Quick Study
A Policy Report Summary by the Institute for Policy Innovation

Barriers To Entrepreneurship:
How Government Undermines Economic Opportunity

A Summary of IPI Policy Report #149

By Naomi Lopez

America's entrepreneurial tradition has provided the nation with a strong economic base, and has been, for many, central to achieving the American dream. Of course, would-be entrepreneurs cannot have an aversion to risk or hard work. But, in addition to the normal challenges associated with starting your own business, today's small companies must also endure government-imposed barriers such as excessive taxation and regulation.

Snapshot

A majority of Americans work for firms with fewer than twenty employees. These small businesses account for a significant portion of job growth. Between 1990 and 1995, companies with fewer than 20 employees were responsible for 49 percent of net new jobs. Firms with fewer than 500 employees were responsible for 76.5 percent of new jobs. In the years ahead, these figures are only likely to rise, with women, minorities, high tech start-ups, and immigrants accounting for the majority of new ventures.

How Taxes Impede Small Business Formation

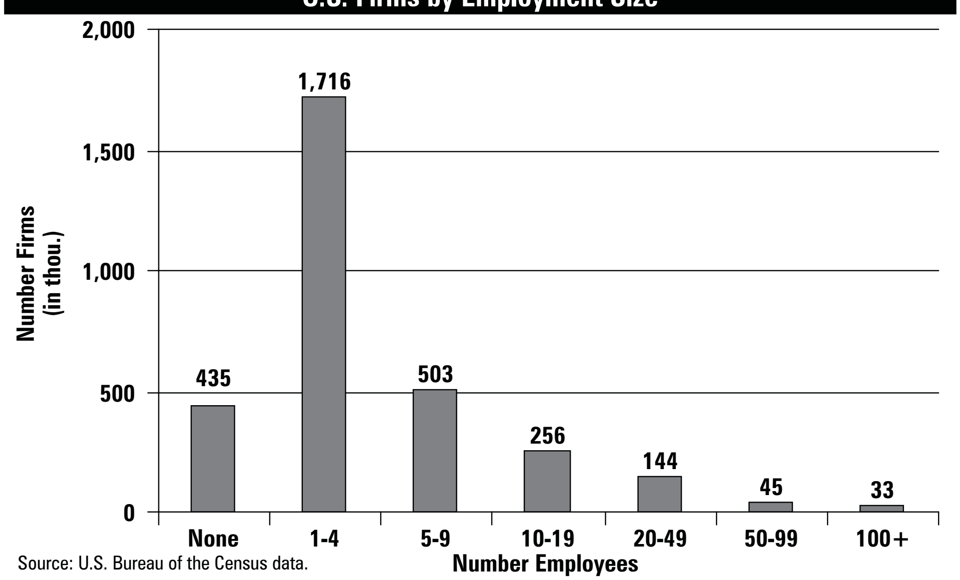
Payroll Tax and Other Mandated Costs

Due to excessive taxation, the cost of labor far exceeds the actual wage businesses' pay their employees. Economists Mark Wilson and Angela Antonelli found that between 40 and 47 percent of an employer's expense of hiring and keeping a worker is directly attributable to taxes and mandated and optional benefits. In 1995, legal and optional mandates cost private industry employers over $17 per employee per hour to hire and keep workers, manufacturing employers over $20, and service industry employers over $15. The high cost of government-mandated benefits alone accounted for almost 9 percent of employer payrolls in 1994 - up from 3.5 percent in 1951. Likewise, the combined employer-employee payroll tax rate has increased from 2 percent in 1937 to 15.3 percent today.

