JOINT ECONOMIC COMMITTEE
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# How the Top Individual Income Tax Rate Affects Small Businesses

Taxpayers in the highest income bracket are often entrepreneurs and small business owners, not just highly-paid executives or people living off their investments. Small business owners typically report their profits on their individual income tax returns, so the individual income tax is effectively the small business tax. Recent economic research shows that individual taxes have a significant impact on the decisions of small business owners. In particular, lowering the highest marginal tax rate encourages small businesses to hire, invest, and grow.

**Many small businesses pay taxes through the individual income tax system**

Small businesses generally pay their income taxes through the individual income tax system, not the corporate tax system. Sole proprietorships, partnerships, and S corporations are the three main organizational forms chosen by small business owners.[1] Under the tax code, each of these three small business types pays taxes at the same rates paid by individuals. In a sole proprietorship, the income from the small business is taxed on the business owner's individual income tax return. In the case of partnerships and S corporations, which typically have multiple owners, income from these businesses is divided among the various owners and taxed on their individual tax returns.[2]

**Small businesses frequently pay the highest marginal tax rate**

Taxpayers in the highest bracket currently face a marginal tax rate of 38.6 percent. Although they file slightly less than one percent of all tax returns, these taxpayers account for 16.7 percent of reported income and more than 31.1 percent of individual income tax payments.[3]

**Small business owners receive almost 80 percent of the tax relief from reducing the top marginal tax rate to 35 percent.**

Of the 750,000 tax filers that would benefit from a reduction in the highest marginal tax rate, more than two-thirds (over 500,000 filers) have some small business income from a sole proprietorship, partnership, or S corporation. These small business owners would receive 79 percent of the $13.3 billion in tax savings from reducing the top marginal rate to 35 percent in 2003 instead of 2006.[4]

**Lower marginal tax rates encourage investment by small businesses**

Small business owners will choose to invest when the expected after-tax return on a particular investment is higher than its cost, including financing expenses. Higher marginal tax rates on the income from an investment reduce its after-tax return, making it harder for a small business owner to justify undertaking that investment.

Higher marginal tax rates also increase an entrepreneur's total tax bill, leaving less money available for new investment. Since small businesses – especially sole proprietors – often encounter difficulties obtaining loans necessary to make investments due to financing constraints, more money to the government through higher taxes on small businesses can mean lower levels of investment.

**Research suggests that a five percentage point reduction in the top marginal tax rate would increase small business investment by ten percent.**

Economists who have studied the effects of taxes on sole proprietorships have found that high marginal tax rates discourage entrepreneurs from investing in new capital equipment and, conversely, that reducing taxes encourages new investment.[5] For example, the marginal rate reductions enacted by the Tax Reform Act of 1986 (TRA86) significantly increased investment by sole proprietorships. The experience of those rate reductions suggests that a five percentage point reduction in the marginal tax rate faced by entrepreneurs increases small business investment by 10 percent – an increase in excess of $10 billion.[6] This research suggests that cutting marginal tax rates – particularly the top 38.6 percent rate faced by many small businesses today – is an effective way of encouraging entrepreneurs to invest in and expand their businesses.

**Lower marginal tax rates also encourage small business hiring**

Another important decision an entrepreneur faces is whether to hire other workers to help run a small business or, rather, to forgo hiring and simply go it alone. At higher marginal tax rates, hiring employees can become a less attractive proposition as a higher fraction of any additional income that a new hire might generate for the business is taxed and diverted to the federal government. Also, as in the case of an entrepreneur's decision about whether to invest in new equipment, the greater the amount of a small business' income paid in taxes, the smaller the amount available for paying the salaries of employees. What happens to the top marginal rate is especially relevant, since entrepreneurs in that tax bracket are the ones most likely to hire employees.

**Marginal rate cuts increase the likelihood that a small business owner hires employees and lead to higher wages for those workers.**

One study that looked at how the marginal tax rate reductions of TRA86 affected the hiring patterns of sole proprietorships found that marginal tax rate cuts make entrepreneurs more likely to hire workers and, on average, pay more in wages.[7] In particular, the study's authors found that a marginal tax cut that lowers a small business owner's marginal tax rate by 10 percent would increase the likelihood of hiring employees by 10 percent. The President's proposal to bring the top marginal rate down from 38.6 percent to 35 percent (a 10 percent decrease) would have such an effect. Such a tax cut would also increase average entrepreneurs' wage payments by 3 to 4 percent for those that do hire, reflecting better wages for those employed by small businesses.

