The costs and consequences of ‘small business fetishism’

Saul Eslake[1]

Abstract

It is widely asserted—and believed—across the Australian political spectrum that small business is the ‘engine room’ or ‘backbone’ of the economy. This belief is, however, without any evidentiary foundation whatsoever. In aggregate, Australian small businesses have not created a single job since before the Global Financial Crisis. Small businesses have, on average, been consistently less innovative than medium-sized and large businesses. Small businesses pay lower wages, on average, than medium-sized and large businesses, and they have significantly lower labour productivity. It would be a mistake to perpetuate the preferential treatment of small businesses simply because they are small, and for no other reason, once the pandemic is over. If preferential tax treatment and other forms of assistance are to be afforded to any businesses, it should be to new businesses, rather than small ones.

There are almost 2.4 million small businesses—conventionally defined as those with fewer than 20 employees—in Australia, according to the Australian Bureau of Statistics (ABS, 2021a). Of these, just over 1.5 million have no employees at all and about 815,000 have between one and 19 employees.[2]

1 Principal, Corinna Economic Advisory; saul.eslake@gmail.com.

2 That compares with a little more than 56,000 businesses having between 20 and 199 employees, which the ABS classifies as ‘medium’; and just less than 4,400 with 200 or more employees, which are classified as ‘large’.

The 'engine room' myth

One of the enduring clichés in Australian political discourse is that small business is the 'engine room' or the 'backbone' of the economy. It is incanted, with almost religious fervour, not only by organisations representing small business (see, for example, COSBOA, 2020), but also by politicians of all persuasions (see, for example, Hockey & Cormann, 2015, pp. 1–9; Frydenberg, 2020; Liberal Party of Australia, 2020; ALP, 2018, pp. 19–20; Australian Greens, 2019).

This belief in turn underpins a broad suite of policies offering preferential tax treatment for small businesses—including longstanding exemptions from payroll tax, less onerous arrangements for remitting the goods and services tax (GST), discounts on personal income tax payable (for unincorporated small businesses), exemptions (in prescribed circumstances) from capital gains tax and, since 2015, upfront tax-deductibility of capital investments, and (for incorporated small businesses) a lower rate of company income tax—as well as a wide range of grants and subsidies, free advice programs and other forms of support.

What is extraordinary about this 'engine room' doctrine is that it is upheld by so many, with such devotion, despite the complete absence of any evidence for it.

Employment

Advocates often point to the large number of people who work for small businesses. According to ABS's most recent count, that is 4.67 million people as at the end of June 2020 (ABS, 2021c). It is equivalent to 37.7 per cent of total employment or 41.3 per cent of employment in businesses of all sizes.

What is far less often pointed out is that this number—4.67 million—is smaller (in absolute terms) than it has been in all but four of the past 13 years (2009, 2012, 2013 and 2014). At no stage in the past 13 years have more Australians been employed in small businesses than in June 2007. While many individual small businesses *have* created jobs during this period, small business *in aggregate* has not created a single job, on net, since before the onset of the Global Financial Crisis (GFC). On the contrary, employment in small businesses has declined by 6.3 per cent since then.

As a proportion of total employment, employment in small businesses has declined from 47.8 per cent in June 2007 to 37.7 per cent in June 2020 (Figure 1).

As a proportion of jobs in 'Australian industry'—which, in the ABS publication from which these figures are derived, excludes the finance, insurance and superannuation fund sectors—employment in small businesses has fallen from 52.6 per cent to 41.3 per cent over this period.

