



## Big Business: The Other Engine of Economic Growth

By Alan D. Viard and Amy Roden

*Popular and political discussion has anointed small business as the engine of job creation and economic growth. A wide array of tax preferences and spending programs give special treatment to small business, distorting the economy and placing heavier burdens on big businesses. In reality, however, big business also makes a critical contribution to the economy. Sound policy would spare firms of any size unnecessary regulation and taxes.*

Politicians of both parties hail small business as the engine of job creation and economic growth. President Barack Obama recently voiced his support for small businesses, calling them “the heart of the American economy.” In the same speech, he claimed, “they’re responsible for half of all private sector jobs and they create roughly 70 percent of all new jobs in the past decade. So small businesses are not only job generators, they’re also at the heart of the American dream.”<sup>1</sup> Christina Romer, chairman of the President’s Council of Economic Advisers, has given similar praise to small firms, describing them as “the engine of growth in the economy.”<sup>2</sup>

Republicans, too, have used similar language to emphasize their support for small business. “We’ve got to do something to help these small business people,” House minority whip Eric Cantor (R-Va.) said in March. “We know that they are the job creators in this economy.”<sup>3</sup> During the 2008 presidential campaign, Senator John McCain (R-Ariz.) described small businesses as “the job engine of America” and promised to “make it easier for them to grow and create more

jobs” because they are “the biggest job creators in our economy.”<sup>4</sup>

The list of such statements could be multiplied many times over.<sup>5</sup> The emphasis on small business is even reflected in the committee structure of Congress. Although the House of Representatives has a Small Business Committee and the Senate has a Small Business and Entrepreneurship Committee, the creation of a “Big Business Committee” would be politically unthinkable. But the preference for small business extends far beyond political rhetoric into numerous spending and tax provisions that give small businesses better treatment than big businesses.

### Key points in this Outlook:

- Tax policy tilts toward small business, but this emphasis is misguided and hurts economic efficiency.
- Large firms create jobs at the same rate as small ones and also provide better wages and benefits.
- Tax policy should move away from a bias against bigness, just as antitrust policy has done.

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## The Policy Tilt toward Small Business

On the spending side, the Small Business Administration (SBA) offers contract preferences, loan guarantees worth nearly \$28 billion, and other assistance to small firms.<sup>6</sup> The stimulus package passed earlier this year provided \$730 million in additional funding for the SBA's emergency lending activities, and the president's 2010 budget allocates \$700 million for the agency's yearly operations.<sup>7</sup>

On the tax side, the most important single break for small firms is the ability to avoid the corporate income tax. Smaller firms can more easily organize as sole proprietorships, partnerships, or limited liability companies, which are not subject to corporate income tax. Even if a small firm organizes as a corporation, it can still choose subchapter S status and thereby avoid corporate income tax if it has one hundred or fewer stockholders and meets certain other conditions. In contrast, large, publicly traded firms have no choice but to pay corporate income tax. Their income is then subject to double taxation, with corporate tax imposed at the firm level and dividend and capital gains taxes imposed (at a preferential 15 percent rate) at the stockholder level.

Even among firms that are subject to the corporate income tax, smaller firms face lower tax rates. While large corporations pay a 35 percent rate on their taxable income, small corporations pay 15 percent on the first \$50,000 of taxable income and 25 percent on the next \$25,000. Also, corporations with gross receipts of less than \$5 million are exempt from the corporate alternative minimum tax.

Section 179 of the Internal Revenue Code gives small firms more generous tax treatment on their equipment and software investments. For 2008 and 2009, this provision (as expanded by recent stimulus legislation) allows firms with less than \$800,000 of such investments to deduct immediately the first \$250,000 when they are made rather than depreciating the costs over time. Big firms are not as lucky; the amount that can be immediately deducted is reduced dollar-for-dollar as equipment and software investments rise above \$800,000 until the provision completely phases out at \$1.05 million.

