
Escaping the Startup Trap: Can Policymakers Help Small Companies Grow to Major Employers?

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INTRODUCTION

Starting a new business is hard. Scaling it up to a significant size is harder.

Europeans have long fretted about their lack of ‘unicorns’ — privately held startups with a valuation of more than \$1 billion. More generally, there is a sense that European startups either fail to grow or are bought out by larger companies before they go public or create a significant number of new jobs.

A January 2019 analysis by CB Insights showed only 33 European unicorn companies, compared to 83 in China and 150 in the United States.¹

For example, SoundCloud, an online audio platform, was founded in 2007 in Stockholm and later moved to Berlin. By 2016, it was valued around \$700 million, and at one point sought a \$1 billion valuation to be sold.² However, by 2017, the company abruptly fired 40 percent of its staff and closed two offices.³ By August 2017, the company was valued at just \$150 million.⁴

Or consider restaurant delivery firm Take Eat Easy, founded in Brussels in 2012. After a year, the company expanded to Paris and raised two rounds of venture capital funding in 2015. Take Eat Easy scaled from 10 to 160 employees and from 2 to 20 cities. But in 2016 Take Eat Easy shut down, citing revenue not yet covering fixed costs and an inability to raise a third round of funding.⁵

Even in the relatively successful United States, it seems that new companies are scaling-up less frequently than they used to. The Progressive Policy Institute analyzed Census Bureau data on business dynamics over time, focusing on “young” businesses—aged 6-10 years after being founded. We found that in 2014, 0.05% of young businesses were major employers, defined as having 1,000 or more workers. That’s half the 1994 rate, when 0.1% of young businesses were major employers.

In Europe, the scale-up problems have been attributed to weak venture capital financing and the lack of a true digital single market. In both Europe and in the United States, large companies have been blamed for acquiring small companies before they can grow.

But there’s another explanation for the scaling-up trap that deserves more attention: The unintentional tax and regulatory cliff created by decades of policies favoring small businesses. For example, small enterprises in most E.U. countries are exempt from value-added tax if the annual turnover of everything they sell is below a certain annual limit (as well as satisfying other conditions).⁶ And in the U.S., small businesses are often exempted from obligations to provide benefits like healthcare, unpaid leave, and the federal minimum wage. For example, small businesses with less than \$500,000 in annual gross volume of sales and not engaged in interstate commerce do not have to pay the federal minimum wage or overtime wages.⁷

These exemptions, or “carve-outs,” are great as long as the business stays below the relevant thresholds. But the flip side is that the threat of losing these carve-outs can make entrepreneurs think twice before expanding. Businesses may choose to stay small or sell out to larger rivals,

rather than start complying with a new level of taxes and/or regulation. This analysis is supported by academic research that shows exemptions might not be the most efficient way of encouraging growth.

The phenomenon of a tax/regulatory cliff is very familiar to economists in another context. At one time, the welfare system in the United States was set up such that when a low-income recipient of social assistance found a paid job, they were effectively penalized by losing welfare and other benefits, while they had to pay Social Security taxes on their still low earnings. The “cliffs” created a stiff implicit tax on every dollar of income earned, which deterred people on public assistance from working because they could quickly find themselves worse off.

To mitigate this “welfare trap” and make work pay, U.S. policymakers introduced the Earned Income Tax Credit (EITC) in 1975 as a modest and temporary measure for helping low-income families with children. The credit was designed to increase as workers earned more, starting at low levels of income. Then past some level of income, the EITC was structured to phase out gradually as people earned more money. Over the years, the EITC was seen to be a successful program by both parties, and was considerably strengthened and expanded. Today, it is America’s largest antipoverty program after Social Security.

In the spirit of the EITC, this paper outlines the basic structure of an innovative approach for supporting small businesses while they continue to scale. This approach, which we call a “Startup Tax Credit,” would be adaptable for either Europe or the United States. The tax credit – refundable against income taxes, payroll taxes in the United States, or value-added taxes in Europe – would

rise to some maximum level as a small business expanded. Then the Startup Tax Credit would gradually phase out as the business expanded further. Such a proposal would not be a panacea, but it would encourage small businesses to grow.

