New Economy, Old Challenges Facing Entrepreneurs

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Abstract

The U.S. economy is facing many challenges today. Economic growth and dynamism are down. This shows up in the lower rates of entrepreneurship that have been observed over the last decade, as well as in the extended periods of slack in the labor market, with high levels of long-term unemployment and youth unemployment. At the same time, many of the traditional factors that affect entrepreneurial dynamism, such as policy uncertainty, taxes, sales, and financing, are even more challenging in this economic environment. The new economy, or the gig economy, presents many opportunities. On the one hand, it offers individuals who otherwise might be left out of the entrepreneurial process an opportunity to behave in an entrepreneurial manner by sharing their skills, assets, and time. However, this new economy lacks much of the safety net that perhaps comes with traditional jobs. In this paper, I discuss these new and old challenges and offer some policy ideas that might help the transition to an economy that offers more stability, security, and opportunity for American entrepreneurs and their families.

I. Introduction

Entrepreneurship is always challenging. The only difference is that sometimes the economy presents new challenges that may change the nature of entrepreneurship itself, and sometimes the economy presents age-old challenges that change the outcomes for entrepreneurial ventures, but not the nature of entrepreneurship itself. With regard to the former, I discuss the new sharing economy, which has allowed individuals across all demographics to be more entrepreneurial by “sharing” their skills, assets, and time. At the same time, older challenges, such as taxes, regulations, and uncertainty persist, which ultimately will affect the entrepreneurial success of these ventures. In the future, as the new economy takes over and spreads widely, it is likely that these two challenges will become one as the new entrepreneurs are faced with the same old set of regulations and tax policies that the older entrepreneurs have faced. But, for now, it seems like the two entrepreneurial economies are moving in parallel: one, the economy that shows up in official statistics, and the second that is visible but largely hidden in official statistics. This paper attempts to shed light on both.

The Great Recession took a big toll on entrepreneurship and overall business creation. The Kauffman Index of Entrepreneurial Activity captures the rate of new business creation at the individual owner level.[1] The businesses captured include all incorporated or unincorporated businesses, as well as employer and non-employer businesses. Data from this index show that entrepreneurial activity increased over the course of the recession, but has recently started to decline. The increase in entrepreneurial activity at the start of the recession most likely was a consequence of the weak labor market, because a significant share of individuals starting businesses were unemployed. The latest data from 2013 suggest that entrepreneurial activity has declined between 2012 and 2013, but a smaller share of owners is coming out of the pool of unemployed. In other words, “necessity” entrepreneurship may have declined marginally. The share of “opportunity” entrepreneurship, which captures individuals coming out of other labor market states, declined significantly over the recession and only recently has shown a slight uptick.

Data from other sources suggest similar trends. Establishment births declined over the recession, as shown by data from the Business Employment Dynamics database, but recently have started returning to pre-recession levels.[2] However, job creation by these businesses is still fairly low. New establishments that are coming up are smaller on average and are staying small, which is affecting overall employment levels. The average employment size of a five-year-old establishment born in 2007 was almost one-third lower than one born ten years earlier. As a consequence, the five-year employment level from establishments born in 2007 is 1.2 million less than the five-year mark for establishments born in 1997.[3]

These data suggest that there is a clear correlation between economic conditions and entrepreneurship. While economic growth may, on the one hand, lead to fewer business startups because unemployed workers are not forced to start businesses out of necessity, economic growth also may lead to higher rates of entrepreneurship as the improvement in economic conditions may offer better prospects for businesses’ survival, as well as ease of access to finance and other factors that may facilitate startups. Further, entrepreneurship itself may lead to economic growth if startup businesses are successful, grow quickly, and employ workers.

Therefore, we need to better understand the factors that affect entrepreneurial activity, small business formation and survival, and large employer businesses. In this paper, I will use that information to suggest ways in which we can help promote “opportunity” entrepreneurship by addressing the new and old challenges faced by these businesses.