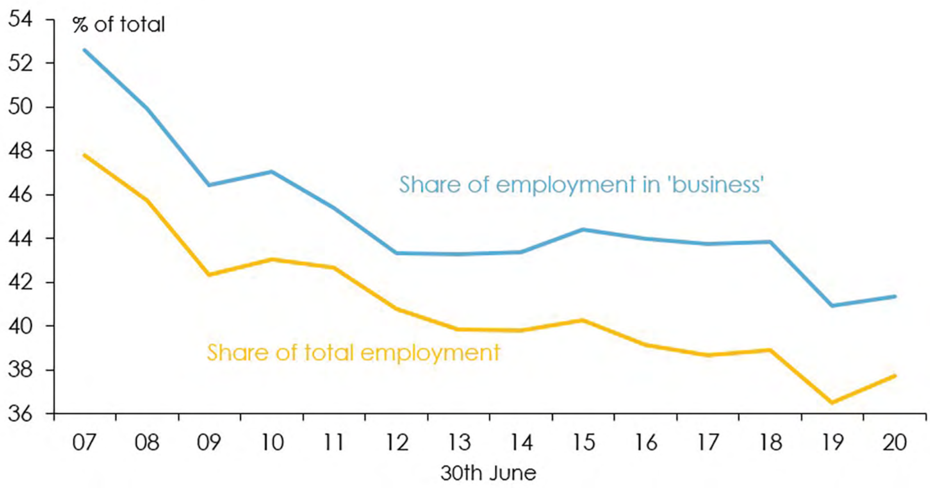

Figure 1. Employment in small businesses as a share of total employment

Note: ‘Business’ employment is as defined in ABS (2021c)—in particular, it excludes employment in the finance, insurance and superannuation sectors. ‘Small businesses’ are those with fewer than 20 employees.

Source: ABS (2021c).

By contrast, employment in medium-sized businesses has increased by 46.4 per cent since June 2007, while employment in large businesses has increased by 48.4 per cent.

This is even though most of these businesses (and certainly all the large ones) would have had to pay payroll tax, and very few would have benefited from the reductions in the rate of company tax since 2015. Indeed, even over the period 2015–20, employment in small businesses has fallen by 1.1 per cent, while employment in medium-sized and large businesses has grown by 10.4 per cent and 13.2 per cent, respectively.

Investment

Nor has the preferential tax treatment for business investment accorded to small businesses through the ‘instant asset write-off’ introduced in the 2015–16 budget done anything to enhance capital expenditure by small businesses. Gross fixed capital expenditure by small businesses fell by 16.1 per cent between 2014–15 (the year before the introduction of the ‘instant asset write-off’) and 2018–19 (the year before the onset of the Covid-19 pandemic)—a much larger decline than that in capital expenditure by medium-sized businesses (2.7 per cent) and large businesses (6.0 per cent) over the same period (Figure 2).

The decline in the shares of both employment and investment attributable to small business has occurred despite a near-trebling in the value of financial assistance to small businesses (in the form of tax concessions and cash payments) from the Commonwealth Government over the past five years (Figure 3).

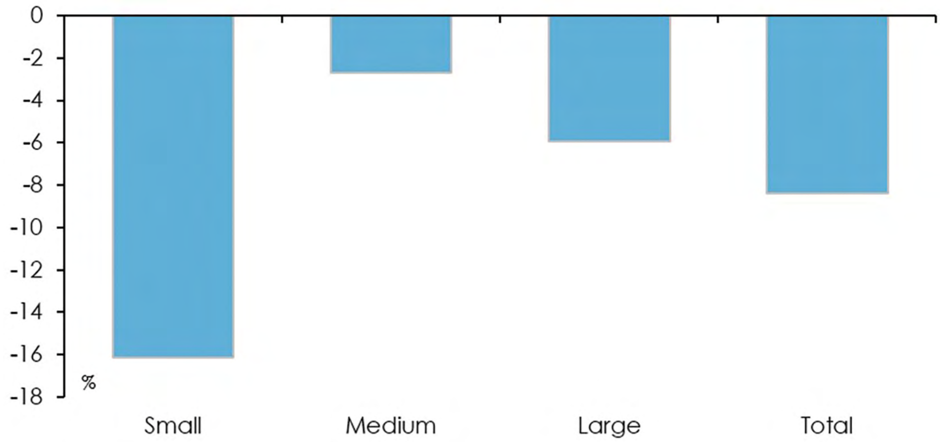

Figure 2. Change in gross fixed capital expenditure by business size, 2014–15 to 2018–19

Source: ABS (2021c); additional data supplied on request.