WHY POLICYMAKERS LIKE SMALL BUSINESS

Policymakers have historically doted on small businesses, and for good reason. Small businesses are the foundation of both the United States and European Union economies, creating jobs and spreading wealth across our societies. In the United States, small businesses—which the Small Business Administration (SBA) defines as having less than 500 employees—comprise 99.7 percent of all firms with employees, 47.8 percent of private sector employees, and 41.1 percent of private sector payroll.⁸ And in the E.U., small and medium-sized enterprises (SMEs)—defined as having less than 250 employees—account for 99 percent of firms and provided two-thirds of all employment in the nonfinancial business sector.⁹

Moreover, small businesses have historically been the major job creators in both the European and U.S. economies. In the E.U., SMEs created 85 percent of net new jobs from 2002 to 2010 and, in the U.S., small businesses accounted for 65.9 percent of net new jobs from 2000 to 2017.^{10,11} European Startup Monitor's 2016 report estimated that startups provide around 50 percent of all new jobs.¹²

Given these facts, it's only natural for policymakers to want to help out small businesses. One major tool has been exemptions from taxes and regulations that apply to larger businesses. For example, in the United Kingdom, small businesses can get relief from business rates – the U.S. equivalent of

property taxes – if their property's rateable value is less than £15,000.¹³

Portugal offers SMEs a reduced corporate income tax rate of 17 percent on the first €15,000 of taxable income, and 12.5 percent for SMEs located in Portuguese inland regions.¹⁴ Starting in 2018, Belgium's corporate income tax rate for SMEs was reduced to 20.4 percent on the first €100,000 of taxable income, and 20 percent starting in 2021.¹⁵ Lithuania allows SMEs with fewer than ten employees and less than €300,000 in gross annual revenues to benefit from a reduced corporate income tax rate of 5 percent.¹⁶ The recently enacted General Data Protection Regulation includes an exemption for SMEs from maintaining records of their processing activities unless the processing is high-risk, occurs regularly, or includes special categories of data or personal data relating to criminal convictions and offenses.

The U.S. has taken a similar approach. Small businesses with less than 50 employees are exempt from the employer mandate and information reporting provisions of the Affordable Care Act.¹⁷ Small businesses with less than 50 employees are also exempt from having to provide unpaid leave for family or medical reasons to employees under the Family Medical Leave Act.¹⁸ Small businesses with less than \$500,000 in annual gross volume of sales and not engaged in interstate commerce do not have to pay the federal minimum wage or overtime wages.¹⁹ Regulation A exempts small businesses seeking to raise \$20 million and \$50 million under tiers 1 and 2, respectively, from registering their securities with the Securities and Exchange Commission.²⁰ And, under Regulation D, small businesses seeking to raise \$5 million are exempt from registering.

DO CARVE-OUTS HELP SMALL BUSINESSES SCALE-UP?

Tax and regulatory carve-outs certainly help small businesses get started and stay alive, especially since they lack the in-house lawyers and accountants big firms employ to deal with regulatory and tax compliance. BusinessEurope finds “when a big company spends €1 per employee in connection with regulations, a small business has to spend €10 on average.”²¹ Reducing tax and regulatory compliance costs for small enterprises enables them to operate much leaner and accept much lower profit margins than bigger businesses.

On the other hand, a small business that is considering scaling up must reckon with the prospect of losing the benefits of these carve-outs. That’s a problem: Growing a small business bigger – say, from a 50-worker enterprise in one location to a 1,000-worker enterprise operating in multiple locations – is already a risky process, requiring borrowing money or raising funds in some other way. Being forced to suddenly take on new tax and regulatory burdens can seem daunting.

Faced with the combination of these risks, many small businesses fail to cross the threshold, opt not to expand, or sell out to larger companies. A 2015 report by Deloitte Fast Ventures found, “The chances of a new enterprise to ascend as a scale-up are around 0.5%, which means that only 1 out of 200 surviving new enterprises will become a scale-up.”²²

Moreover, a preliminary analysis of U.S. Census Bureau data suggests that the odds of scaling up are lower now than they were in the past. We focused on businesses that are 6-10 years old, which we call “young” businesses. The Census

data allows us to determine the employment of these young firms, ranging from 1-4 workers to over 10,000. We ask the question: What percentage of these young firms have scaled-up to become major employers, with over 1,000 workers?

In 1994, 887 young firms, or just under 0.1 percent, employed 1,000 workers or more. In 2014, only 503 young firms, or just over 0.05 percent, had scaled up to employ 1,000 workers or more.²³

Of course, this decline in the odds of scaling-up can be due to any of a number of different factors. One possibility is that the industrial composition of young firms may have shifted. Another possibility is that companies are more likely to outsource non-essential functions, so that their total employment is lower for the same amount of output.

