

## A Wealth of Small Business Research

In this newsletter and in other ways, the Office of Advocacy makes the case for the importance of small business to the economy and the need to avoid one-size-fits all regulatory approaches. But can we really say for certain the role small business plays in our economy? The answer is yes, and the reason is because of the work done by Advocacy's Office of Economic Research.

Every year Advocacy's team of economists and outside researchers make in-depth contributions to our understanding of small business through studies, academic papers, conferences, and data collection. These contributions are brought together in Advocacy's annual research catalog.

Advocacy's annual research catalog is the "yellow pages" of current small business research

topics. The catalog itemizes the office's entire research output for the year—including *The Small Business Economy*; annual updates on finance, state-level, and demographic data; and proceedings documenting Advocacy conferences.

The current catalog documents major Advocacy research activities in 2006. There were two conference proceedings released in 2006. The

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*Message from the Chief Economist—Page 3*

**Who creates the most net new jobs—small businesses or large?**

*Turn to page 3 to find out.*



Between 2000 and 2005, employment in Littleton, Colorado, grew 35 percent. Littleton's success is attributed to "economic gardening," a self-reliant economic development strategy that emphasizes investment in home-grown businesses instead of attracting established ones from elsewhere. Turn to page 6 for more on small business and economic development. *Photo courtesy City of Littleton.*

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## Regional Roundup

### State Model Legislation Gears Up for 2007 Legislative Season

More than 93 percent of the businesses in every state are small businesses, and they face a disproportionate share of regulatory costs and burdens. While federal measures are in place to reduce such burdens on small businesses, the need does not stop there. Any small business owner on Main Street will explain that regulatory burdens stem from state capitols and state agencies as well.

In December 2002, the Office of Advocacy introduced model legislation for consideration by states that mirrors the federal Regulatory Flexibility Act. According to the model legislation, successful state-level regulatory flexibility laws address the following areas:

- A small business definition that is consistent with existing state practices and permitting authorities;
- A requirement that state agencies perform an economic impact analysis on the effect of a rule on small businesses before they regulate;
- A requirement that state agencies consider less burdensome alternatives for small businesses

that still meet the agency's regulatory goals;

- Judicial review to give the law "teeth;" and
- A provision that requires state governments to review existing regulations periodically to minimize the impact on small business.

Since Advocacy's model legislation was introduced, 34 state legislatures have considered regulatory flexibility legislation, and 19 states have implemented regulatory flexibility via executive order or legislation. As the new year begins, state legislators are introducing regulatory flexibility legislation to strengthen their current system. As of the end of January, five new bills had been introduced (Arkansas, Hawaii, Illinois, Mississippi, and Montana). A sixth bill, in New Jersey, carried over from last year.

As a result of the success of the model legislation, the initiative is now entering an exciting new phase. Advocacy staff are working with the small business community, state legislators, and state government agencies to assist with implementation of their regulatory

#### Research, from page 1

first covered a symposium observing the Regulatory Flexibility Act's 25th anniversary; the second covered the the April 2006 conference in response to Hurricanes Katrina and Rita.

Advocacy's annual publications include *Frequently Asked Questions (FAQ)*, *Quarterly Indicators*, *The Small Business Economy*, *State and Territory Small Business Profiles*, and *Small Business and Micro Business Lending*. Each report serves as a "portal" to the office's other research and data products.

About a dozen studies published by the office were the work of outside contractors. Joanne Pratt documented the importance of home-based sole proprietors. Two reports focused on economic growth and entrepreneurship in urban and rural settings. Charles and Adrian Cowan surveyed financial institutions on their use of credit scoring for small business lending, and a number of studies concentrated on small businesses' ability to win contracts from the federal government.

*Research Publications, 2006* is online at [www.sba.gov/advo/research/res\\_pub06.pdf](http://www.sba.gov/advo/research/res_pub06.pdf). All

#### The Small Business Advocate

Editor Rebecca Krafft

Managing Editor Rob Kleinsteuber

**Contributing Editors** Kevin Bromberg, Keith Holman, John McDowell, Chad Moutray, Janis Reyes, Joe Sobota, Kathryn Tobias, Sarah Wickham

**Production Assistant** Dawn Crockett

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the items listed—including those before and after 2006—can be found at [www.sba.gov/advo/research](http://www.sba.gov/advo/research). To keep informed about Advocacy's latest research, visit <http://web.sba.gov/list> to subscribe to Advocacy's research Listserv. If you prefer to receive RSS feeds, visit Advocacy's webpage and click on "Newsroom."

