

The SBPI Fails to Predict Entrepreneurial Dynamism

The Small Business and Entrepreneurship Council's (SBEC) claims that their index measures "the environment for investment, entrepreneurship and small business growth." The measures that make up the Small Business Policy Index (SBPI), however, demonstrate the SBEC's single-minded focus on government regulation and progressive taxation rather than a broader consideration of the range of factors affecting small business dynamism.

Small business growth and survival is not synonymous with entrepreneurial activity, though SBEC appears to treat them so. A lot of new retail activity, for example, is merely a response to the growth of consumer markets in a cookie-cutter fashion rather than a result of innovation.¹ Those who have studied the development of innovation and entrepreneurial activity find that it is generated by some combination of human capital (an educated workforce), financial capital (the availability of venture capital and higher risk loans), ideas, and a set of intangibles that foster an entrepreneurial culture or climate. In fact, one attempt to measure the relative influence of these factors found that the level of education in the workforce, the level of patent activity and innovation research grants (as a measure of ideas), and the availability of capital together explained 60 percent of the variation in state entrepreneurial activity.²

Of these factors proven to boost entrepreneurial activity, government has the biggest role in human capital, which requires investment of tax dollars in public education and university research. But the variations in the role of state government evaluated in the SBPI are largely irrelevant to the development of innovation, and in fact are counterproductive to the extent that they favor smaller government expenditure.

Progressive income taxes actually support new business and innovation

The SBEC incorrectly believes that the most crucial determinant of the viability of small businesses in a state, and the vitality of the entrepreneurial sector, is the level and degree of progressivity of individual and corporate income taxes and the presence of estate/inheritance taxes. In fact, a state tax system that relies most heavily on progressive income taxes for revenue is probably the most supportive of new business and innovation. Under this type of tax code, start-ups and young firms that lose money owe no income taxes. By contrast, firms must pay more regressive taxes, such as sales and property taxes, no matter what their level of profitability, so states that depend more heavily on those taxes create a heavier burden on start-ups and young businesses in those critical formative years.

The SBPI's predictions don't line up with reality

We compared the states' overall SBPI scores with their performance and the relationship

between the two is very weak. To do this, we looked at five measures of economic dynamism as calculated by the Information Technology and Innovation Foundation (ITIF) in its “New Economy Index.”³ ITIF’s state scores are based on: the number of fast-growing firms as a percentage of all firms; the number of independent inventor patents per 1,000 working-age people; the number and value of initial public stock offerings; the number of individuals starting new businesses as a percentage of the population; and the number of business startups and failures as a percentage of total business establishments. We find that the correlations between these measures and the SBPI are quite weak, and in no case approached statistical significance.⁴

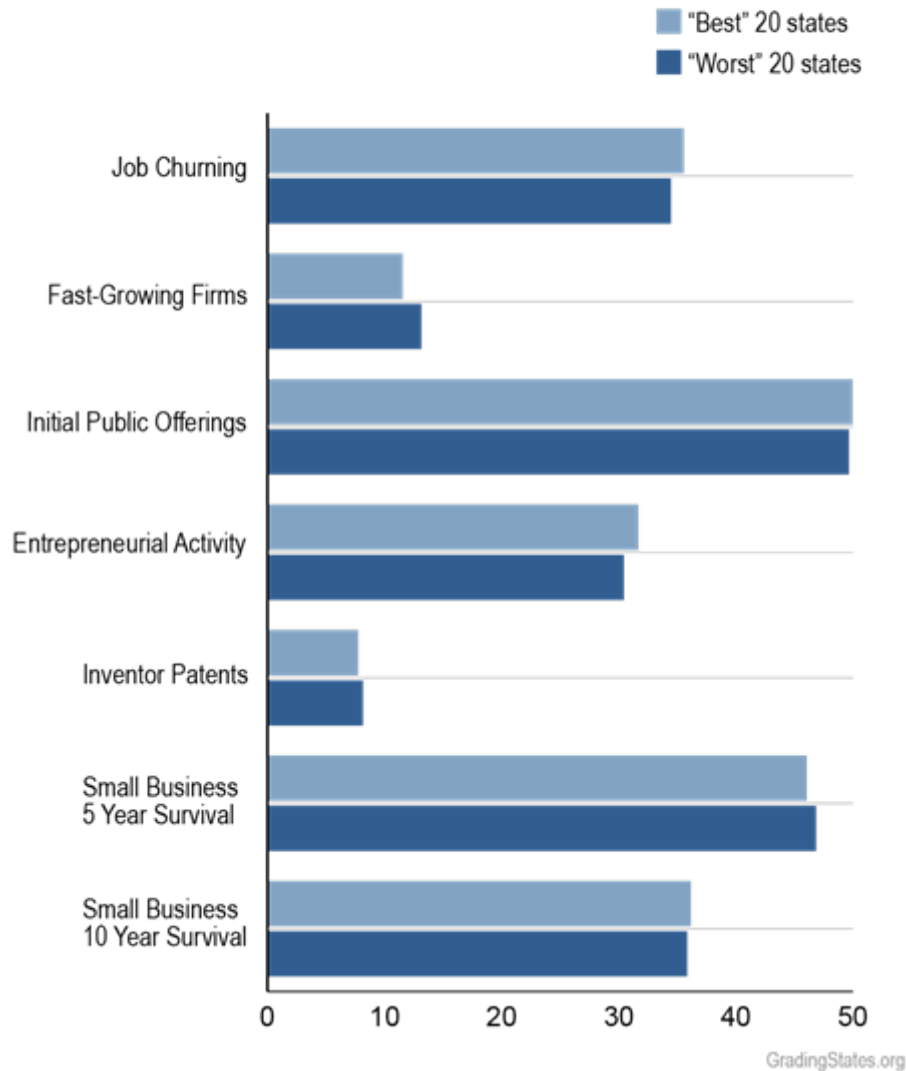
We also compared a state’s ranking on the SBPI with its ranking on the Kauffman Index of Start-up Activity,⁵ and the correlation between the two was insignificant. Finally, we compared the state’s SBPI score with the small business survival rates for the state, which is the percent of new businesses surviving five years or twelve years.⁶ Again, there was virtually no correlation between the two.