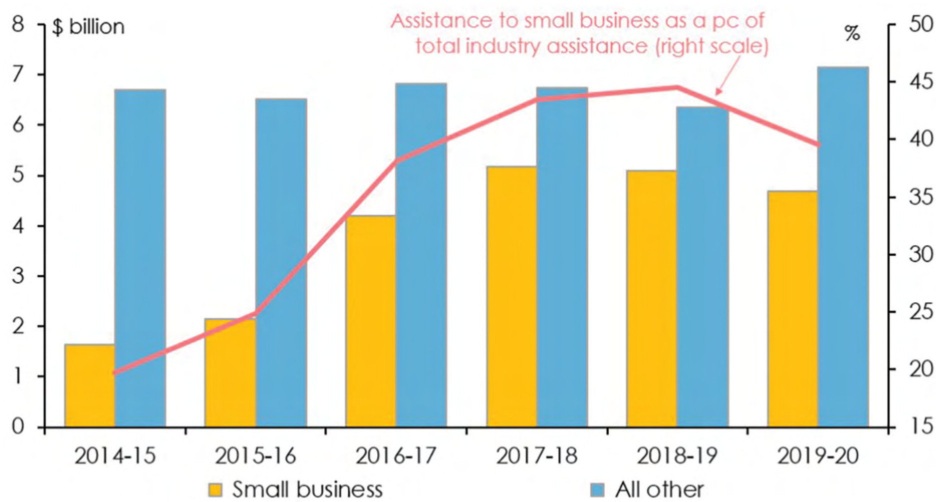

Figure 3. Commonwealth Government budgetary assistance to small business compared with other forms of industry assistance, 2014–15 to 2019–20

Sources: Productivity Commission (2021b); and author's calculations.

Innovation

Another widely entrenched belief is that ‘innovation is in the DNA of small businesses’ (Eggleton, 2020). Most state governments provide financial assistance to small businesses specifically for the purpose of fostering innovation (see, for example, Chief Scientist and Engineer, 2021; Business Victoria, 2021; Kelly, 2020).

The reality, however, is that small businesses are typically much *less* innovative than medium-sized and large businesses. The ABS’s surveys of innovation activity in Australian businesses have consistently found that small businesses are less likely to engage in any form of innovative activity than medium-sized and large businesses (Figure 4).

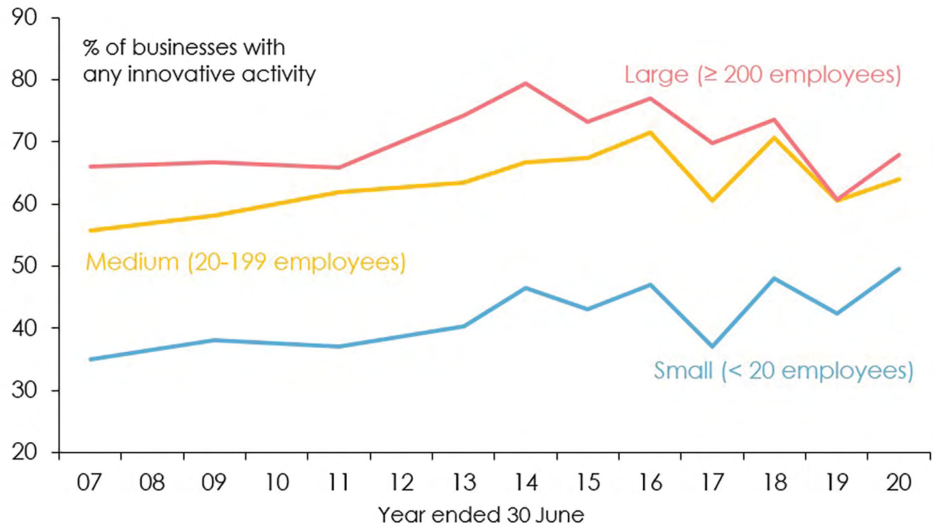

Figure 4. Innovation activity by business size, 2006–07 to 2019–20

Note: Surveys were not conducted in 2007–08, 2009–10 and 2011–12.