Stay tuned. Next month, Advocacy will release the annual report on the Regulatory Flexibility Act, which will provide the much awaited regulatory year-in-review and important regulatory cost savings.

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## Message from the Chief Economist

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### Small Businesses As Job Generators

by Chad Moutray, Chief Economist and Director of Economic Research

It is easy to be an advocate for small business. Small firms account for half of our gross domestic product, employ half of the American workforce, and generate most of our net new jobs. Moreover, small business patents push the boundaries of technology, and their innovations are the source of new markets, enhanced competition, and expanded economic growth and employment. It is no wonder that politicians of both parties are eager to embrace entrepreneurs.

From time to time, small business advocates are challenged by those who feel that small businesses' importance to the economy is exaggerated. These arguments are not new. A recent article in *American Enterprise Institute* magazine, for instance, attempts to refute entrepreneurs' impact on net job creation. But this article, like those that came before it, is simply inaccurate. Thirteen months ago, the U.S. Bureau of Labor Statistics found that small businesses generated 65 percent of the net employment growth between September 1992 and March 2005, confirming similar data from the U.S. Census Bureau.

Far from a myth, the reality is that most net job creation takes place in the first two years of a firm's existence and within firms that employ fewer than 20 workers. Many of these firms will become fast-growing "gazelles" that will eventually grow to be large firms that employ hundreds or thousands of people. That growth is due to hard work, innovation, and risk-taking by entrepreneurs who have a vision for the future and the passion to turn dreams into reality.

Many of those who attempt to deny the data on small business and job creation also take issue with

attempts to level the playing field for small firms by reforming rules and regulations. However, Office of Advocacy research shows that firms with fewer than 20 employees annually pay 45 percent more per employee than their larger counterparts to comply with federal regulations.

Clearly, one-size-fits-all regulatory approaches have much larger impacts on small businesses. Moreover, many times these firms are caught in a web of safety, tax, and environmental regulations when small businesses are not part of the problem those regulations are meant to solve. Over 25 years ago, Congress recognized this dilemma and passed the Regulatory Flexibility Act (RFA). Simply stated, the RFA helps protect small business from unnecessary regulatory burdens. It requires federal regulators to draft small business impact statements when they propose new rules. The RFA also requires agencies to consider less burdensome alternatives that do not undermine the intent of the regulations.

Ensuring that small businesses are taken into consideration when

#### Why "Net" New Jobs?

Job creation is a moving target. As employment grows at some firms, it decreases at others. Economists use the measure of "net" new jobs to show actual increases in the number of jobs, after you subtract the number of jobs lost from the number of new jobs created. The result shows the overall increase, with the losses taken into account.

new regulations are being written does not give small businesses an unfair advantage. It merely helps level the playing field and allows small business owners to focus their attention on what they do best—create innovative new products and services, generate jobs, and grow the economy.

Reputable research and statistics show that entrepreneurs play a unique role in our economy; they are dynamic, creative, innovative, and job-creating. Policymakers and academics appreciate their importance to economic growth and future employment. To do otherwise would be a serious omission.

#### For More Information

The U.S. Bureau of Labor Statistics tracked employment changes over a 13-year period and found that firms with fewer than 500 employees created 13.5 million of the 20.6 million net jobs generated by the private sector. See [www.bls.gov/news.release/pdf/cewfs.pdf](http://www.bls.gov/news.release/pdf/cewfs.pdf).

The Office of Advocacy has published three studies on the cost impact of regulations since 1995:

- W. Mark Crain, *The Impact of Regulatory Costs on Small Firms*, September 2005, 93 pages. [www.sba.gov/advo/research/rs264tot.pdf](http://www.sba.gov/advo/research/rs264tot.pdf).
- W. Mark Crain and Thomas D. Hopkins, *The Impact of Regulatory Costs on Small Firms*, October 2001, 61 pages. [www.sba.gov/advo/research/rs207tot.pdf](http://www.sba.gov/advo/research/rs207tot.pdf).
- Thomas D. Hopkins, *A Survey of Regulatory Burdens—Profiles of Regulatory Costs*, November 1995, 103 pages. [www.sba.gov/advo/research/rs1995hoptot.pdf](http://www.sba.gov/advo/research/rs1995hoptot.pdf).