II. New Economic Challenges Facing Entrepreneurs

Economic growth and labor market dynamism

As mentioned in the introduction, entrepreneurship and economic dynamism may be highly correlated. Per a recent paper by Roger Gordon, the growth rate of real per capita GDP has been slowing down and will slow down further in the next few decades.[4] This is a consequence of many factors, but primarily the decline in the labor force participation rates for prime age adults and youth, the decline in educational attainment as captured by the high dropout rates in high school and college, and the lack of real wage growth at the bottom of the income distribution. Nor will this slowdown be offset by rapid changes in the rate of technological innovation.

The slow recovery in the labor market shows up in more than the decline in labor force participation. Today, nearly 6.5 million persons are employed part-time involuntarily because they could not find full-time jobs. Meanwhile, another 1.9 million want jobs, but have not searched for work in the previous few months because they are too discouraged to look.

Another 2.1 million workers have been jobless for twenty-seven weeks or more.[5] This labor market slack has resulted in weak wage growth. A recent study from the Federal Reserve Bank of Atlanta suggests that the large supply of unemployed and underemployed workers, which includes part-time workers who want full-time jobs, could be restraining wage growth.[6] Further, while full-time workers experienced year-over-year median wage gains of 3 percent in 2014, part-time workers experienced wage growth of about half as much as that of full-time workers from 2011 to 2013. Hence, an elevated share of part-time workers may have depressed overall hourly wage growth.

The labor market also is seeing an increasing polarization in work. Polarization can be a consequence of automation, which happens when machines or computers replace workers in routine tasks. It can also occur due to international trade or the offshoring of jobs to countries where wages are lower. Jobs in the middle part of the skill distribution are thought to be particularly vulnerable to these two factors, because these more generally involve routinized tasks rather than high-skill or low-skill jobs.[7], [8] Data show that, over the Recession, middle-skill jobs experienced a sharper and more long-lasting employment decline than high- or low-skill jobs did. The paper finds that middle-skill workers (primarily in manufacturing, construction, or clerical work) with no college degrees typically leave unemployment and exit the labor market, rather than finding low-skill or high-skill jobs. This can be explained by the fact that, when transitioning out of a job, a middle-skill worker needs to invest in more education to get a high-skill job. About 85 percent of high-skill workers have taken at least some college courses, as opposed to half of middle-skill workers. On the other hand, middle-skill workers earn considerably more than low-skill workers, which affects their willingness to take up low-skill jobs. In general, participation appears to be a function of education. Workers with the lowest education levels have the lowest participation rates. Results from this study suggest that falling labor force participation among prime-age males can be primarily explained by a lack of demand for middle-skill workers, providing a strong link between polarization and labor force participation.

Another challenge facing the economy is the high levels of youth unemployment. Per research compiled by the U.S. Chamber of Commerce, one-half to two-thirds of millennials are interested in entrepreneurship, and more than 25 percent are already self-employed. In 2011, millennials launched almost 160,000 startups each month, and 29 percent of all entrepreneurs were twenty to thirty-four years old.[9] It is important to encourage this trend, because startups are essential to job creation in the United States, and there has been a large dip in new business creation since the recession.

How do we address these challenges? While there are many policies that potentially could improve economic dynamism and labor market slack, I will focus on a couple that relate directly to entrepreneurship and the new economic challenges.

First, how do we encourage entrepreneurship for a generation that is burdened by student loans, has low levels of work experience, and is frequently turned down by banks for startup loans?

