities” such as sole proprietorships and partnerships; those organizational forms are not subject to the corporate income tax. Their profits (even those retained by the firm) are deemed to pass through to their owners, where they are taxed at the individual level. For investments not financed through borrowing, the pass-through tax treatment results in a lower effective tax rate—and higher after-tax profits—than does the tax treatment of firms subject to the corporate income tax, effectively giving an advantage to small businesses. For investments financed through borrowing, however, the opposite is true, putting small businesses at a disadvantage.

17. In 2013, the tax rate on dividends is scheduled to revert to the rate on ordinary income—as high as 39.6 percent for some taxpayers. The tax rate on capital gains is scheduled to increase to a maximum of 20 percent.

Some observers maintain that the estate tax poses a hardship for small businesses and family farms. They base their concerns on the fear that beneficiaries of estates may have to wholly or partially liquidate the business or farm if building up such an enterprise has resulted in a taxable estate without enough liquid assets to pay estate taxes.<sup>18</sup> However, the tax code contains special provisions to reduce the burden of the estate tax on small businesses and family farms. Very few such enterprises have sufficient assets to trigger estate taxes upon the owner's death; and among those that do, the vast majority of estates, including those of farmers and small-business owners, have enough liquid assets to pay the estate taxes they owe.<sup>19</sup> Some of those observers also charge that, because the estate tax lowers the rewards from investment, a business owner or family farmer wishing to leave the enterprise (whether large or small) to his or her heirs may be less inclined to invest in it or to hire workers—or may even be dissuaded from starting the business or farm in the first place. Those effects, however, may be mitigated by other factors. First, some people with taxable estates leave larger estates than they originally intended because they did not live long enough to spend more of their savings; the estate tax is unlikely to affect the behavior of those people. Second, some heirs may be less likely to work or to start their own businesses if they expect to receive a large inheritance.

### Credit Policies

Many businesses depend on financing to grow and to hire workers. Typical sources of financing for small businesses include personal savings, bank loans (such as business loans, equity loans secured by primary residences and investment property, and credit lines), funds from friends and family, credit cards, vendor financing, and various equity arrangements.<sup>20</sup> External financing for small firms—that is, from sources other than personal savings—most commonly takes the form of bank loans. In contrast, large firms have greater access to capital markets, where they can raise equity through the sale of stock

18. For example, see Patrick F. Fagan, *How the Death Tax Kills Small Businesses, Communities—and Civil Society*, Backgrounder No. 2438 (Washington, D.C.: Heritage Foundation, 2010), [www.heritage.org/Research/Reports/2010/07/How-the-Death-Tax-Kills-Small-Businesses-Communities-and-Civil-Society](http://www.heritage.org/Research/Reports/2010/07/How-the-Death-Tax-Kills-Small-Businesses-Communities-and-Civil-Society).

19. See Congressional Budget Office, *Federal Estate and Gift Taxes*, Issue Brief (December 2009); and *Effects of the Federal Estate Tax on Farms and Small Businesses* (July 2005).

20. See Paglia, *Private Capital Markets Project*, Figure 7.



(through public offerings and private-equity placements) and borrow funds through the public issuance of debt (such as long-term bonds and short-term commercial paper) and through lines of credit from groups of banks.

As a supplement to private financing, the federal government has historically provided loan guarantees that enable small firms to borrow at more attractive terms (for example, lower interest rates and fees) than they might otherwise obtain. In particular, the Small Business Administration guarantees loans to some borrowers that are otherwise unable to meet commercial lenders' underwriting criteria. Through its 7(a) Loan Program, SBA guarantees loans to small businesses for the purchase of land, buildings, equipment, machinery, and supplies, as well as to pay short-term operating expenses, such as salaries. Additionally, SBA's Certified Development Company/504 loan program guarantees long-term financing to small firms to help them acquire significant fixed assets for expansion or modernization.

The recent financial crisis disproportionately affected small businesses' access to capital. During the recession, asset values and household wealth fell, making it more difficult to fund small-business activities using personal wealth or to obtain credit using personal assets as collateral. As of June 2010, the outstanding value of loans to small firms had declined by 6.5 percent, to about \$650 billion, from a peak of \$700 billion in June 2008.<sup>21</sup> That decline probably reflects declines in both the demand for and supply of loans—and the relative importance of those factors is difficult to quantify. In general, the demand for loans decreases during recessionary periods when the pace of economic activity is slower and the supply also decreases as banks tighten their credit standards.