### White House Moves To Oversee Significant Guidance Documents from Federal Agencies

On January 18, the Bush Administration took two important steps toward establishing standard practices for federal agencies when they issue guidance documents. Small businesses have long been concerned about the agency practice of issuing guidance documents intended to have legal effect without going through notice-and-comment rulemaking. Advocacy has strongly supported efforts to develop a more transparent, consistent process for agencies to use when they issue guidance documents.

To address this need, President Bush amended Executive Order 12866, which requires federal agencies to submit significant proposed rules for review by the Office of Information and Regulatory Affairs (OIRA) within the Office of Management and Budget (OMB). The

amendment to E.O. 12866 requires agencies to give OIRA advance notice of any significant guidance documents they plan to issue. "Significant" guidance documents are those that are expected to have an annual effect of \$100 million or more on the national economy; that could interfere with another agency's actions; that could materially affect entitlements, grants, or loan programs; or that raise novel legal or policy issues.

Accompanying the amended E.O. 12866 is OMB's final *Bulletin on Good Guidance Practices*. The bulletin establishes standard procedures for agencies when they develop, issue, and use guidance documents. Under the bulletin, agencies must implement written procedures for the approval of significant guidance documents by

appropriate senior officials, and the documents themselves must clearly indicate that they only give guidance and do not impose legal requirements. Agencies are required to maintain a current list of significant guidance documents on their websites and provide a means for the public to comment on them. Agencies that issue economically significant guidance documents are now required to publish a notice in the *Federal Register*, take comment on the document, and prepare a response-to-comments document prior to issuing the final guidance.

Taken together, these new requirements aim to improve the regulatory process by bringing greater transparency and accountability to federal agency guidance practices.

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### EPA Makes Changes to Spill Prevention Program

In December, the Environmental Protection Agency (EPA) issued a final rule promulgating changes to its Spill Prevention, Control, and Countermeasure (SPCC) program. The SPCC program is designed to prevent spills of oil into waterways and to contain spills after they occur. Facilities subject to the program must develop spill prevention plans designed to prevent and minimize such discharges. In July 2002, EPA amended the SPCC requirements for hundreds of thousands of small businesses, farms, manufacturers, and electrical facilities. Later, EPA postponed the effective date of the changes while it studied burden reduction alternatives. Advocacy filed comments on the proposals in June 2004 and February 2006.

The final rule incorporates Advocacy's recommendations for revisions in two distinct areas: small facilities (whose aggregate capacity for oil is less than 10,000 gallons) and oil-filled equipment. Major changes include the following:

- EPA will now allow facilities that handle up to 10,000 gallons of oil and that have had no reportable discharge of oil in the previous three years to certify their own spill prevention plans. The rule otherwise requires a professional engineer to certify SPCC plans.

- Mobile refuelers such as airport refueling trucks are exempt from secondary containment requirements. EPA will allow facilities with oil-filled equipment to "implement an inspection and monitoring program, develop an oil spill contingency plan, and provide a written

commitment of resources to control and remove oil discharged, for qualified equipment in lieu of secondary containment for the oil-filled operational equipment."

- Farms received an indefinite extension to comply with the SPCC rule until EPA issues a rule specifically addressing farms. In a separate rulemaking, EPA proposed to extend the compliance dates for non-farm facilities until July 1, 2009.

EPA estimates that these changes, which follow many of Advocacy's recommendations on behalf of small businesses, will reduce the regulatory and paperwork burden on small facilities by \$128 million annually, while increasing overall compliance with the SPCC program and focusing facilities on measures that will prevent oil spills from reaching waterways.

## Advocacy Roundtable Focuses on Latest Sarbanes-Oxley Act Proposals

On January 26, the Office of Advocacy held a small business roundtable to solicit input on the latest proposals by the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) on Section 404 of the Sarbanes-Oxley Act of 2002. Over 40 people participated, including small business owners and representatives, trade association staff, federal agency personnel, and congressional staffers.