**New investment and hiring lead to small business growth**

New hiring and greater investment induced by lower marginal tax rates lead to growth of small businesses. When an entrepreneur hires new workers to assist with operation of the business, that company's earning potential naturally increases. Investment also promotes small business growth, since how much a worker can produce for a company depends on the amount and quality of the equipment that the worker has to work with. That is why when low marginal tax rates spur a business to make new capital investments in software, computers, or machinery, for example, that company's workers become more productive, causing the company to grow. One study has shown that when the marginal tax rate for small businesses is reduced by 10 percent, those businesses' gross receipts increase by over 8 percent.[8] One example of a 10 percent rate reduction is the drop in the top marginal income tax rate from 38.6 percent to 35 percent, as has recently been proposed by the president.

**Small businesses are a crucial part of the nation's economy**

Small businesses are a crucial component of the nation's economy, accounting for a significant share of economic activity. More than 98 percent of all companies have fewer than 100 employees. These companies are responsible for almost 36 percent of total employment. More than one out of every two employees works at a company with fewer than 500 employees.[9] In light of the negative effect that marginal tax rates have on entrepreneurs' hiring decisions, it is clear that the top marginal rate affects many more workers than just those whose incomes fall in the top rate bracket.[10]

Small businesses are important to the national economy not only for the jobs they provide, but also for the investment they undertake, spurring economic growth. While investment data is not available for partnerships and S corporations, it has been estimated that sole proprietorships alone account for at least 10 percent of business investment in the economy.[11] Investment by small businesses, given their prominent role in the broader economy, is thus an important element for economic recovery as the nation emerges from a recession that has been characterized by solid consumer spending growth but lagging investment.

[1] An S corporation is a form of corporation, allowed by the IRS for many companies with 75 or fewer stockholders, which permits the company to enjoy benefits of incorporating but which is taxed as a partnership.

[2] Partnerships give each partner a Schedule K-1, which details the partner's share of income, credits, and deductions from the partnership; S corporations similarly give a K-1 form to each of their shareholders. Individual partners and shareholders then use these K-1s to report income from their businesses on Schedule E of their individual income tax returns.

[3] Campbell, David and Michael Parisi. "Individual Income Tax Rates and Shares, 2000," *Statistics of Income Bulletin* (Internal Revenue Service, Winter 2002-2003).

[4] U.S. Department of the Treasury. "Effect of Major Individual Tax Relief Provisions of the President's Growth Package," Press Release KD-3741 (January 7, 2003).

[5] Carroll, Robert, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen. "Entrepreneurs, Income Taxes, and Investment," in *Does Atlas Shrug*, Joel B. Slemrod, ed. (Russell Sage Foundation, 2000).

[6] See note 5. Carroll et al. (2000) calculate that sole proprietorships alone in 1993 accounted for 10 percent of nonresidential fixed investment, which currently stands at over $1.1 trillion.

[7] Carroll, Robert, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen. "Income Taxes and Entrepreneurs' Use of Labor." *Journal of Labor Economics* XVIII (1999).

[8] Carroll, Robert, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen. "Personal Income Taxes and the Growth of Small Firms." National Bureau of Economic Research Working Paper 7980 (October 2000).

[9] U.S. Census Bureau. *Statistical Abstract of the United States: 2002*. (2003): p. 482.

[10] While some of these smaller companies may be C corporations taxed through the corporate tax system, a large share are nonetheless sole proprietorships, partnerships, or S corporations taxed through the individual tax system.

[11] See note 6.

## Recent Publications of the Joint Economic Committee

**Published in the past month:**

- "How the Top Individual Income Tax Rate Affects Small Businesses," May 6, 2003. Explains how reducing the top individual income tax rate of 38.6% to 35% would help small businesses and economic growth.

- "Recent Economic Developments: Mixed Economic Signals Continue," April 29, 2003. Reviews key economic indicators released during the month of April.

- "Economic Update: Economy Grew 1.6% in 1st Quarter of 2003," April 25, 2003. Takes a brief look at what's behind the latest GDP estimate.

- "Medicare Beneficiaries' Links to Drug Coverage," April 10, 2003. Provides new data from the Centers for Medicare and Medicaid (CMS) about existing coverage of prescription drugs among Medicare beneficiaries.

**Other JEC publications include:**

- "10 Facts About Oil Prices," April 1, 2003.

- "Understanding the Size of the Economic Growth Package," March 12, 2003.

- "Who Benefits from Ending Double Taxation of Dividends?," February, 2003.

- "The President's Budget and the Federal Debt," February 11, 2003.

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