From my perspective, the real issue is that millennials very often lack the necessary expertise and experience to start and run a business. Work skills can be earned while still in school through vocational training and apprenticeship programs, or can be obtained after school through work and on-the-job training. For millennials, the recession and subsequent unemployment resulted in fewer opportunities to gain these skills after school. At the same time, they regret that they did not get enough work experience while still in school. This is evident from another Pew survey that asked college graduates if, in retrospect, they could have better prepared for the types of jobs they wanted. About half of all college graduates said getting more work experience while still in school would have put them in a better position to get the kinds of jobs they wanted. Another three in ten said they should have started looking for jobs sooner or picked different majors.[10]

Confirming this view, a Kauffman Foundation poll of 872 millennials found that 92 percent support increased access to education and training needed to run a small business as a way to encourage people to become entrepreneurs. A smaller number, 81 percent, supported student loan relief and 83 percent believe that Congress should increase the availability of startup loans.[11]

To help prepare this younger generation for the job market, we need better training programs at high schools and colleges and more apprenticeships in partnership with businesses and industries around the country. These programs could be run as tax credit programs for employers that offer these kinds of training programs. This would incentivize businesses to participate by offsetting some of the program costs. Such a program is currently being tried in South Carolina through the Apprenticeship Carolina program, which has doubled the number of apprenticeship offerings in the state.

Second, to help the unemployed and, especially, the long-term unemployed, we need to reform the unemployment insurance system. One idea is to use unemployment insurance (UI) funds to help startups by the unemployed. Research suggests that programs such as these in France and Germany have been successful at helping the unemployed become entrepreneurs. For instance, in France, the reform allowed unemployed individuals who started their own businesses to keep their access to unemployment insurance for three years in case their business ventures failed.[12] Before the new rule, an entrepreneur would lose his unemployment insurance once he declared self-employment. The main objective of the program was to provide insurance against failure and shortfalls in cash flow during the first three years. The study suggests that the program was successful. The monthly entry of new businesses increased by 12 percent post-reform. More importantly, the quality of new firms did not deteriorate; there were no significant differences in the failure rate, hiring rate, or growth rate of young firms in the industries where the reform had the most impact. In addition, the unemployed entrepreneurs who started these businesses were ambitious about the growth prospects and were interested in hiring new workers. The overall positive benefits included shorter unemployment spells and the reallocation of labor to more productive and higher-paying jobs. This would involve reforming our current Self-Employment Assistance programs that are available only in a few states and to a limited pool of UI recipients. One reason for the low participation is that the program only offers support to workers who are permanently separated and likely will exhaust their unemployment benefits. This likely affects the quality of workers who are eligible for these programs. A redesigned program could make support available to all unemployment insurance recipients across the country and could provide some level of downside insurance for a limited period of time for a new business.

Another idea is to use UI funds to match workers directly to jobs through a wage subsidy. UI funds could supplement incomes for workers as they undergo training at an employer firm. This could help these workers attain skills that would improve their productivity on the job, and also benefit employers. The more skilled the workers become, the more likely they would be to contribute to productivity growth and respond to technological changes.

The new sharing economy

The new sharing economy, or gig economy, is posing its own sets of challenges and opportunities and creating a new group of “micropreneurs.” On the one hand, it provides flexibility and offers opportunities to individuals across all demographics. In these times of uncertainty, it provides an additional avenue for earning an income through assets such as cars, houses, time, and abilities that people already possess.[13] People with an extra room can offer a room for rent. People with a car can offer rides to other passengers. Sixty-two percent of New York Airbnb hosts say that being able to provide this service helped them stay in their homes.[14] Anecdotal evidence suggests that people doing two to three tasks a day through TaskRabbit can earn almost $3,500 a month. Full-time workers can earn as much as $6,000–$7,000 a month.[15]

On the downside, these are not traditional jobs that provide benefits and security of tenure, but, in many ways, they allow people to supplement incomes, earn enough for their families, or boost retirement savings. But then, it’s not clear that we need benefits to be tied to jobs, either. With the Affordable Care Act, workers can buy health insurance individually on the exchanges instead of getting it through their jobs, which improves their ability to be mobile across jobs. There are new technologies that allow these 1099 employees to keep track of their taxes and do withholdings automatically. TaskRabbit has introduced a wage floor, making it impossible for workers to earn less than $12.80 an hour.[16]That’s higher than any state minimum wage in the United States. Guilds like Peers.org and Freelancers Union are creating ways for independent contractors to pool bargaining power to access discounted health insurance and telecom plans.

