Small businesses aren't the 'engine room of the economy'
(Article published in 'Management Today'*, the monthly magazine of the Australian Institute of Management, August 2015*).

Small business was the principal beneficiary of this year's Federal Budget, with a 1.5 pc point cut in the tax rate for incorporated businesses with an annual turnover of less than $2 million, a 5% 'discount' (up to a maximum of $1,000) on income tax payable by unincorporated small businesses, an 'instant tax write off' for purchases by small businesses of assets valued at up to $20,000, and a range of measures designed to facilitate 'start-ups'.

Not surprisingly, these measures have been warmly received by small business organizations, and appear to have provided an initial fillip to business confidence.

Nonetheless, given that these measures will, according to the Budget Papers, add around $5-1/2 billion to the budget deficit over the four years to 2018-19, it's worth asking what they might achieve in terms of improving Australia's economic performance.

Small business is the object of a lot of folklore, especially on the Coalition side of politics, where 'support for small business' is an article of faith.

Certainly, there are a lot of small businesses in Australia - almost 2 million as at 30th June 2014, according to the most recent data from the Statistics Bureau. And their owners tend to be more evenly spread across Australia - unlike the owners, directors and senior managers of large businesses, who tend to be concentrated in safe Liberal electorates, where their votes aren't as crucial in determining election outcomes.

But they are not the 'job creation' machine that they are frequently portrayed as being. Employment in small businesses (defined here as those with 20 or fewer employees) actually *fell* by 0.3% over the five years to 2012-13 (the latest year for which these figures are available), whereas employment among larger businesses rose by 15.4% over the same period.

Nor is small business a major engine of innovation in the Australian economy. *Some* small businesses are highly innovative. But Statistics Bureau data shows that less than 35% of businesses with fewer than 20 employees engage in some form of product or process innovation, compared with almost 59% of larger businesses.

So there is no compelling economic policy rationale for small businesses to enjoy more favourable tax treatment than large ones.

Because they often find it difficult to raise equity capital, small businesses are often highly leveraged and are therefore typically more vulnerable to fluctuations in economic conditions - including local or regional ones - and in interest rates than large businesses. For that and other reasons, small businesses have a high failure rate. 40% of all businesses with a turnover of $2 million or less in 2009-10 had gone out of business by the end of the 2013-14 financial year, compared with only 18% of larger businesses.

Only 51% of incorporated businesses with a turnover of $2 million or less in 2012-13 were profitable, according to the latest available figures from the Australian Taxation Office; and only 37% were both profitable and taxable (because some companies which were profitable in 2012-13 had accumulated tax losses from previous years).

This means that the cut in the tax rate for incorporated small businesses will not actually benefit many of them. If you're not making profits - or if you are making profits but you have accumulated tax losses - then a tax cut is of no use to you. And even for those small businesses which are making taxable profits, the tax cut is too small to induce them to do anything that they weren't planning to do anyway. That's also true of the 'tax discount' of up to $1,000 for unincorporated businesses. It might be nice to pay $1,000 less in tax: but that's hardly going to prompt a small business owner to put on an extra employee, or invest in some new equipment.

Indeed the creation of a *de facto* tax threshhold in the company income tax structure at $2 million of turnover could, perversely, act as a disincentive for businesses whose turnover is just below that figure to grow above it - since if they did, their entire profit would then become subject to the 30% tax rate applicable to larger companies.

It's also hard to reconcile the introduction of a two-tiered company tax structure with the Government's stated aim of a simpler tax system.

The 'instant write-off' for small business purchases of assets valued at up to $20,000 undoubtedly *will* prompt an increase in purchases of such assets by businesses entitled to it - not least because the measure is only available until 30 June 2017. However, most of the assets are likely to be imported - so that the *net* benefit to the Australian economy will actually be quite small. Moreover, the more successful this measure is in inducing small businesses to 'bring forward' investment decisions, the greater the risk of a slump in small business investment after 30 June 2017.

Hence, while there's no doubt that the Budget's small business measures are popular - especially among the Government's support base - it's far less clear what longer-term benefits they might bring for the economy.