Investors are also allowed to exclude from taxable income 50 percent (75 percent in 2009 and 2010) of capital gains on stocks in businesses that have less than \$50 million of assets. Another provision allows more generous tax deductions for capital losses on stocks of firms that

have issued less than \$1 million of stock. A tax credit for removing barriers to access by disabled persons is available only to firms with thirty or fewer employees or less than \$1 million in gross receipts. Under the Domestic International Sales Corporation provisions, tax breaks are available to exporting firms that have gross receipts of less than \$10 million. A variety of provisions allow small firms to use simpler and more favorable accounting methods.<sup>8</sup>

The stimulus package offered a striking example of tax favoritism toward small business. The versions of the package initially passed by the House and the Senate each allowed firms that lost money in 2008 greater latitude to offset the losses against past profits and obtain refunds of past tax payments. Both versions made this provision available to firms of all sizes. But when House and Senate negotiators reached agreement on the final version of the package on February 11, they unexpectedly restricted this tax relief to firms with gross receipts of less than \$15 million.

Tax discrimination against large firms has been particularly conspicuous in the oil industry. A tax break known as percentage depletion is available to independent oil producers, but not to integrated, generally larger, producers that refine as well as drill. Small oil producers also get more generous tax treatment for intangible drilling costs.

Political hostility to "Big Oil" has led to some very narrowly targeted measures. On November 18, 2005, the Senate passed a bill that would have required six large companies (BP, Chevron, ConocoPhillips, Exxon Mobil, Shell, and Total) to revalue their end-of-2005 oil inventories upward and pay tax on the revaluation and would have prevented them from amortizing their geophysical and geothermal (G&G) expenditures. The law that was ultimately enacted on May 17, 2006, omitted the inventory provision, but it lengthened the G&G amortization period from two to five years for the six firms.<sup>9</sup> A December 19, 2007, law further extended the amortization period to seven years for the six disfavored companies while continuing to allow two-year amortization for all other producers.<sup>10</sup>

President Obama has sent mixed messages about his attitude toward the taxation of small and big business. He has proposed beefing up the capital gains preference for small business stock, which would widen the disparity between small and large firms. In some other areas, though, he has called for equalizing the treatment of small and large firms. He has proposed to extend the stimulus

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package’s tax relief for 2008 losses to firms of all sizes (as the original House and Senate bills had provided). He has also proposed to subject all oil producers to the seven-year G&G amortization period currently imposed on the six big companies and to end the percentage depletion and intangible-drilling-cost preferences for independent oil producers, which would put them on the same footing as integrated producers.

### Is Small Business Special?

Despite the extensive favoritism for small firms, there is no economic rationale for most of the preferential provisions. To begin, there should be no illusion that a preference for small business over big business is a way to provide tax relief to people with lower incomes. In fact, the bulk of small business income goes to high-income households; in 2006, households in the top two income tax brackets received 72 percent of all income from noncorporate firms and S corporations.<sup>11</sup> Indeed, an advantage of large firms is that their ownership shares can be publicly traded on stock exchanges, making it easier for ordinary workers and investors to buy shares, either directly or through pension funds and mutual funds.

The most common argument for preferential treatment of small business—its uniquely powerful role in job creation—does not stand up under scrutiny. To begin, the statement that small firms create the majority of jobs does not imply that they play a unique role in job creation. No matter how jobs are distributed across firm sizes, one can always find some threshold size such that firms smaller than that size account for a majority of jobs.

Careful statistical studies do not assign any special role to small firms. Instead, such studies have largely reaffirmed Gibrat’s Law, formulated by Robert Gibrat in 1931, which holds that there is no relationship between a firm’s employment size and its growth rate of employment.<sup>12</sup> As Federal Reserve Bank of Cleveland economists Ben R. Craig and James B. Thomson and University of North Carolina professor William E. Jackson III noted in 2004, “economic studies find little evidence to support” the claim that small businesses are an important source of employment growth.<sup>13</sup> In their authoritative book on job creation and destruction, Steven J. Davis of the University of Chicago and AEI, John C. Haltiwanger of the University of Maryland, and Scott Schuh of the Federal Reserve

