No. 10-59
September 2010

WORKING PAPER

THE BUSINESS OF GOVERNMENT SHOULDN'T BE BUSINESS

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This paper is an updated version of working paper 09-15, "A Culture of Kindness."

The Business of Government Shouldn't Be Business
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With the unemployment rate in the United States lingering just below 10 percent and elections approaching rapidly, job creation has become Washington's top priority. Arguing that small businesses create the most jobs, lawmakers are instituting several programs that focus on helping small businesses. The effectiveness of these policies, though, is dubious. If government wants to help the economy, which in turn would create jobs, it needs to get out of the business of helping business.

Every Business is Special

If policy makers' main goal is to create new jobs, it doesn't make sense to favor small firms over the large or the large over the small. New jobs come from small *and* big businesses. Small businesses—firms with fewer than 500 employees according to the official definition—compose 99.7 percent of all employer firms and account for about half of the country's total employment.[1] Companies that employ more than 500 workers represent only 0.3 percent of all employer firms in the U.S. and yet they also account for about half of the country's total employment. In the 1990s, large multinational corporations created jobs more rapidly than other companies, and they have been vital to employment in the subsequent decade as well.[2]

The government's current policies promote 50 percent of the workforce at the expense of the other 50 percent. That's the problem with preferential government policies in business: they choose the interests of one group over another, which creates a host of problems.

Special treatment creates special interest groups, and special interests groups tend to undermine the application of economic efficiency criteria. Preferential government policies for small businesses, for example, have inspired those small businesses to join together to protect their benefits and lobby for more. Thus joined together, small businesses have lobbied for policies that benefit all small businesses equally.

Special but equal treatment may sound great in theory, but in practice, it's highly inefficient. This equal treatment diverts resources to businesses that do not deserve it.[3] Moreover, special treatments rarely go away, even when the original conditions change and even if the policy is a failure. Government officials are reluctant to acknowledge policy failure, and the targeted group has a strong incentive to want the policies to be made permanent.[4]

In addition, special treatment for small businesses often creates perverse side effects. A tax code that favors small firms over large ones, for instance, makes it more profitable to stay small rather than grow. [5] This perverse incentive leads to a misallocation of resources away from their most productive uses and interferes with the natural growth and evolution of firms. Preferential regulatory treatment has the same effect.

The Dubious Effectiveness of the Business Policies

Despite the problems of preferential treatment, there's a lot of it going on Capitol Hill, much of it targeted at small businesses. Even if small businesses were the engine of growth, these policies would not fire that engine up. Consider just two of those policies: the tax credit and small business loans.

1. Tax Credit

A new $26 billion job bill going through Congress would give enterprises of any size a $5,000 tax credit for each employee they add to their payrolls in 2010. (Startups launched in 2010 would be eligible for half of the tax credit.) This is a bigger version of the $1,000 tax credit passed by Congress in February or the ones included in the $17 billion bill in May.

Lawmakers assume rightly that lowering the cost of employment helps firms keep their current employees or hire new ones. They assume wrongly, however, that tax credits are a good way to reduce these costs. Tax credits are useful only if businesses have tax liabilities, which tend not to exist when business is slow. As William Dunkelberg, chief economist for the National Federation of Independent Business points out, "Our member surveys for plans to add inventory and plans to hire are all coming in at 35 year lows. They have no reason to hire anybody because they don't have anything to do. That's why the tax credit is a silly idea."[6]

Another reason is basic economic inefficiency. The government shouldn't be the one deciding that hiring one new employee is better for the business than increasing the productivity of existing employees. Overall, this reduces national productivity.

2. Loan to Small Businesses

Direct or guaranteed loans to small businesses are another popular approach to helping small businesses. The idea is that increasing small businesses' access to capital will help them create jobs. With that in mind, the administration included $730 million in the stimulus bill to increase the government guarantees from 75 to 90 percent on some $17 billion of Small Business Administration loans. This reduces lender risk by covering borrowers' fees up to $75,000 per loan. The government also took aggressive steps to boost bank liquidity, with up to $15 billion aimed at unfreezing the secondary credit market, where most commercial and small-business loans are made.

So far these efforts have been fruitless as the demand for loans has remained flat.[7] The failure of his earlier policies however, hasn't stopped the president from requesting an additional $30 billion of TARP money to start a new program that would provide loans to small businesses, arguing, among other things, that small businesses aren't borrowing money, investing, and hiring because risk-averse banks won't lend them the money. But the reality is not as straightforward.