In fact, a recent study by Alan Krueger of Uber shows that independent contractors represented 7.4 percent of the workforce in 2005, up slightly from 6.7 percent in 1995. Eighty-two percent of these workers in 2005 reported that they preferred their work arrangements to traditional jobs. This was despite the fact that they knew that workers in those traditional relationships were more likely to have health insurance coverage.

At Uber, 19 percent of the drivers are under the age of thirty, and 25 percent are aged fifty or older. They are highly educated, with 48 percent having college degrees. Sixty-six percent still have full-time jobs, and 8 percent had been unemployed prior to becoming Uber drivers. About 25 percent are actively looking for full-time jobs, and another 25 percent are looking for part-time jobs. About 38 percent of people do this as their main job, working more than thirty-five hours per week.

About 91 percent said that this job helps them earn more income to better support their families, 87 percent value the flexibility, and 74 percent said that the job helps them maintain a steady income because other sources of income are unstable or unpredictable. Women drivers were more likely to state flexibility as an important benefit. It is also important for the drivers to earn an income while looking for another job. Sixty-one percent said that it strengthened their sense of financial security.

Uber provides driver-partners with access to a service called Stride Health to help them select health insurance coverage that is appropriate for their situations. So, it does seem that, going forward, there will be fewer formal jobs, but more sharing in work, a more entrepreneurial approach to work, and cooperation in the production of goods and services.

III. Older, Persistent Problems Facing Entrepreneurs

Moving beyond the new economic challenges typified by the loss in business dynamism and labor market slack, there are older, more long-term challenges that have persisted for entrepreneurs. These are the subject of much research. For instance, we know that the highest rates of job creation come from young and small businesses.[17] However, per the most recent (April 2015) report from the National Federation of Independent Businesses, small business owners are, on average, less optimistic than they were before the recession.[18] They still face tremendous uncertainty about the future, coming from poor expectations of sales, hiring, and government regulations. Nearly two-thirds of owners in a Bank of America survey said that their businesses still have not recovered completely from the Great Recession. In another survey by Pepperdine University's Graziado School of Business and Management and Dun & Bradstreet Credibility Corp, 63 percent of small businesses said it was difficult to get loans, while only 36 percent of larger businesses said it was difficult.[19] These results are also reflected in the National Federation of Independent Business data. Per the latest NFIB survey, 11 percent of small business owners cited weak sales as their top business problem. A large majority of business owners cited government regulations and red tape as the biggest hurdle (23 percent), followed by taxes (22 percent) and quality of labor (12 percent). A much smaller fraction cited cost and availability of insurance, competition from other businesses, and cost of labor as factors.[20] I will address each of these in turn and recommend some policy ideas to overcome these challenges.

Policy uncertainty

There is a rapidly growing body of literature that focuses on the effect of uncertainty on business or economic activity. A new paper by Baker et al. investigates whether uncertainty about taxes, government spending, and other policy matters deepened the 2007–2009 recession and slowed the recovery. The authors develop a new index of policy-related economic uncertainty and estimate its dynamic relationship to output, investment, and employment. The index averages several components that reflect the frequency of news media references to economic policy uncertainty, the number of federal tax code provisions set to expire in future years, and the extent of forecaster disagreement over future inflation and federal government purchases. Vector autoregressive (VAR) model estimates show that an increase in policy uncertainty equal to the actual change between 2006 and 2011 foreshadows large and persistent declines in aggregate outcomes, with peak declines of 2.2 percent in real GDP, 13 percent in private investment, and 2.5 million in aggregate employment.