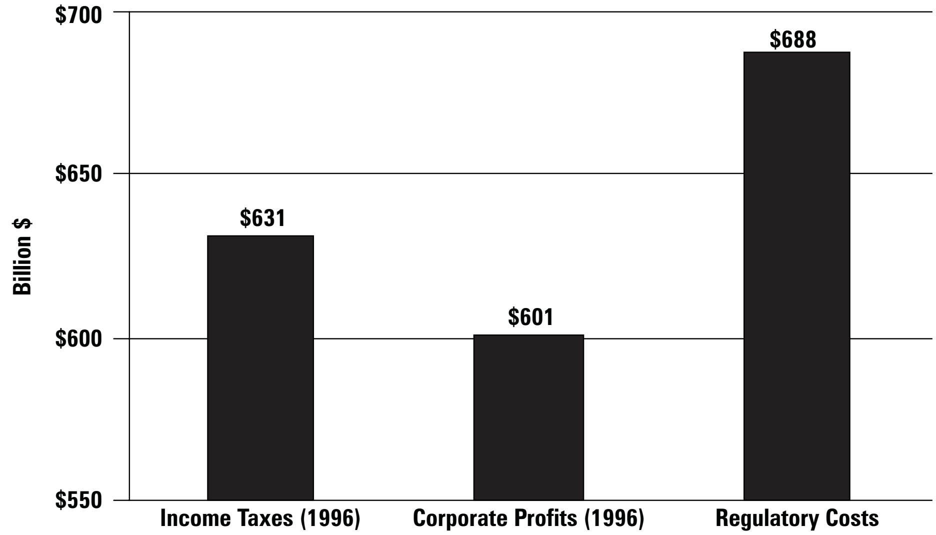
Income and Death Taxes

Research by Stephen Moore of the Cato Institute shows that dramatic tax increases have accompanied the rise of big government. While

U.S. Firms by Employment Size



U.S. Regulatory Costs



Source: U.S. Small Business Administration data as cited in C. Wayne Crews, Jr., 1998.

the top income tax rate in 1914 was 7 percent; in 1994, it had reached 40 percent. In 1914, the tax rate for the median family was 0 percent; whereas, by 1994, it was 28 percent.

In addition to countless other forms of sales and property taxes, federal policy makers have merged death and taxation into the ultimate necessity: the estate tax. According to a recent Joint Economic Committee report, the estate, or "death," tax is the leading cause of dissolution of family-run businesses. In order to meet death tax demands, which can exceed 50 percent, one-third of small business owners must sell or liquidate part of their company; half of those who liquidate are forced to eliminate 30 or more jobs in the process. Moreover, the estate tax diverts capital away from business expansion and towards insurance and legal fees.

Capital Gains Tax

Finally, higher taxes slow economic expansion by "crowding-out" funds that should be available for capital markets. Most onerous are capital gains taxes that discourage investment in business formation and expansion. And, as if that were not enough, because the capital gains tax is imposed on "profits" generated by inflation, even an investor whose real return is less than zero is subject to taxation on the gain.

How Regulations Undermine Entrepreneurs

Staying Small

The total economic burden for regulatory compliance *on the federal level alone* is now $700 billion annually, or $7,000 per household! Economist Richard Vedder suggests that, absent the regulatory buildup since the Johnson administration, the nation's GDP would be 20 percent higher today — a $1 trillion "misunderstanding." As Walter Olsen of the Manhattan Institute explains, the abundance of federal regulations encourage small businesses to stay small:

