September 11, 2014

Last month, the University of Nebraska’s Bureau of Business Research released the tenth installment of its annual State Entrepreneurship Index, which uses a specific formula to measure entrepreneurship in each of the fifty states. In the latest report, there’s a real surprise for North Carolina: ranked #28 in 2012, we’ve fallen in just one year to 49th. Only Michigan ranks lower. Is this a true reflection of declining entrepreneurial health in North Carolina? Probably not.

To understand the steep decline in NC’s ranking, we need to look more closely at how the State Entrepreneurship Index works. The Index looks at the following five specific measures:

- Percent growth in employer establishments
- Percent growth in employer establishments per person
- Business formation rate (i.e., new establishments per person)
- Patents per person
- Average non-farm proprietor income

University of Nebraska’s State Entrepreneurship Index (2013 data; higher numbers are better)

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Featured Report

North Carolina’s economy remains sluggish, and some counties remain in poverty’s tight grip. Learn more about N.C. Percent Poverty by County by clicking here.
Looking at the State Entrepreneurship Index for key states over ten years (see chart below) we see that NC ranked as high as 17\textsuperscript{th} in 2007. North Carolina fell to 39\textsuperscript{th} following the Great Recession of 2008 but rebounded to 28\textsuperscript{th} in 2013, that quick growth mirroring a similar trajectory we experienced from 2005 to 2007. Now, however, the Index suggests a dramatic decline in North Carolina’s entrepreneurial fortunes in the space of a single year. Only three other states had a steeper decline across the last twelve months: Virginia (21 spots), Vermont (22 spots), and Alabama (32 spots).

Typically, business activity and economic phenomena reflect regional dynamics. In the Index, however, we don’t find a southeast region pattern. All other southern states saw improvements or maintained their relative standing; notably, both South Carolina and Georgia moved up in the rankings (27 spots and 5 spots, respectively).

\textbf{Entrepreneurship Rankings Comparison}

Looking at the chart, it is evident that of the comparison states (southeastern states with Texas and California added for broader comparison) only Virginia
demonstrates a pattern in Index performance that is similar to North Carolina’s since the recession. The drop in Virginia’s ranking largely reflects the negative impacts of the federal sequester and shutdown on the state’s numerous defense and other federal contractors. All other comparison states demonstrate a pattern of upward progress.

So, why did North Carolina drop so far, so fast in the Index? The state has shown a steady increase in the number of patents per person since 2005, and average non-farm proprietor income has shown a modest increase, as well. So far so good, as far as NC’s positioning in the Index is concerned. However, North Carolina did experience marked declines across the three other measures relevant to the Index: percent growth in employer establishments (falling from 9th to 47th); percent growth in establishments per person (from 13th to 49th); and establishment births per person (from 26th to 31st). What’s happening here?

Before we sound an alarm about North Carolina’s supposed declining entrepreneurial health, let’s first note that the state significantly changed its tax code in 2013. The legislature eliminated a $50,000 business deduction for corporations and also lowered top personal income tax rates. As a result, many small businesses operating as corporations likely sought a lower tax bill by becoming sole proprietorships and filing a personal (rather than corporate) tax return. Because the data source used by the University of Nebraska’s State Entrepreneurship Index - the Quarterly Census of Employment and Wages - excludes proprietorships from its counts of “employer establishments,” this flight from corporate to sole proprietor status probably explains the downward trend in North Carolina’s number of establishments and the state’s related fall in the Index rankings.

As with all things, the devil is in the details. This is as true of tax reform initiatives as it is for the tools we use to measure their impacts. Next year’s State Entrepreneurship Index should give us a truer picture of North Carolina’s business climate because the baseline number of establishments will likely have stabilized after the tax code-inspired reclassifications so the Index can again pick up and reflect relative year-over-year gains off that new, lower base. We’ll then begin to get a clearer picture of the ripple
effects of last year’s tax reform package, beyond the reshuffling of business classifications, on North Carolina’s economy.

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