Sources: ABS (2018a, 2018b, 2021d).

Wages

In circumstances where the Reserve Bank has been warning for some years that ‘slow wages growth is diminishing our shared sense of prosperity’ (Lowe 2018a) and is ‘one of the reasons why some in our community question whether they are benefiting from our economic success’ (Lowe 2018b), it is also relevant that small businesses typically pay lower wages to their employees than medium-sized and larger ones, as suggested by the data shown in Figure 5.

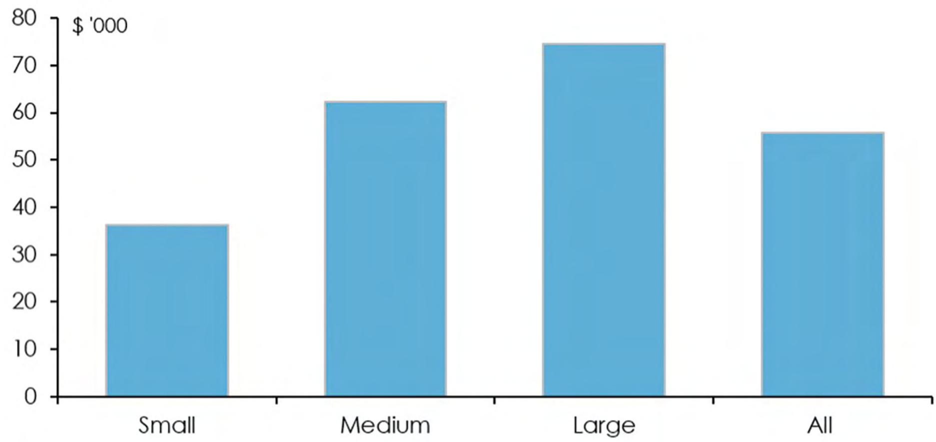

Figure 5. Apparent average annual wage or salary by size of business, 2019–20

Note: 'Average annual wage or salary' is obtained by dividing total wages and salaries paid by each category of business in 2019–20 by the average number of employees as at 30 June 2019 and 30 June 2020. In the absence of relevant data, no allowance is made for differences in the proportion of full or part-time employment between businesses of different size.

Sources: ABS (2021c); and author's calculations.

In 2019–20, small businesses paid their employees an average of almost $19,500 or 35 per cent less than the annual average wage or salary paid by all businesses, whereas medium-sized businesses paid their employees an average of $6,500 or 11.75 per cent more than the average for all businesses and large businesses paid their employees almost $19,000 or 34 per cent more than the average for all businesses.[3]

At face value, this would suggest that, had the share of employment in small businesses not fallen as it has over the past five years, wages growth may have been even slower than it was.

Productivity

Another serious long-term challenge confronting the Australian economy is the slowing in the growth rate of labour productivity over the past decade (Productivity Commission, 2021a, pp. 44–50; The Treasury, 2021b, pp. 45–56).

Labour productivity appears to be lower, on average, in small businesses than in medium-sized and large ones. Estimates compiled by the ABS (2021c) suggest that gross valued added (GVA) per person employed in small business was almost $24,000 or 21 per cent below the average for all businesses in 2019–20.

3 These differences may be exaggerated to the extent that there is a greater proportion of employees in small businesses than in medium-sized or large businesses, but to the best of the author's knowledge there are no data indicating whether that is the case or, if so, the extent to which it is.