The Sarbanes-Oxley Act requires companies that submit financial reports to submit both a management report and an auditor report on internal controls. (Internal controls are the systems in place in a company that guard against fraudulent or mistaken transactions and ensure the accuracy of the financial reporting.) In December 2006, the SEC adopted a rule that provided small public companies (“non-accelerated filers”) extensions of time to implement Section 404 of the Act.

Michael G. Gaynor, from the SEC’s Office of the Chief Accountant, discussed the proposed interpretive guidance to help the management of public companies comply with Section 404. This guidance directs managers to utilize a “risk-based” approach, focusing on areas that will result in a material misstatement in their financial statements. Since managers are encouraged to tailor their evaluation to fit their company’s facts and circumstances, small companies are supposed to benefit from this scalability and flexibility.

Laura Phillips, deputy chief auditor for the PCAOB, summarized the proposed Auditing Standard No. 5. This standard will replace the much criticized Auditing Standard No. 2. The board, which was created by the Act to oversee auditors of public companies, released the new standard as a guide for external auditors and

accountants to assess the internal controls of public companies under Section 404. The proposed auditing standard requires only one auditor’s attestation report instead of two, redefines important terms, directs auditors to utilize risk assessment in their audits, and recommends that auditors tailor their audits to reflect the attributes of smaller and less complex companies.

Sharon Haeger, regulatory counsel for America’s Community Bankers observed that “the board’s proposed auditing standard has addressed many of the issues with Accounting Standard No. 2 raised over the past couple of years.”

Comments on both proposals are due on February 26. To learn more, visit Advocacy’s Regulatory Alerts webpage at [www.sba.gov/advo/laws/law\\_regalerts.html](http://www.sba.gov/advo/laws/law_regalerts.html).



Small business stakeholders at the Sarbanes-Oxley Act roundtable included (from left) Jennifer C. Dowling, National Venture Capital Association; Grace Hinchman, Financial Executives International; Marshal Shichtman, Marshal Shichtman & Associates, PC; Donna Fisher, American Bankers Association; Grant Seiffert, Telecommunications Industry Association; William J. Zaiser, MHI Hospitality Corp.

### New RFA Research Published

Jennifer A. Smith, the Office of Advocacy’s assistant chief counsel for economic regulation and banking, is the author of a newly published law paper, “Squeezing Back: Making Federal Agencies Measure Their Economic Impact on Small Entities.” Smith’s research appears in the proceedings of the 52nd Annual Rocky Mountain Mineral Law Institute.

The paper reviews the history of the Regulatory Flexibility Act (RFA), and its subsequent amendment by the 1996 Small Business Regulatory Enforcement Fairness Act (SBREFA). SBREFA reshaped the requirements of the RFA and provided for judicial review of agencies’ final decisions under the RFA. Smith examines case law post-SBREFA, including the case of *Northwest Mining v. Babbitt*, SBREFA’s impact on small entities, and current legislative proposals to further strengthen the RFA.

The paper was originally presented in Santa Fe in July 2006; the official citation is 52 Rocky Mt. Min. L. Inst. 5-1 (2006).

### Recent Research Uncovers Multifaceted Relationship of Entrepreneurship and Local Economic Growth

The Office of Advocacy has conducted a number of studies on state economic growth and entrepreneurship. Overall, these reports conclude that small businesses play an important role in revitalizing state and regional economies. In February, Advocacy is publishing a report by Donald Bruce, John Deskins, Brian Hill, and Jonathon Rork. This new report finds that a state's ability to increase the number of small firm establishments is the most important thing it can do to influence economic growth. The report's authors conclude, "The most fruitful policy option available to state governments is to establish and maintain a fertile environment for new establishment formation."

This report is not alone in focusing on business climate. In her 2004 analysis of state laws, Aparna Mathur finds that business conditions in neighboring states are a significant determinant of small firms' entry and exit decisions.

Other studies have tied state economic performance to such important factors as innovation. In 2005, Michael Camp note that entrepreneurial regions tend to be technologically oriented. Such regions are characterized by a higher number of patents per labor force participation and more high-tech firms. Camp's report echoes observations by Bruce Kirchoff and Catherine Armington/BJK Associates. These authors find that the metropolitan areas surrounding universities with significant research and development dollars tend to lead in firm formation.