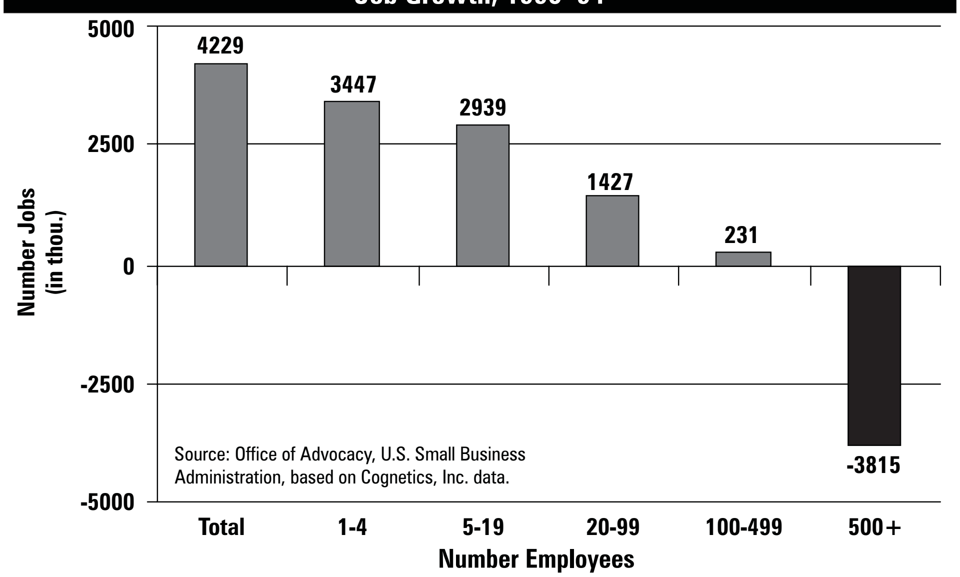
> "Occupational Safety and Health Administration regulations kick in at 10 employees, the Americans with Disabilities Act and the Civil Rights Act at 15, age bias and the health insurance continuation provisions of the Consolidated Omnibus Budget Reconciliation Act of 1986 at 20, plant-closing-notification and family-leave mandates at 50, and Employee Retirement and Income Security Act and Equal Employment Opportunity Commission reporting at 100."

It is not surprising, then, that a study by the National Association of Business Economists revealed that almost two-thirds of small firms still active in 1994 maintained the exact same employment levels they had in 1985.

Wage Laws

Heritage Foundation data predicts that a $1 increase in the federal minimum wage will result in

Job Growth, 1990–94



Source: Office of Advocacy, U.S. Small Business Administration, based on Cognetics, Inc. data.

Regulatory Costs per Employee for Different Size Firms, 1992			
Type of Regulation	**1-19 Employees**	**20-499 Employees**	**500+ Employees**
Environmental & risk reduction	$1904	$1824	$1025
Price & entry controls	$1624	$1440	$810
Paperwork	$2017	$1931	$1086
All federal regulations	$5545	$5195	$2921

Source: Thomas Hopkins, 1996.

345,000 fewer jobs in the year 2000. In addition, there would currently be 128,000 more entry-level jobs for American teens if Congress had not raised the minimum wage in 1996. State mandated "living-wage" programs, as well as the 65+ year old Davis-Bacon Act, similarly impose heavy costs on small employers, while freezing out low-skilled laborers.

Environmental

According to Angela Antonelli,

> "…environmental laws, regulations, and guidances are today worse than the U.S. tax code in terms of their invasiveness, burdensomeness, and reach into the activities of businesses and individuals."

A study by the U.S. Small Business Administration found that environmental regulations impose higher costs on small firms by requiring more complex administrative and operational activities and more difficult facility siting and permitting procedures. Likewise, "Superfund" laws that govern hazardous waste cleanup, impede development in industrial centers.

Health and Safety

Judy's Bakery, a 30-person operation that nets only $50,000 annually, was fined a whopping $13,000 for the following three infractions: (1) household bleach and pink dishwashing liquid clearly marked as "hazardous," required a written "Material Safety Data Sheet"; (2) Hooper's first floor shop, with four clearly marked exits, lacked a written emergency plan; and (3) despite a perfect record, there was no accident log on the shop's wall. Judy's is not an isolated case. According to a study by Thomas J. Kneisner and John D. Leeth, OSHA compliance costs businesses $11 billion per year, while the benefits of prevented injuries and fatalities may be no higher than $3.6 billion — and possibly as low as zero.

Other

Legions of other burdensome regulations, from zoning laws to occupational licensing to record keeping requirements, stifle entrepreneurial growth. Clyde Wayne Crews of the Competitive Enterprise Institute identified over 700 such rules in 29 departments and agencies. (Small business is subject to more than 4,000 additional regulations.) And while every business will not actually encounter each of these rules, they impose heavy costs on many small firms.