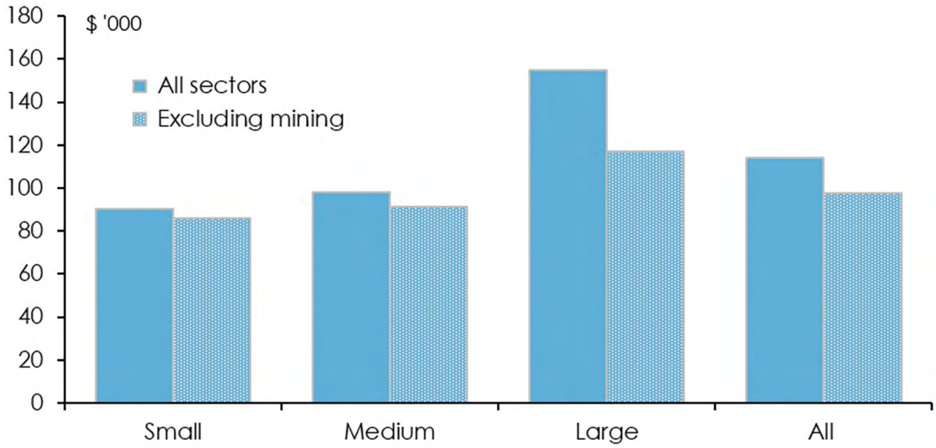

Figure 6. Gross value added per person employed, by size of business, 2019–20

Note: ‘Gross valued added per person employed’ is obtained by dividing total gross valued added by each category of business in 2019–20 by the average number of employees as at 30 June 2019 and 30 June 2020.

Sources: ABS (2021c); and author’s calculations.

GVA per person employed in medium-sized businesses was about $16,000 or 14 per cent below the average for all businesses, and GVA per person employed in large businesses was nearly $41,000 or 36 per cent above the average for all businesses (Figure 6).

Even if the mining sector (which, being highly capital-intensive, has much higher labour productivity than other sectors of the economy) is excluded, GVA per person employed in small business in 2019–20 was 12 per cent below the average for all non-mining businesses, whereas in medium-sized businesses, it was only 6.5 per cent below the all non-mining business average, and in large businesses it was 20 per cent above that average.

Again, this suggests that had the various measures of assistance to small business succeeded in their presumed objective of arresting the long-term decline in small businesses’ overall share of employment and economic activity, the growth rate of labour productivity would have been even slower than it was.

The obvious conclusion from the foregoing is that the widely (if not almost universally) held belief that small business is the ‘engine room of the economy’ is simply *wrong*—as is the corollary that increased assistance to small businesses (in the form of tax preferences, grants and subsidies) *simply because they are small* and for no other reason is a good way of boosting employment, investment, innovation and economic growth more broadly. That widely held view is, likewise, completely without foundation.

Tax avoidance and evasion

One thing that small business *is* very good at is not paying its 'fair share' of tax.

According to estimates compiled by the Australian Taxation Office's 'Tax Gap' program (ATO, 2020), small businesses (which it defines as those with income of up to $10 million a year) paid only 88.5 per cent of the personal and company income tax they 'should' have paid if they had fully complied with the tax law (as the ATO interprets it) in 2017–18. This is larger than for any of the other groups of taxpayers for which the ATO estimates a 'tax gap'. In particular, it is less than that for 'high-wealth' individuals, who, according to the ATO, paid 92.6 per cent of the tax they would have paid given 'full compliance', and less than that for large corporations, who paid 96.3 per cent of the tax the ATO estimates would have represented 'full compliance' in 2017–18—the latest year for which these estimates are available (Figure 7).

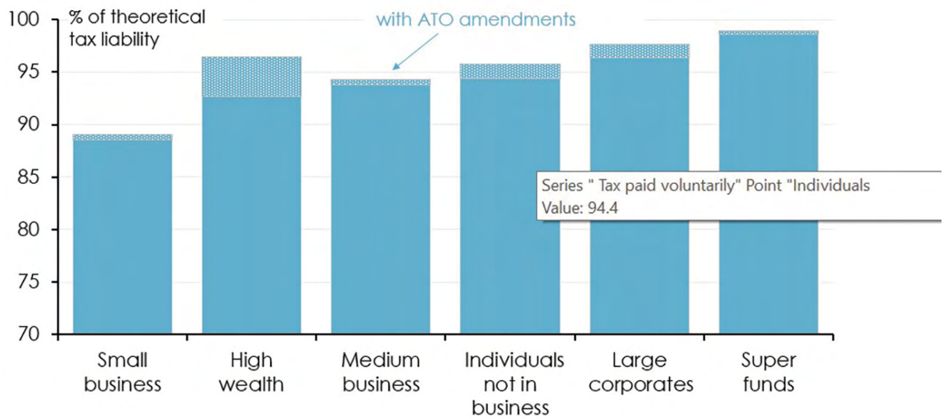

Figure 7. Share of theoretical tax liability paid 'voluntarily' and after ATO amendments, by category of taxpayer, 2017–18