Another paper by Bachmann et al. (2010) uses microdata from the Federal Reserve Bank of Philadelphia's Business Outlook Survey and Germany's IFO Business Climate Index to investigate how measures of business uncertainty, which are derived from managers' business expectations, are related to economic activity. They find that increases in business uncertainty are associated with prolonged declines in economic activity. Rodrik (1991) shows how policy uncertainty can act as a tax on investment and cause firms to forego investments until its resolution.

A 2011 paper by economists at the Federal Reserve Bank of Cleveland also finds that policy uncertainty specifically affected small firm hiring and capital investments over the period 1986 to 2011.[21]

While it is impossible to argue that there should be no uncertainty about the policy climate facing small businesses, it is important not to ignore the idea that uncertainty matters for small business hiring and expansion. It also is important to recognize that temporary policies can create uncertainty, because business owners need to be able to forecast costs and revenues. Finally, legislation that is complex and hard for businesses to unravel creates its own issues. An example of this is the Affordable Care Act, which I will discuss in the next section. However, an issue with that legislation is that not only was there uncertainty about when and whether it would be passed and would come into full effect, and about what costs would be associated with it, but the legislation itself is complex and hard for businesses to understand and incorporate in their decision making. This is likely to have affected business owners' decisions relating to investment and hiring, which are particularly important in today's economy.

Health care costs

New government regulations, such as the Affordable Care Act, likely are holding back entrepreneurial growth. Many business owners are confused about what their health care liabilities are likely to be when they are forced to provide health insurance to employees or pay a penalty. The employer mandate, which took effect in 2014, applies to all firms with fifty or more employees. If an employer fails to provide "qualifying health insurance," the employer has to pay a per-employee excise tax fine. The tax is $2,000 per employee ($3,000 if an employee receives coverage through an exchange). If the employer has a waiting period to get into the plan, there is an additional tax of $400 to $600. A small employer with 100 employees could easily find himself paying a tax of $300,000 per year. Even if an employer provides health insurance, it can be deemed "unqualified" by the U.S. Department of Health and Human Services.[22]

Further, many self-employed people choose not to have health insurance—because either they would rather self-insure, they have a mini-med plan, or they want to retain capital in their small businesses. The Affordable Care Act strips this choice. Starting in 2015, everyone was required to obtain "qualifying" health insurance or face an excise tax of at least 2.5 percent of adjusted gross income. For those who are employees of their own firms of at least fifty employees, the firm also would be subject to the employer mandate excise tax described above.

A number of papers have focused on the effect of health care costs on entrepreneurship. Gruber (1992) finds that health insurance mandates reduce employee coverage in small firms by as little as 1 percent. This is similar to the finding by Gabel and Jensen (1989), though in a 1992 survey, they showed that 19 percent of sampled small firms did not offer coverage due to state-mandated benefits. Of the papers linking health insurance and entrepreneurship, Gruber and Poterba (1994) analyze the impact of the Tax Reform Act of 1986, which allowed self-employed individuals to deduct a certain percentage of their health insurance costs from their taxable income, thus bringing them closer to the tax treatment afforded to employer-provided health insurance. Their paper suggests that a 1 percent increase in the cost of health insurance coverage would reduce the probability for coverage for self-employed households by 1.8 percent. Perry and Rosen (2001) find a statistically negative effect of self-employment on the probability of being insured.