In its new survey of bank lending practices, the U.S. Federal Reserve Board finds that for the first time since 2006, banks are making commercial and industrial loans more available to small firms, with about one-fifth of large domestic banks having eased lending standards.[8] Also, the study finds that for the past six months, banks have continued easing lending to large and mid-sized firms. Yet the demand for credit remains unchanged.

According to the Fed, the growing distaste for credit among small business owners has hampered the way for new purchases and investments. Borrowing money, investing, and increasing staff are things to do during good times, not bad. And businesses think the times are bad.

Growing Uncertainty

Part of the reason businesses think times are bad might be due to public policy uncertainties. The health care overhaul will bring new but still unknown obligations; legislation tackling climate change could raise businesses' energy costs; the new financial regulations will take years to put in place. Meanwhile, as government spending increases, so do the chances of more taxes in the future. These changes all add uncertainty to an already uncertain economy.

Public policy uncertainties tend to decrease business investment and hiring.[9]As Richard Fisher, president and CEO of the Federal Reserve Bank of Dallas, explains, "Businesses and consumers are being confronted with so many potential changes in the taxes and regulations that govern their behavior that they are uncertain about how to proceed downfield. Awaiting clearer signals from the referees that are the nation's fiscal authorities and regulators, they have gone into a defensive crouch."[10]

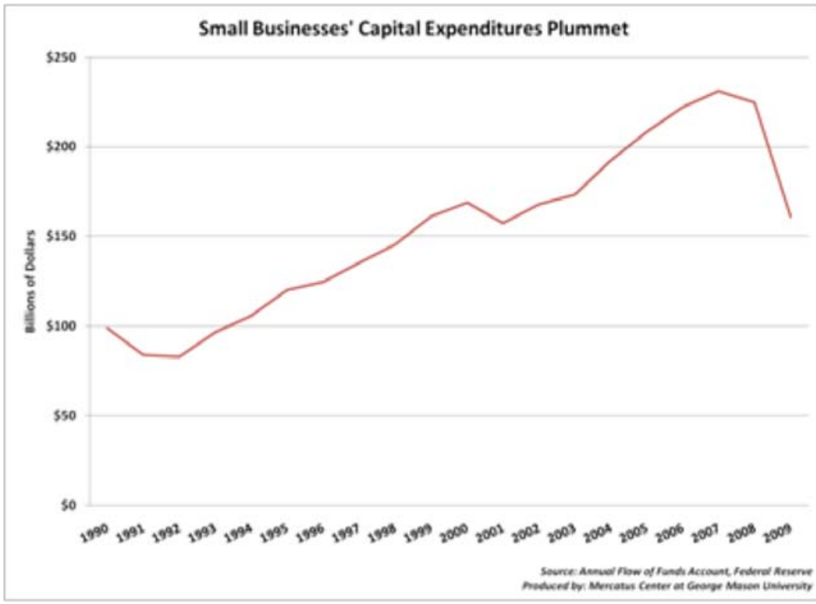
Federal Reserve data confirm this impression (figure 1). Today businesses are sitting on $1.8 trillion in capital instead of investing it. From 2008 to 2009, small-business capital expenditures plummeted by $63.6 billion (see chart), while owners' personal investments in their businesses fell by $2.5 billion following a decrease of $9.2 billion the previous year.

Maybe more relevant to small businesses is the fact that the Bush-era tax cuts are set to end next year, but their fate is still unclear. According to an NFIB poll, 75 percent of small businesses are organized as pass-through entities (sole proprietors, partnerships, S Corps, etc.), meaning they pay taxes on their business income based on the individual tax rates. If the tax cuts expire for "wealthy" citizens, this increase in taxes will affect many small firms, which will in turn affect small business employment.[11]

In addition to the uncertainty introduced by the possible tax hikes, tax hikes stop firms from creating jobs. Raising the tax rates on the top two income brackets will have a negative impact on small business job creation. Based on an NFIB small business survey, the businesses most likely to face a tax increase by raising the top two rates are businesses employing between 20 and 250 employees. These firms will suffer if the tax cuts expire so as a result, companies are freezing hiring, cutting benefits, and delaying expansion plans.

Conclusion

Neither small nor large businesses can flourish in a world of uncertainty. By reaching into virtually every sector of economic life and by picking winners and losers, the government is injecting uncertainty into the marketplace, making it harder for the economy to recover. The administration and Congress need to stop trying to “help” business and instead focus on promoting an environment that gives incentives, such as low taxes and stable regulations, to individuals and businesses to take risks, produce, and be entrepreneurial.



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