Notes: 'Small' businesses are those with income of up to $10 million; medium businesses are those with income of up to $250 million; and large corporations are those with income of more than $250 million. 'High-wealth' individuals are those who (with associates) control wealth of more than $50 million.

Source: ATO (2020).

The ATO's numbers indicate that small businesses accounted for 44 per cent of the aggregate 'tax gap' between what it collected from personal and company income tax in 2017–18 and what it estimated it would have collected given full compliance with the tax laws by all taxpayers. By contrast, large corporations and high-wealth individuals (to whom the ATO devotes a lot more compliance attention) accounted for only 15 per cent and 3.5 per cent of the total income 'tax gap' in 2017–18.

Again, this is starkly at odds with the popular perception that small businesses are unfairly persecuted by the ATO (Ferguson et al., 2018), and that all Australia’s fiscal problems would disappear overnight if only ‘the top end of town’ paid its ‘fair share’ of tax.

Small business policies during Covid-19

However, while the foregoing suggests the ‘fetishisation’ of small business across a wide range of policy instruments over the past decade has been completely misplaced, it does not necessarily mean that it was wrong for small businesses to have been a major focus of government responses to the Covid-19 pandemic.

Small businesses account for a disproportionately large share of most of the sectors that were hardest hit by the restrictions imposed to suppress Covid-19—in particular, accommodation and food services; transport, postal and warehousing; rental, hiring and real estate services; ‘other services’; and construction.

All these sectors experienced larger contractions (in real gross value added) in the June quarter of 2020 than the economy as a whole, and small businesses account for a larger share of employment and sales and service income in these sectors than they do of the economy as a whole (ABS, 2021c).

And although a higher proportion of small businesses than of medium-sized or large ones was able to continue operating ‘as normal’, at least during the first six months of the pandemic (Figure 8), small businesses were more financially vulnerable than medium-sized or large ones, according to surveys conducted by the ABS (Figure 9), and thus at greater risk of not surviving extended lockdowns.

Had governments not provided the extensive support for small businesses that they did, it seems highly probable the economy would have contracted by more and the unemployment rate would have risen by more than they did during the June quarter of 2020—and the ensuing recovery would have been weaker than it turned out to be.

But that support came at a considerable cost. Apart from JobKeeper, the most expensive component of the Commonwealth Government’s fiscal policy response to Covid-19 was the ‘cash flow boost’ scheme, which provided small and medium-sized businesses (and not-for-profits) with annual turnovers of up to $50 million with credits equal to the amount of PAYG withholding tax instalments deducted from their employees’ pay during the March and June quarters of 2020 (from a minimum of $20,000, even if their employee PAYG withholdings were less than that, up to a maximum of $100,000).

More than 800,000 small businesses received credits totalling almost $32 billion under this scheme (Frydenberg & Cormann, 2020, p. 275)—with more than one-third of the payments going to businesses in the professional, scientific and technical services, and the construction sector.