A paper that I published (Mathur 2009) focused specifically on state health insurance mandates and their impact on job creation by small firms. Health insurance is regulated at the state level by state-mandated health benefits.[23]These are regulations issued by the state that mandate minimum levels of certain benefits as part of policies offered (e.g., chiropractic services, mental illnesses, etc.).[24] The cost effect of mandates varies due to differences in state laws. For example, mandated benefits accounted for about 12 percent of claims costs in Virginia in 1993, 22 percent of claims in Maryland in 1988, and 5 percent of claims in Iowa in 1987.[25] The studies that reported the highest costs were those for Maryland and Massachusetts, which have more mandated benefits than most other states do. Unlike a lot of earlier studies that focused on the 1980s, the study focuses on the 1990s, when there was a tremendous increase in the number of mandates passed by states. The number of states with six or more mandated benefits increased dramatically between 1988 and 1997. The evidence strongly suggests that, while some mandates matter more than others in the job creation decision of small firms, the most significant impact on small firms is simply in terms of the total number of mandates in a state: the larger the number of mandates, the lower the probability of employment generation. Studying the predicted probabilities for different levels of mandated benefits, the data show a clear negative relationship between the size of the firm and the total mandated benefits. The predicted probability of owning a business with more than one employee goes down from 0.45 to 0.34 (i.e., nearly ten percentage points) as the number of mandates goes up from zero to sixteen. The probability of owning a firm with more than two employees goes down by nearly 50 percent for the same change in mandated benefits, and by about 35 percent for firms with six or more employees.

The fact that the ACA employer penalty is based on the number of employees could create a disincentive for firms to add workers. This is aggravated by the fact that a recent study of small employers with fewer than ten employees found that 56 percent of the employers misunderstood portions of the ACA's employer penalty, 32 percent believed they would be required to provide health insurance, and 24 percent believed they would have to pay a penalty.[26] A related concern is that firms may try to cut worker hours below the threshold for full-time, which is thirty hours a week under ACA. Perhaps one way to avoid these losses is to change the definition of full-time to forty hours per week.

Some ACA provisions aim to reduce the burden on small firms.[27] For example, small business health care tax credits offset the costs of providing insurance to employees. According to the GAO, many business owners have complained that the size of the credit is too small to create the incentive to begin offering insurance, and the rules are too complex. One way to fix these issues is to expand the credit and simplify the rules, as suggested in a recent Congressional Research Service (CRS) report.[28] Other ideas include a deduction for health insurance costs for the self-employed for themselves and their families.

Taxes

The recent NFIB survey rated taxes, aside from regulations, as the most important problem facing small businesses.[29] The problem is not only high taxes, but also the complexity of the tax code. Many small employers pay taxes using the individual tax brackets, and a large share of small employer profits are taxed in the top bracket. According to the Tax Foundation, many small employer businesses face top marginal rates between 44 percent and 48 percent.[30] These businesses account for 67 percent of business income. These high tax rates discourage investment and employment creation. Therefore, reforming the tax code to lower the marginal rates on these employer businesses would help the economy.

The most recent tax hike comes from the Affordable Care Act, which imposes new taxes on businesses. Under the ACA, the first tax increase on small employers is a Medicare payroll tax hike. The Medicare payroll tax for wages and self-employment earnings in excess of $250,000 for couples ($200,000 for singles) will rise from 2.9 percent to 3.8 percent. This is a direct tax hike in the marginal income tax rate paid by the self-employed and general partners.

Starting in 2013, the Affordable Care Act also imposes a 3.8 percentage point hospital insurance tax on investment income of more than $250,000. Some of this so-called "investment income" is actually small business profits. Notably, investors in small businesses (limited partners and passive shareholders in Subchapter-S corporations) will face this tax. Active trade or business income is excluded, but, of course, most of that will face the higher Medicare tax described above. This provision will make it harder for employers to raise capital to create jobs and expand business operations.