Bank of Boston dismiss what they call the “small business job-creation myth,” concluding that “conventional wisdom about the job-creating prowess of small businesses rests on statistical fallacies and misleading interpretations of the data.”<sup>14</sup>

Davis, Haltiwanger, and Schuh, along with other authors, emphasize the “regression fallacy” that arises from temporary changes in firm employment. Most of the studies computing job gains between two dates classify firms as big or small based on their size at the earlier date, a practice that inflates job gains at small firms.<sup>15</sup> When a firm

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that has temporarily become small due to a recent setback regains its former position, a job gain for a small firm is recorded; when a firm that has temporarily become large due to a recent expansion falls back to its prior position, a job loss at a large firm is recorded. Opposite results are obtained if the firms are classified as large or small

based on their employment at the later date.<sup>16</sup>

It is also important to look at net, rather than gross, job gains. For any category of firms and time period, gross job creation is the sum of job gains at those firms that added jobs during the period. Conversely, gross job destruction is the sum of job losses at those firms that reduced jobs during the period. Net job creation is equal to gross job creation minus gross job destruction. As Davis, Haltiwanger, and Schuh—and others—document, smaller firms have proportionately higher rates of gross job creation than larger firms. Unfortunately, small firms’ high gross job creation is offset by high gross job destruction. Davis, Haltiwanger, and Schuh conclude that “[i]n a nutshell, net job creation in the U.S. manufacturing sector exhibits no strong or simple relationship to employer size.”<sup>17</sup>

Recent research by Giuseppe Moscarini of Yale University and Fabien Postel-Vinay of the University of Bristol finds that small firms tend to report stronger employment growth than large firms during periods of economic weakness but weaker employment growth during upturns, with little net difference.<sup>18</sup>

While there may be no strong pattern of differences in net job creation between large and small firms, one difference is well established: jobs at large firms tend to feature higher wages and other desirable attributes. In the words of Davis, Haltiwanger, and Schuh, “A large body of empirical research documents that, on average, larger employers offer better wages, fringe benefits, working conditions, opportunities for skill enhancement, and job security.”<sup>19</sup> A common explanation for this firm-size wage

effect is that economies of scale enable large firms to purchase more sophisticated capital, which then requires them to hire more skilled workers who receive higher wages.<sup>20</sup>

## Distorting the Economy

Even if small firms play no unique role in job creation, one might think that tax policies that favor small firms over big ones are harmless. Unfortunately, that is not true. Preferences for some firms over others interfere with the market's allocation of resources and disrupt the efficient workings of the economy.

Consider a simple example in which the profits of small firms are taxed at a 20 percent rate and those of large firms are taxed at a 50 percent rate. (These numbers are purely illustrative and do not correspond to actual tax rates.) Investors are willing to invest in any project that provides at least a 4 percent after-tax rate of return. Thus, they will invest in all small-firm projects that yield at least 5 percent before tax and all large-firm projects that yield at least 8 percent before tax.

The good news is that this tax system does not end up treating anyone unfairly. Although investors in large firms are taxed more heavily, they are compensated by a higher before-tax return. Since all investors clear 4 percent after tax, no one can complain about unfair treatment.

The bad news is that this tax system wastes resources and causes inefficient production, reducing the amount of output that can be produced from the total investment funds available. All large-firm projects with before-tax returns below 8 percent fail to go forward because they cannot provide a 4 percent return after paying the 50 percent tax. Yet, small-firm projects that yield as little as 5 percent go forward. Output would be higher if funds were reallocated away from small-firm projects that yield 5 or 6 percent to large-firm projects that yield 7 or 8 percent.

With neutral tax treatment, the market would produce an efficient allocation of resources. If both sectors were taxed at 33 percent, all projects yielding more than 6 percent before tax would go forward in both sectors, while all projects yielding less than 6 percent would not. There would then be no way to reallocate funds to achieve higher total output. Uneven tax treatment blocks this efficient outcome. Neutral tax treatment would still be appropriate even if small firms really did create more jobs than large firms. If small firms have a

competitive advantage in job creation, they will be able to exploit that advantage in a neutral tax environment.