These findings are equally true for urban and rural locations. Steven Craig and Janet Kohlhasse observe that small firms play a large role in developing urban subcenters, and Innovation and

Information Consultants explain the various factors and challenges of rural entrepreneurial growth.

Advocacy recently documented the phenomenon of "economic gardening" in the office's annual economic report, *The Small Business Economy*. This self-reliant approach to economic development relies on

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**"The most fruitful policy option available to state governments is to establish and maintain a fertile environment for new establishment formation."**

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grooming new and existing entrepreneurs instead of chasing larger companies, known as "economic hunting." The authors argue that luring existing large businesses into town can be expensive or unrealistic. Instead, economic development resources are best expended on the existing and nascent small businesses in one's own community.

Research studies that seek to isolate the drivers of economic development are complicated by the numerous factors at work in economic growth. For example, population trends explain much of the variation in entrepreneurship rates across states; hence, regions that have experienced phenomenal growth in population are also seeing higher growth in firm births. But one has to ask, "Which came first?" Did population migrate because of the new businesses and opportunities, or vice versa?

A second challenge is the existence of large, research-driven technology clusters. This could be called the Stanford or M.I.T. effect. Such institutions produce a large volume of new patents that

are eventually commercialized into new ventures. They have an exceptionally entrepreneurial climate, and the enormous opportunities that exist in these locations supersede prevailing business conditions as a creative factor. The high cost of living in Silicon Valley, for instance, has not stopped new business creation. The reasons for locating there may outweigh the perceived tax or regulatory climate or other factors.

Researchers attempting to explain state entrepreneurship may reach conclusions that de-emphasize the business climate. In their December 2006 report, Donald Bruce and John Deskins found that state tax policy had only a modest impact on aggregate state entrepreneurship rates. Likewise, Whitney Peake and Maria Marshall studied state expenditures to determine which ones were more likely to produce higher rates of entrepreneurship. Their findings appear counterintuitive: states found to have high entrepreneurship rates per capita in other studies are deemed by these authors as less likely to produce entrepreneurship via their state expenditures.

Nonetheless, it is essential to note that in each of these studies, the creation of new small businesses has an impact on local economies, and this is important in and of itself. In reading these reports, policymakers will find that, as the most recent Bruce study shows, a state or region's ability to generate new entrepreneurs will influence its overall economic success over the long term.

—Chad Moutray, Chief Economist

**Recent research published by the Office of Advocacy is listed on page 7.**

## Research Examines Self-Employment By Service-Disabled Veterans

The Office of Advocacy estimates that in 2005 veterans owned more than 3.7 million businesses, 240,000 of which were headed by service-disabled veterans. Public Law 106-50 directed Advocacy to develop statistical and other information on veterans in business and the role they play in our economy. Since 2004, the office has issued five economic research studies on a variety of veterans' entrepreneurship issues.

On January 26, Advocacy released its most recent veterans study, *Self-Employment in the Veteran and Service-Disabled Veteran Population*. This study was conducted by Open Blue Solutions, Inc., in Chapel Hill, North Carolina. Open Blue is a service-disabled veteran-owned business (SDVOB); the research was completed under the first contract let by both Advocacy and Small Business Administration using a new procurement authority that allows competition

to be reserved exclusively for SDVOBs.

The new study uses data from the Bureau of Labor Statistics' Current Population Survey to examine the self-employment choices of veterans and service-disabled veterans. Key findings include:

- Veterans with service-connected disabilities are self-employed at significantly lower rates than veterans without such disabilities. Substantially all of the difference between the self-employment rates of service-disabled veterans and those of other veterans results from the service-connected disabilities themselves, and not from differences in demographic or other characteristics.

- One-half to two-thirds of the difference in these self-employment rates is due to service-disabled veterans not working at all. Controlling for the effects of service-connected disabilities results in nearly identical rates of labor-force par-

ticipation among service-disabled veterans and those without such disabilities.

- Computer use is correlated with higher employment rates among all veterans, with additional benefits for the service-disabled. Computer use also increases self-employment rates among all veterans, but there is no additional effect on the self-employment choices of service-disabled veterans beyond that observed for all veterans.

The Department of Defense's Computer/Electronic Accommodations Program (CAP) supports wounded service members by providing needs assessments, assistive technology, and training through all phases of recovery and transition to employment. To learn more, visit [www.tricare.mil/cap](http://www.tricare.mil/cap).