What are the effects of high taxes on entrepreneurship? There is vast academic literature studying this topic. Many papers have studied transitions from wage and salary employment to entrepreneurship as a function of the tax rates faced by individuals and firms. This option is valuable to the extent that personal income is taxed at a higher rate than corporate income is. In recent years in the United States, the corporate tax rate for a small firm could be as low as 15 percent, which is below the marginal personal (plus payroll) tax rate faced by, effectively, all individuals. As a result, a firm generating tax losses will prefer to be non-corporate so that the entrepreneur can deduct these losses against other personal income, saving on personal income taxes. In contrast, when and if the firm generates profits, for tax purposes, the entrepreneur will prefer to incorporate so that these profits are taxed at the lower corporate tax rate. The paper by Cullen and Gordon (2002) shows that reducing the minimum corporate income tax by five percentage points leads to a doubling of entrepreneurial activity in different quintiles and in the aggregate. If personal income tax rates were cut by five percentage points, this would lead to a nearly 30 percent drop in entrepreneurial activity, with larger percentage drops in the highest-earning quantiles. Finally, a flat tax of 20 percent would increase self-employment activity by 15 percent. Such a tax cut reduces the taxes saved from deducting business losses, while profits remain largely taxed at the corporate tax rate. As a result, risk-taking is discouraged. In addition, as emphasized by Domar and Musgrave (1944), a lower personal tax rate implies less risk-sharing with the government, in itself making self-employment less attractive to risk-averse individuals. The potential tax savings from going into business simply to reclassify earnings as corporate rather than personal income for tax purposes also falls when personal tax rates fall.

In another paper, Gentry and Hubbard (2000) show that the less progressive the income tax schedule is, the greater the incentive to entrepreneurial entry. Gentry and Hubbard (2000) emphasize a different effect of the tax system on risk-taking that arises even if investors are risk-neutral. If the marginal tax rate under the personal income tax is an increasing function of taxable income, then entrepreneurs are able to save little in taxes on any losses they incur but can owe substantial taxes on any profits. The more progressive the tax schedule, therefore, the more risk-taking lowers the expected after-tax return from the project. As a result, a progressive rate schedule discourages risk-taking.

Bruce (1998) similarly finds that taxes have significant effects on the probability that an individual will leave a wage and salary job to become self-employed. Estimates indicate that a five percentage point increase in the difference between an individual's expected marginal tax rates in wage and salary employment and self-employment reduces his transition probability by about 2.4 percentage points.

A different strand of literature focuses on the effect of the entrepreneur's own taxes on his or her ability to hire workers and expand investment. Carroll et al. (1998) analyze the income tax returns of a large number of sole proprietors before and after the Tax Reform Act of 1986 and determine how the substantial reductions in marginal tax rates associated with that law affected the decision to hire labor and the size of those individuals' wage bills. The authors find that raising the entrepreneur's "tax price" (one minus the marginal tax rate) by 10 percent raises the probability of hiring workers by about 12 percent. Further, conditional on hiring employees, taxes also influence total wage payments to workers. A 10 percent increase in the tax price would increase the median wage bills of entrepreneurs by 3 percent to 4 percent. These effects are more pronounced for high-income sole proprietors. Therefore, raising tax rates on high-income entrepreneurs could result in lower wages for workers employed at these firms.

Using a similar dataset, Carroll et al. (1998) also study capital investment decisions by entrepreneurs. Taxes affect the demand for investment through their impact on the user cost of capital. An increase in the personal tax rate raises the user cost and negatively affects investment. Another channel through which taxes affect investment is liquidity constraints. An increase in taxes reduces the entrepreneur's cash flow. To the extent that liquidity constraints are present, this leads to a reduction in the demand for capital. The authors investigate both channels and find that the substantial reductions in marginal tax rates for the relatively affluent had quantitatively significant influences on their investment decisions. A five percentage point increase in marginal tax rates reduced the proportion of entrepreneurs who made new capital investments by 10.4 percent and decreased mean expenditures by 9.9 percent.

In another closely related paper, the authors find that income taxes exert a statistically and quantitatively significant influence on firm growth rates. Raising the proprietor's tax price by 10 percent increases gross receipts by about 8.4 percent. This finding is consistent with the view that raising income tax rates discourages the growth of small businesses.

Another challenge for large corporations is corporate tax reform. Today, the United States has the highest corporate tax rate in the Organisation for Economic Co-operation and Development. This discourages investment in the United States, as capital flows to low-tax jurisdictions. In addition, the U.S. rules for international taxation are based on the worldwide system of taxation, which place firms at a competitive disadvantage, encouraging them to engage in corporate tax inversions and creating incentives to retain foreign earnings overseas.