In one respect, placing heavier taxes on large firms is worse than other types of uneven tax treatment because it is a built-in penalty on growth. For example, Section 179 puts a penalty on increasing equipment and software investment above \$800,000 because each additional dollar invested reduces the amount that can be immediately

deducted. Similarly, if a firm has thirty employees, hiring one more can trigger the loss of the disability-access credit, putting a significant tax penalty on hiring the worker.

There is one legitimate reason for tax policy to distinguish between small and large firms. As many authors have noted, the cost of complying with tax (and regulatory) provisions is often greater, on a proportional basis, for small firms than for large firms.<sup>21</sup> That differential burden can put small firms at a competitive disadvantage. Offering smaller firms an exemption

from some compliance burdens can be a sensible response to this disparity of burdens. Some existing provisions, such as the ability of small firms to use cash rather than accrual accounting, may fit into this category. Of course, it is best to find ways to minimize compliance costs for all firms.

There is no reason for tax and spending policy to tilt the scales between big and small firms. There is nothing inherently bad about being big. In this regard, tax policy could benefit from the insights gleaned in another area of public policy.

## Learning from Antitrust Policy

If any aspect of the law might be expected to reflect prejudice against large firms, it would be antitrust law. Ironically, however, antitrust law has largely thrown off its initial bias against bigness even while tax policy has failed to do so.

The country's first antitrust law, the Sherman Act, was enacted in 1890 in response to a growing anxiety about the rise of big business and its accumulation of economic power. Politicians, capitalizing on growing unease among farmers and small businessmen, sought to ensure that the marketplace would be dominated by numerous small, independent firms.<sup>22</sup> Early interpretations of the Sherman Act emphasized the protection of small businesses and other social goals, such as fairness, equity, and political stability, and gave less weight to economic consequences.<sup>23</sup>

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In his famous 1945 *Alcoa* opinion, Judge Learned Hand noted “the belief that great industrial consolidations are inherently undesirable, regardless of their economic results. . . . [I]t has been constantly assumed that one of [antitrust laws] purposes was to perpetuate and preserve, for its own sake and in spite of possible cost, an organization of industry in small units which can effectively compete against one another.”<sup>24</sup>

The bias against bigness continued in another guise in the 1950s and 1960s as courts followed the theories of industrial organization economists known as “structuralists,” who condemned all increases in market concentration. Citing small increases in concentration ratios, courts blocked mergers that would have permitted greater efficiency, even when there was little threat of monopoly power.<sup>25</sup>

In the 1970s, antitrust policy came to be influenced by the Chicago School, the law and economics movement that originated at the University of Chicago. These economists noted that mergers often reflect the pursuit of efficiency gains rather than monopoly power. Moreover, in industries with relatively low entry barriers, monopolies can often be eroded through the entry of new firms. The Chicago School urged that antitrust laws be limited to price-fixing cartels and to mergers that pose a genuine threat of monopoly power, precepts largely followed by the Reagan administration. The debate about antitrust continues, but, as one commentary noted in 2002, “many of [the Chicago School’s] views, once controversial, are now accepted.”<sup>26</sup> Tax policy needs to assimilate the Chicago School insights that have been accepted in antitrust policy.

## Conclusion

Small business has played, and will continue to play, an important role in the American economy. But the role of big business is equally important. Public policy should protect firms of all sizes from unnecessary taxes and regulation.

Supporters of free markets often seek to maximize the short-run political appeal of their arguments against excessive taxation and regulation by highlighting the harmful effects on small business. Unfortunately, this strategy carries a steep price because it implicitly treats harmful effects on big business as acceptable. Even worse, it ratifies the fallacy that the government, rather than the market, can determine which firms best serve consumer needs.

As policymakers continue to honor small business as an engine of economic growth, they should give equal

recognition to big business, the other engine of economic growth.