To increase the supply of credit to small firms, the American Recovery and Reinvestment Act of 2009 (ARRA) raised the 7(a) loan limits and guaranteed lending to refinance commercial real estate loans. The number of lenders participating in the 7(a) program increased by

27 percent from 2009 to 2010, the total number of loans approved under the 7(a) and 504 programs increased by 14 percent, and the total dollar amount of loans approved under the 7(a) and 504 programs increased by 29 percent. The Small Business Jobs Act of 2010 further increased loan limits available under the 7(a) program and increased loan limits available through the 504 program as well; at the same time, the act also waived the loan fees usually assessed in those two programs. Despite those program changes, the lending guaranteed by SBA through its 7(a) and 504 programs constituted less than 3 percent of total small-business lending in 2010. ARRA also established the Small Business Lending Fund, which allocated up to \$30 billion to community banks and community development loan funds with less than \$10 billion in assets to encourage them to increase their lending to small businesses. As of September 2011, however, demand for those funds remained low, with only \$4 billion distributed to qualifying lending institutions.<sup>22</sup>

### Regulatory Policies

Smaller firms are exempt from a variety of laws and regulations that apply to larger firms. For example, the 1972 amendments to the Civil Rights Act of 1964 explicitly exclude firms with fewer than 15 employees.<sup>23</sup> Similarly, federal contractors with 50 or more employees must develop affirmative action programs that are subject to compliance review by the Office of Federal Contract Compliance Programs.<sup>24</sup> Those reports count employees by sex and race or ethnic category for each of 10 occupational categories and subcategories. Companies also use the information in those reports to prepare affirmative action plans indicating how they plan to address any statistical shortfalls that may exist in their employment of people in certain demographic groups. Apart from those reports, large contractors may have their compensation practices reviewed and compared against formal standards for interpreting nondiscrimination requirements, and a contractor may be declared ineligible for federal contracts if its compensation practices are found to be

21. Based on data collected by Highline Financial from call reports submitted to the Federal Financial Institutions Examination Council from June 2008 through June 2010. Loans to small firms are defined as loans of \$1 million or less. For more details, see Federal Deposit Insurance Corporation, "Loans to Small Businesses and Small Farms" (2010), [www.fdic.gov/regulations/resources/call/crinst/2010-03/310RC-C2\\_03312010.pdf](http://www.fdic.gov/regulations/resources/call/crinst/2010-03/310RC-C2_03312010.pdf).

22. Department of the Treasury, "Small Business Lending Fund Provides More Than \$4 Billion to 332 Community Banks Across the Nation" (press release, Washington, D.C., September 28, 2011), [www.treasury.gov/press-center/press-releases/Pages/tg1315.aspx](http://www.treasury.gov/press-center/press-releases/Pages/tg1315.aspx).

23. Equal Employment Opportunity Act of 1972, 42 U.S.C. §2000e(b).

24. 41 C.F.R. §60-2 (2009).

systemically discriminatory. Small contractors are not subject to those reporting requirements or those rules regarding compensation practices.<sup>25</sup> Another example of regulations that do not apply to small employers is the Family and Medical Leave Act of 1993, which exempts firms with fewer than 50 employees.<sup>26</sup>

In addition, some environmental rules apply more stringently to large firms. For example, the Environmental Protection Agency maintains the Toxics Release Inventory database, which records the nature and location of toxic materials released into the environment. The reports that generate that database are prepared by businesses, and larger firms face greater reporting requirements.<sup>27</sup>

Lastly, many federal contracting programs contain set-asides for small businesses that guarantee they will receive a minimum share of federal contract dollars. For example, the Small Business Innovation Research program awards contracts worth billions of dollars in bidding processes open only to small firms.<sup>28</sup>

25. See William J. Carrington, Kristin McCue, and Brooks Pierce, "Using Establishment Size to Measure the Impact of Title VII and Affirmative Action," *Journal of Human Resources*, vol. 35, no. 3 (Summer 2000), pp. 503–523.

26. Family and Medical Leave Act of 1993, 29 USC §2601 et seq.

27. See Environmental Protection Agency, *Toxic Chemical Release Inventory Reporting Forms and Instructions* (October 2009), p. 1, [www.epa.gov/tri/report/rfi/ry2009rfi121709.pdf](http://www.epa.gov/tri/report/rfi/ry2009rfi121709.pdf).

28. See Scott J. Wallsten, "The Effects of Government–Industry R&D Programs on Private R&D: The Case of the Small Business Innovation Research program," *RAND Journal of Economics*, vol. 31, no. 1 (Spring 2000), pp. 82–100.

## Other Policies

Federal investments in infrastructure, tax credits for research and development, and funding for basic scientific research enhance the economic environment in which all firms operate. Those policies do not target firms of any specific size, but they may generate market opportunities that contribute to the formation of new small firms and the creation of new jobs. For example, small Internet companies would not exist had the federal government not funded the original research and development that led to the creation and growth of the Internet. In addition, even if larger firms are better able to take advantage of certain federal policies that support research and development or that expand certain business markets (for example, through the sale of portions of the electromagnetic spectrum), their responses may ultimately benefit smaller firms—as was the case when larger companies marketed so-called smart phones, and smaller companies developed applications for those phones.

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