Both the new study and other research on veterans entrepreneurship are available at [www.sba.gov/advo/research/veterans.html](http://www.sba.gov/advo/research/veterans.html).

### Research on Entrepreneurship, State, and Regional Development

- *Small Business and State Growth: An Econometric Investigation*, by Donald Bruce, John Deskins, Brian Hill, and Jonathon Rork. February 2007. [www.sba.gov/advo/research/rs292tot.pdf](http://www.sba.gov/advo/research/rs292tot.pdf).
- *A Spatial Model of the Impact of State Bankruptcy Exemptions on Entrepreneurship*, by Aparna Mathur. July 2005. [www.sba.gov/advo/research/rs261tot.pdf](http://www.sba.gov/advo/research/rs261tot.pdf).
- *The Innovation-Entrepreneurship Nexus: A National Assessment of Entrepreneurship and Regional Economic Growth and Development*, by Michael Camp. April 2005. [www.sba.gov/advo/research/rs256tot.pdf](http://www.sba.gov/advo/research/rs256tot.pdf).
- *The Influence of R&D Expenditures on New Firm Formation and Economic Growth*, by BJK Associates. October 2002. [www.sba.gov/advo/research/rs222tot.pdf](http://www.sba.gov/advo/research/rs222tot.pdf).
- *The Economic Role of Small Businesses Using Large Data Sets: An Analysis of the Contribution of Firms to Urban Growth*, by Steven Craig and Janet Kohlhase. November 2006. [www.sba.gov/advo/research/rs287tot.pdf](http://www.sba.gov/advo/research/rs287tot.pdf).
- *An Empirical Approach to Characterize Rural Small Business Growth and Profitability*, by Innovation and Information Consultants. February 2006. [www.sba.gov/advo/research/rs271tot.pdf](http://www.sba.gov/advo/research/rs271tot.pdf).
- "Economic Gardening: Next Generation Applications for a Balanced Portfolio Approach to Economic Growth," by Steve Quello and Graham Toft. *The Small Business Economy: A Report to the President for Data Year 2005*. Chapter 6. December 2006. pp. 157-193. [www.sba.gov/advo/research/sb\\_econ2006.pdf](http://www.sba.gov/advo/research/sb_econ2006.pdf).
- *State Tax Policy and Entrepreneurial Activity*, by Donald Bruce and John Deskins. December 2006. [www.sba.gov/advo/research/rs284tot.pdf](http://www.sba.gov/advo/research/rs284tot.pdf).
- *Getting the Most Bang for the Buck: An Analysis of States' Relative Efficiencies in Promoting the Birth of Small Firms*, by Whitney Peake and Maria Marshall. January 2007. [www.sba.gov/advo/research/rs290tot.pdf](http://www.sba.gov/advo/research/rs290tot.pdf).

## Nationwide Effort Seeks To Inspire a New Generation of Entrepreneurs

Later this month, hundreds of organizations will join together in an unprecedented effort to inspire and encourage young people to consider entrepreneurship as a career choice.

The event, EntrepreneurshipWeek USA, runs from February 24 to March 3. It promotes entrepreneurship and celebrates America's unique culture of inventiveness. It features events and activities in communities across the country to inspire, educate and prepare young people, primarily ages 14 to 25, to be America's next great entrepreneurs and innovators.

The week and its catchy theme, "What's Your Big Idea? Take it On!" are designed to serve as an inspiration for young people to think creatively and to turn their ideas into action—whether that

means starting a new business, developing an innovation for an existing company, or solving a problem that makes society better.

Official events are planned in cities across the country, culminating in Washington, D.C., where the focus will be on the importance of policy to the nation's entrepreneurs.

The Office of Advocacy is involved in this policy discussion. Chief Counsel for Advocacy Thomas M. Sullivan and Chief Economist Chad Moutray will participate on two panels at the Brookings Institution during EntrepreneurshipWeek USA. These panels will examine the impact of regulation and litigation on small business.

EntrepreneurshipWeek USA is sponsored by the Ewing Marion Kauffman Foundation along with hundreds of entities from the government, nonprofit, and business sectors. To learn more, visit [www.entrepreneurshipweekusa.com](http://www.entrepreneurshipweekusa.com).



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