## Notes

1. Barack Obama, “Remarks by the President to Small Business Owners, Community Leaders and Members of Congress” (White House, Washington, DC, March 16, 2009), available at [www.whitehouse.gov/the\\_press\\_office/Remarks-by-the-President-to-small-business-owners](http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-to-small-business-owners) (accessed June 10, 2009).

2. Christina Romer, interview by David Gregory, *Meet the Press*, NBC, March 15, 2009, available at [www.msnbc.msn.com/id/29705720](http://www.msnbc.msn.com/id/29705720) (accessed June 10, 2009).

3. Eric Cantor, interview by David Gregory, *Meet the Press*, NBC, March 15, 2009, available at [www.msnbc.msn.com/id/29705720](http://www.msnbc.msn.com/id/29705720) (accessed June 10, 2009).

4. John McCain, “Speech to LULAC” (79th Annual League of United Latin American Citizens Convention, Washington, DC, July 8, 2008), available at [www.realclearpolitics.com/articles/2008/07/mccains\\_speech\\_to\\_lulac.html](http://www.realclearpolitics.com/articles/2008/07/mccains_speech_to_lulac.html) (accessed May 26, 2009).

5. For a collection of comments, see Véronique de Rugy, “Are Small Businesses the Engine of Growth?” (Working Paper 123, AEI, December 8, 2005), available at [www.aei.org/paper/23537](http://www.aei.org/paper/23537).

6. *Ibid.*; Ben R. Craig, William E. Jackson III, and James B. Thomson, “Are SBA Loan Guarantees Desirable?” *Federal Reserve Bank of Cleveland Commentary*, September 15, 2004, available at [www.clevelandfed.org/Research/Commentary/2004/0915.pdf](http://www.clevelandfed.org/Research/Commentary/2004/0915.pdf) (accessed June 10, 2009); and Emily Maltby, “\$700M for Small Business in Obama’s Budget,” *CNNMoney.com*, March 3, 2009.

7. Emily Maltby, “\$700M for Small Business in Obama’s Budget.”

8. For more complete discussions, see Jane G. Gravelle, “Federal Tax Treatment of Small Business: How Favorable? How Justified?” *NTA Proceedings of the 100th Annual Conference* (2007), available at [www.ntanet.org/images/stories/pdf/proceedings/07/017.pdf](http://www.ntanet.org/images/stories/pdf/proceedings/07/017.pdf) (accessed June 10, 2009); Eric Toder, “Does the Federal Income Tax Favor Small Business?” *NTA Proceedings of the 100th Annual Conference* (2007), available at [www.ntanet.org/images/stories/pdf/proceedings/07/018.pdf](http://www.ntanet.org/images/stories/pdf/proceedings/07/018.pdf) (accessed June 10, 2009); and Andrew B. Lyon, “Tax Reform and Small Business” (testimony, Committee on Small Business, U.S. House of Representatives, April 10, 2008), available at [www.house.gov/smbiz/hearings/hearing-04-10-08-tax/testimony-04-10-08-lyon.pdf](http://www.house.gov/smbiz/hearings/hearing-04-10-08-tax/testimony-04-10-08-lyon.pdf) (accessed June 1, 2009).

9. *Tax Increase Prevention and Reconciliation Act of 2005*, Public Law 109-222, § 503, U.S. *Statutes at Large* 120:354.

The legal provision identifies the six companies by gross receipts, volume of oil production, and refinery ownership rather than by name.

10. *Energy Independence and Security Act of 2007*, Public Law 110-140, § 1502, *U.S. Statutes at Large* 121:1,800.

11. U.S. Department of the Treasury, “Treasury Conference on Business Taxation and Global Competitiveness” (background paper, July 23, 2007), 15, available at [www.ustreas.gov/press/releases/reports/07230%20r.pdf](http://www.ustreas.gov/press/releases/reports/07230%20r.pdf) (accessed June 11, 2009). See also Jane G. Gravelle, “Federal Tax Treatment of Small Business: How Favorable? How Justified?”; and Gene Steuerle, “When Is It Best to Tax the Wealthy? (Part 2 of 2),” *Tax Notes*, December 19, 2005, available at [www.taxpolicycenter.org/UploadedPDF/1000858\\_EP\\_121905.pdf](http://www.taxpolicycenter.org/UploadedPDF/1000858_EP_121905.pdf) (accessed June 10, 2009).