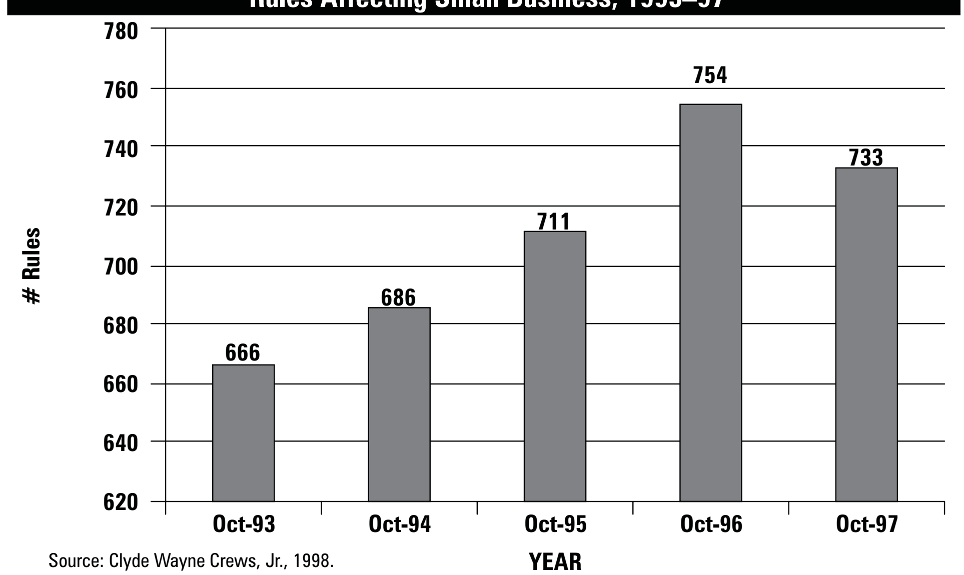
How Government Impedes the Economy

Government transfers and subsidies hinder small business growth by fostering reliance upon government largess. A 1995 Congressional Research Service report identified 177 federal assistance programs that provided direct or indirect financial benefits to businesses. Yet, as economist Dale Jorgenson has shown, for every additional dollar of federal government spending, there is an efficiency loss of 30 to 40 cents from the required taxes to pay for that spending.

Corporate Welfare

When government assistance to business is targeted to a specific firm or industry, it is commonly referred to as corporate welfare. Whether in the form of direct government grants, loans, insurance, subsidies, trade barriers, or tax loopholes carved out for the benefit of a particular company or industry, there is an efficiency loss of between 30 and 40 cents from the required taxes to pay for that spending.

Rules Affecting Small Business, 1993–97



Source: Clyde Wayne Crews, Jr., 1998.

The Small Business Administration

Along with the Commerce Department, the Small Business Administration (SBA) has outlived its usefulness. Created in 1953 as a temporary agency, the SBA operates an extensive loan program and government contract set-aside program. Contrary to popular belief, SBA loans only serve less than one percent of small businesses. Similarly, SBA set-aside programs shield well-established firms from true competition. A study by the General Accounting Office (GAO) revealed that in 1994 less than 9 percent of 8(a) set-aside contracts were awarded competitively. More disturbing is the fact that these programs are often reserved for the wealthiest and most well-connected firms.

The SBA's performance record highlights the fact that the real victims of current tax and regulatory policies are the lower and middle classes. However well-intentioned, these misguided initiatives lead to higher unemployment rates, lower take-home wages, and decreased productivity.

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The Top Five Things Lawmakers Can Do to Unleash America's Entrepreneurial Potential

If America is to remain competitive, innovative, and vibrant in the next century, we must cultivate small business formation and expansion. The top five things lawmakers can do to unleash America's entrepreneurial potential are:

1. Abolish minimum wage and living wage laws;
2. Abolish the capital gains tax;
3. Abolish estate taxes;
4. Regulatory moratorium and rollback;
5. Cut taxes and government spending, including corporate welfare.

The best policies lie in allowing entrepreneurs the freedom to succeed and fail on their own merits, with their own resources — without the interference of stifling regulations and wasteful government programs.

Want More Info?

This study is a summary of IPI Policy Report # 149, *Barriers To Entrepreneurship: How Government Undermines Economic Opportunity.*

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