We need to reform corporate taxes, personal taxes, and the system of international taxation. Perhaps lowering the headline rate, eliminating some business tax deductions, and moving toward a system of territorial taxation would be a step in the right direction.

Other ideas include increasing the small business expensing limit so businesses are able to immediately recover costs instead of claiming depreciation deductions over specified periods, repealing the AMT, and making healthcare costs deductible, same as for large employers.

Financing issues

In the NFIB survey, 53 percent of owners said that they did not want to borrow.[31]This weak loan demand is indicative of the pessimism of small business owners who are reluctant to take loans that they may not be able to repay. So the fact that only 2 percent of owners reported that financing was their top business problem does not provide the complete picture. Over the course of the recession, between 2008 and 2011, the number of owners with a business loan declined from 44 percent to 29 percent.[32] As per a more recent study, small business loans (less than $1 million) dropped significantly between 2008 and 2012 to a level 17 percent below that prior to the recession.[33] In contrast, lending to larger businesses has rebounded faster.

Small business loans are down because of weak sales. Despite increases in recent and expected future revenues, revenues still have not reached levels seen prior to the recession.

To the extent that small businesses are facing a credit crunch, encouraging the growth of alternative lending programs such as online lending may improve access. Some studies suggest that loan approval rates for small businesses are much higher from alternative lending sources than from traditional, commercial banks.[34] Online lending platforms offer applications that can be completed faster than all the paperwork required by large banks, and they can be approved and the loans obtained faster, as well.

Occupational licensing

Differences in state licensing requirements can make it difficult for entrepreneurs and workers to find opportunities and jobs, creating stale labor markets and under-employment. Mutual recognition of other state licenses would improve worker mobility and, thereby, boost economic dynamism. Stephen Slivinski, a senior economist at the Goldwater Institute, finds that states with strict occupational licensing standards have lower levels of low-income entrepreneurship.[35] The average low-income entrepreneurship rate is higher than the national average, at 380 entrepreneurs per 100,000 low-income residents. Yet, some states have higher rates than average and some have lower rates. To explain that difference, the study matches data from the Kauffman Foundation and the Institute for Justice for the first time ever and discovers that the higher the rate of licensure of low-income occupations, the lower the rate of low-income entrepreneurship. The states that license more than 50 percent of the low-income occupations had an average entrepreneurship rate 11 percent lower than the average for all states. The states that licensed less than a third had an average entrepreneurship rate that was about 11 percent higher. Colorado, Vermont, and New Mexico have the highest rates of low-income entrepreneurship in the country, while Kentucky, Wisconsin, and Mississippi have the lowest.[36]

A separate Aspen Institute study found that half of all low-income entrepreneurs leave poverty within five years.[37] To encourage entrepreneurship among low-income workers, the report recommends reforming state occupational licensing laws so they aren't barriers to entry. Those reforms should include eliminating some existing licensing requirements and creating a private-sector-directed certification system that would replicate what exists in many industries already.

IV. Conclusion

The U.S. economy is facing many challenges. Economic growth and dynamism are down. This shows up in the lower rates of entrepreneurship that have been observed over the last decade, as well as in the extended periods of slack in the labor market, with high levels of long-term unemployment and youth unemployment. At the same time, many of the traditional factors that affect entrepreneurial dynamism, such as policy uncertainty, taxes, sales, and financing, are even more challenging in this economic environment. The new economy, or the gig economy, presents many opportunities. On the one hand, it offers individuals who otherwise might be left out of the entrepreneurial process an opportunity to behave in an entrepreneurial manner by sharing their skills, assets, and time. However, this new economy lacks much of the safety net that perhaps comes with traditional jobs. In this paper, I discuss these new and old challenges and offer some policy ideas that might help the transition to an economy that offers more stability, security, and opportunity for American entrepreneurs and their families.

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Endnotes

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