The 20 “best” states and the 20 “worst” states on the SBPI perform about the same

Another way of measuring whether the SBPI is a worthy measure is to compare the performance of the 20 states that scored best on the SBPI with the 20 states that scored the worst. Based on the eight measures of economic vitality discussed above (survival rates, the Kauffman Index, and the five components of economic dynamism in the New Economy Index), there is virtually no difference in actual performance between the two groups. The 20 states that scored the best do slightly better on some measures, slightly worse on others, and in no case is the difference of any significance.

The 20 “Best” States and the 20 “Worst” States Perform About The Same

On Measures of Entrepreneurialism, Economic Dynamism, and Small Business Survival



The SBEC, in the 19th edition of the Index, asserts that the states that ranked higher on the 2014 SBPI had faster real economic growth from 2010 to 2013, compared to states that ranked lower. However, when we tested this conclusion we found that the relationship is statistically insignificant. We then tested the conclusion two more ways, to see if either the 2014 SBPI or the 2008 SBPI (the earliest one available on the SBEC web site) was related to economic growth over a longer time period—2007 to 2014. It turns out that there is no significant relation between the SBPI for either year and growth in state GDP or private non-farm employment, which are standard measures of economic growth.

The SBEC also asserts that states ranking higher on the SBPI experience greater net migration (people moving into the state minus people leaving), and faster population growth. However, we found that the correlation between the index for either 2008 or 2014 and net migration from 2008 to 2012 is insignificant. There is a significant relation between the SBPI and population growth. However, the entire premise of the SBPI is that

it measures policies that induce greater innovation, entrepreneurialism, and small business growth. Since this appears not to be the case, any greater population growth in the highly ranked states is not apparently due to their greater economic vitality, but to any number of other factors that influence birth rates, mortality rates, and people's desire to move.

Conclusion

The SBPI does not appear to be measuring things that contribute to higher rates of innovation and entrepreneurship, nor does it appear to bear any relationship with state economic growth. States that rank better on the SBPI do no better than the states ranked worse in terms of patents, business start-ups, fast-growing firms, small business survival, other measures of entrepreneurial activity, or growth in output or employment.

1. Stephen Goetz and David Freshwater. "State Level Determinants of Entrepreneurship and a *Preliminary Measure of Entrepreneurial Climate*." *Economic Development Quarterly*, vol. 15, no. 1, Feb. 2001, pp. 58-70.

2. Goetz and Freshwater.

3. Information Technology and Innovation Foundation, *The 2014 State New Economy Index*, Washington, D.C., June, 2014. <http://www.itif.org/publications/2014/06/11/2014-state-new-economy-index>

4. In academic research, the statistical significance of a result indicates the probability that the relationship occurred by chance rather than because of a casual effect. In general, these probabilities should be 5 percent or below to indicate a statistically significant result, or 10 percent for marginal significance. When we say that a correlation or regression result is not even marginally statistically significant, we mean that the probability it occurred by chance exceeded the 10 percent standard.

5. Kauffman Foundation, *Kauffman Index: Startup Activity (1997- 2015)*. Kansas City, Missouri. June 2015, at: <http://www.kauffman.org/microsites/kauffman-index>

6. Survival rates were from the U.S. Small Business Administration report, *Small Business Profiles for the States and Territories*, June, 2014, at https://www.sba.gov/sites/default/files/files/_All%20States%2013.pdf