Nevertheless, the decline in scaling-up also suggests that the practice of exempting small businesses from taxes and regulations may not be the best way to catalyze growth. For example, a 2009 study found some firms with an exemption from Section 404 of the Sarbanes-Oxley Act had an incentive to remain below the threshold.²⁴ Section 404 requires all publicly-traded companies to establish internal controls and procedures for financial reporting and to document, test, and maintain those controls and procedures to ensure their effectiveness. The authors found that the exemption for non-accelerated filers – or companies with a public investment of less than \$75 million – created incentives for firms to remain small. They found non-accelerated filers remain small by undertaking less investment, making more cash payouts through dividends and share repurchases, reducing the number

of shares used to compute public investment for non-accelerated filers, releasing more bad news disclosures, reporting lower earnings, and engaging in more insider selling.

ESCAPING THE STARTUP TRAP

Current policy focuses on providing tax and regulatory carve-outs to small firms, but little support to companies that are scaling up. Indeed, the exemptions disappear suddenly as firms expand, creating a startup trap that discourages entrepreneurs from growing. It's a complicated and difficult problem, but it's worth thinking about whether we can do better.

It turns out that policymakers have faced similar issues in the past. In particular, the United States used to have a social assistance system that removed benefits from poor people as soon as they got a job, even a low paying one. This created a "welfare trap," where it made financial sense for people to avoid getting jobs.

One response was the Earned Income Tax Credit (EITC), which is structured to provide financial support for low-income families without undercutting the incentives to work. Workers receive a credit equal to a percentage of their earnings so that the credit increases until it reaches a maximum level. The credit then remains flat until the phaseout point is reached, where it begins to decline as more income is earned until the credit is no longer available.²⁵ Since its initial implementation in 1975 as a small temporary program, the EITC has been expanded multiple times. It enjoys bipartisan support and is widely considered to be one of the most successful social programs in terms of moving low-income recipients from assistance to higher incomes.

In the spirit of the EITC, we outline an innovative approach for supporting small businesses while

they continue to scale. This approach, which we call the Startup Tax Credit, would be adaptable to either Europe or the United States.

The Startup Tax Credit would be a refundable tax credit that would be tied to payroll, revenue, profit or some combination. Like the EITC, the credit would rise to a certain point as the metric increases to encourage scaling up. Once the credit reaches its maximum, it would remain flat until the startup reached the phaseout point, where it would decline in value slower than it phased in until the company is no longer considered an SME or small business and the credit is no longer available. The credit could be used to offset income taxes, payroll taxes in the United States, or value-added taxes in Europe.

To alleviate budgetary concerns, the credit could be capped in terms of annual amount claimed, the amount claimed over a lifetime, or the annual amount of funding available. Businesses could also be required to show growth for two consecutive years prior to claiming the credit, and a business plan that includes plans for future growth.

Obviously the details of such a proposal matter a lot. One related program is Nebraska's Advantage Microenterprise Tax Credit, which went into effect beginning in 2006.²⁶ The credit allows microbusiness owners to take a refundable income tax credit equal to 20 percent of the microbusiness' new investment or employment, up to \$10,000 in a lifetime. In 2009 the Corporation for Enterprise Development, now known as Prosperity Now, proposed a New Entrepreneur Tax Credit, which would provide a refundable credit to new start-ups during the first few years of operation, when they face unusual start-up costs.²⁷

CONCLUSION

Policymakers want to see startups grow. Yet the current system of tax and regulatory exemptions provides an incentive for small companies to stay small. Indeed, this startup trap may help explain the relative paucity of unicorns in Europe, and the lower odds of young companies becoming major employers in the United States.

What these companies need is a policy that supports them as they scale. As a starting point for discussion, PPI proposes a Startup Tax Credit to provide support for small companies as they grow. Based on the EITC, the refundable tax credit could be tied to various metrics and would rise to a certain point as the metric increases to

encourage scaling up. Once the credit reaches its maximum, it would remain flat until the startup reaches the phaseout point, where the credit would phase out slower until the company is no longer an SME or a small business and no credit is available.

The Startup Tax Credit draws on sound economic principles to address the important problem of helping start-ups scale up. It certainly is not a complete solution to Europe's dearth of unicorns, or to the relative lack of young major employers in the United States. But in a world in which policymakers are looking for levers to help their economies grow faster, the Startup Tax Credit is a good place to start.

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