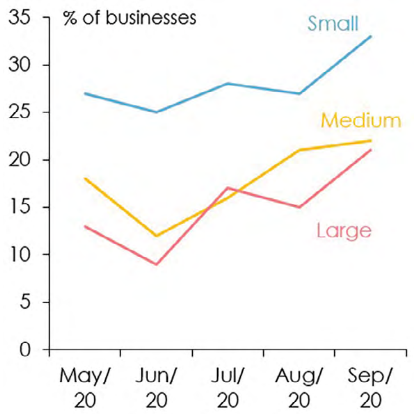

Figure 8. Businesses operating 'as normal' during Covid-19 (percentage of total)

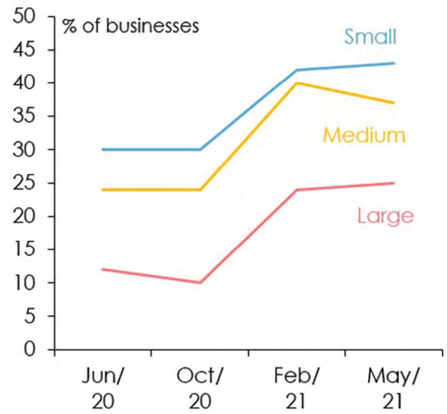

Figure 9. Businesses with cash insufficient to sustain operations for three months

Sources: ABS (2020b, 2021b, and earlier issues of these publications).

Other Commonwealth Government budgetary assistance to small businesses included:

- wage subsidies for apprentices and trainees employed by small and medium-sized businesses, at a cost of $2.4 billion in 2019–20
- an increase in the annual turnover threshold used to determine eligibility for a range of small business tax concessions (providing for the deductibility of certain start-up expenses, fringe benefits tax exemptions for carparking and portable electronic devices provided to employees, and a range of other administrative concessions), from $10 million to $50 million, at a cost (in terms of revenue forgone) of $105 million over four years
- $7 million to support mental health programs directed to small business owners and their financial advisors
- $7 million over two years to 'provide more support to small and medium businesses impacted by the Covid-19 pandemic' through the business.gov.au Contact Centre
- $5 million over two years for a 'national campaign to encourage Australians to support their local small businesses' (Frydenberg & Cormann, 2020, pp. 16, 114, 229, 256).

State and territory governments also provided a range of assistance measures to small businesses through their budgets, including payroll tax relief, rebates of licence and other fees, grants and concessional loan schemes (see, for example, Service NSW, 2021; Business Queensland, 2021; Business Tasmania, 2021).

In addition to measures funded by the Commonwealth Government, support for small businesses was also provided through:

- guarantees of 50 per cent of new loans (up to a total of $40 billion) to small and medium-sized businesses (The Treasury, 2021b)
- the Reserve Bank's Term Funding Facility, which provided three-year fixed-rate funding of $188 billion to financial institutions, initially at an interest rate of 0.25 per cent and subsequently (from November 2020 through to June 2021) at 0.10 per cent, on terms intended to incentivise additional lending (by them) to small and medium-sized businesses (Alston et al., 2020; RBA, 2021)
- a 'temporary exemption' from responsible lending obligations for lenders providing credit to small business customers, to 'help small business get access to credit quickly and efficiently' (The Treasury, 2021b)
- suspension until the end of 2020 of the liabilities facing company directors under the Corporations Law for trading while insolvent, a temporary increase in the threshold at which creditors can initiate bankruptcy proceedings or issue a statutory demand (for repayment of a debt), and an increase in the time allowed to respond to such demands (these applied to all businesses) (ASIC, 2020)
- loan repayment deferral arrangements provided by banks and other lenders (at the height of which, in May 2020, repayments on almost 18 per cent of all loans to small and medium-sized businesses had been deferred) (APRA, 2021)
- temporary changes to state and territory laws governing commercial leases to prevent business tenants from evictions due to non-payment of rent (for example, Small Business Commissioner, 2021).

As necessary as these forms of assistance to small businesses may have been during the pandemic, it will be important to ensure they do not become entrenched as permanent features of the policy landscape whenever Australia finally emerges from the need to impose severe restrictions on economic activity to manage the health risks posed by Covid-19.

By design, these measures have had the effect of preserving existing small businesses and their employees' jobs.

While that is understandable in the context of the pandemic, it should not remain a policy objective once the pandemic has passed.

As noted earlier, one of the major challenges facing the Australian economy (albeit one not unique to Australia) is the slowing rate of growth in labour (and multifactor) productivity.