12. For further explanation and evidence of Gibrat’s Law, also known as the Law of Proportional Effect, see John Sutton, “Gibrat’s Legacy,” *Journal of Economic Literature* 35, no. 1 (1997): 40–59.

13. See Ben R. Craig, William E. Jackson III, and James B. Thomson, “Are SBA Loan Guarantees Desirable?”

14. Steven J. Davis, John C. Haltiwanger, and Scott Schuh, *Job Creation and Destruction* (Cambridge, MA: MIT Press, 1996), 57, available through [www.aei.org/book/824](http://www.aei.org/book/824).

15. Véronique de Rugy, “Are Small Businesses the Engine of Growth?”

16. Steven J. Davis, John C. Haltiwanger, and Scott Schuh, *Job Creation and Destruction*, 66–70. For a vivid illustration of the regression fallacy, see Cordelia Okolie, “Why Class Size Methodology Matters in Analyses of Net and Gross Job Flows,” *Monthly Labor Review* (July 2004): 10, available at [www.bls.gov/opub/mlr/2004/07/art1full.pdf](http://www.bls.gov/opub/mlr/2004/07/art1full.pdf) (accessed June 10, 2009).

17. Steven J. Davis, John C. Haltiwanger, and Scott Schuh, *Job Creation and Destruction*, 10–11, 60–62; and Véronique de Rugy, “Are Small Businesses the Engine of Growth?”

18. Giuseppe Moscarini and Fabien Postel-Vinay, “Large Employers Are More Cyclically Sensitive” (Working Paper 14,740, National Bureau of Economic Research, Cambridge,

MA, February 2009), available at [www.nber.org/papers/w14740.pdf](http://www.nber.org/papers/w14740.pdf) (accessed June 10, 2009).

19. Steven J. Davis, John C. Haltiwanger, and Scott Schuh, *Job Creation and Destruction*, 170–71.

20. John Gibson and Steven Stillman, “Why Do Big Firms Pay Higher Wages? Evidence from an International Database,” *Review of Economics and Statistics* 91, no. 1 (February 2009): 213–18; and Thierry Lallemand, Robert Plasman, and François Rycx, “Why Do Large Firms Pay Higher Wages? Evidence from Matched Worker-Firm Data,” *International Journal of Manpower* 26, nos. 7/8 (2005): 705–23. Another possible explanation, which relies on efficiency-wage theory, holds that large firms face higher costs of monitoring their workers and therefore pay higher wages to increase the cost of job loss and motivate better performance. See Douglas Kruse, “Supervision, Working Conditions, and the Employer Size-Wage Effect,” *Industrial Relations* 21, no. 2 (1992): 229–49. Other possibilities are that large firms are more vulnerable to unionization and pay higher wages to ward it off or that large firms are more likely to extract monopoly rents that they then share with workers.

21. Andrew B. Lyon, “Tax Reform and Small Business”; Jane G. Gravelle, “Federal Tax Treatment of Small Business: How Favorable? How Justified?” 157; and Eric Toder, “Does the Federal Income Tax Favor Small Business?” 165–66.

22. Warren S. Grimes and Lawrence A. Sullivan, *The Law of Antitrust: An Integrated Handbook*, 2nd ed. (St. Paul, MN: Thomson West), 5–6.

23. Andrew I. Gavil, William E. Kovacic, and Jonathan B. Baker, *Antitrust Law in Perspective: Cases, Concepts and Problems in Competition Policy* (St. Paul, MN: Thomson West), 32–33.

24. *United States v. Aluminum Co. of America*, 148 F.2d 416 (2d Cir., 1945), 428–29.

25. Andrew I. Gavil, William E. Kovacic, and Jonathan B. Baker, *Antitrust Law in Perspective: Cases, Concepts and Problems in Competition Policy*, 61–62.

26. *Ibid.*, 62–64.