A growing body of research supports the hypothesis that a major reason for this slowing in productivity growth is a decline in 'economic dynamism'—that is, the rate at which factors of production (labour and capital) move from one use to another—for example, by workers changing jobs, firms changing management or ownership and firms exiting and entering product markets (Quinn, 2019; Andrews & Hansell, 2019; Brennan, 2020; Hambur, 2021).

Two of the most important channels through which improvements in productivity 'happen' are the migration of labour and capital from lower to higher-productivity firms within the same industry and from lower to higher-productivity industries.

Policies that serve to prolong the existence of small businesses—which, as noted earlier, have lower average levels of labour productivity than medium-sized and large businesses—simply because they are small, and for no other reason (which is the basis of most existing forms of assistance to and preference for small businesses), unavoidably have the effect of slowing the rate at which factors of production move from lower to higher-productivity uses within individual industries, and across the economy as a whole.

That effect is arguably magnified during extended periods of ultra-low interest rates, which seem likely to prevail in the aftermath of Covid-19, providing succour to so-called zombie firms (McGowan et al., 2017; Banerjee & Hoffman 2018).

The real engine room

Ideally, existing schemes of preferential tax treatment and other forms of assistance to small businesses, simply because they are small and for no other reason, should be scrapped entirely and replaced with preferential tax treatment for *new* businesses.

There are at least five reasons for this:

1. New businesses are more likely to be started in sectors of the economy with more sustainable economic prospects, whereas small businesses are typically in the sector they are in because that is the sector they were in when their founders started them.
2. New businesses are much more likely than small businesses to create jobs; one recent study showed that firms less than two years old created 1.44 million full-time-equivalent jobs in Australia between 2006 and 2011, while firms three years or older shed around 400,000 jobs over the same period (Hendrickson et al., 2015).

3. New businesses are much more likely than small ones to innovate (Huergo & Jaumandreu, 2004); indeed, the desire to introduce a new product or service, or to produce an existing product or service in a new way, is one of the principal motives for starting a new business.
4. Since there is no way a new business can prevent itself from eventually becoming an older one, tax preferences and other forms of assistance for new businesses are not subject to the perverse incentives associated with preferences for and assistance to small businesses to cease growing just short of the point at which they are no longer eligible for those preferences or assistance.
5. Although almost all new businesses are inevitably small, most small businesses are *not* new, so the budgetary cost of measures aimed at assisting new businesses (whether in terms of revenue forgone or cash outlays) will be significantly less than those directed towards small businesses simply because they are small, as a result of which tax preferences or other forms of assistance to new businesses could be much more generous than the existing preferences and assistance to small business (and hence more likely to achieve their intended result).

There would, of course, need to be appropriate provisions to prevent businesses from continuing to access preferences intended for new businesses through 'rebirthing'. But both the ATO (2021) and the Australian Securities and Investments Commission (ASIC, 2021) already have established protocols to monitor and prevent 'phoenixing'[4] that could also be used to deter and prevent tax avoidance and evasion in this area.

Conclusion

The importance to Australia's near-term economic prospects of lifting wages growth (as repeatedly stressed by the Reserve Bank), and to Australia's medium and longer-term economic prospects of lifting productivity growth (as stressed *inter alia* in the most recent *Intergenerational Report*), suggest that, as Australia emerges from the Covid-19 pandemic, it would be both timely and appropriate to reexamine the shibboleths that have long informed policies towards small business under governments of all political persuasions.

In particular, the fervently and almost universally held belief that small business is the engine room or backbone of the Australian economy—and that, as a consequence, small business operators should pay less tax on any given amount of income than

4 The term used to describe a situation where a new company is created to continue the business of an existing company that has been deliberately liquidated to avoid paying outstanding company debts, which can include taxes, trade creditors and employee entitlements.

others who earn the same amount of income in different ways, or should enjoy preferential access to other forms of assistance through the tax system, grants, subsidies or 'free advice'—is without any empirical foundation.

Australia's economic prospects would be brighter if government policies in this area were more firmly grounded in reality.

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