Taxing Small Business and Innovation

In 1993 the Clinton Administration and its allies in Congress enacted a large package of tax increases, including an increase in the top personal income tax rate. During the debate of this legislation, there was considerable controversy about the impact of higher tax rates on small business. The Administration argued that the impact of the tax increase on small business would be trivial, while opponents of the 1993 tax increase argued that the negative impact would be considerable.

This paper examines the statistical evidence of small business ownership among taxpayers affected by the higher income tax rates imposed in 1993. These statistics were provided through a request by the JEC for a special tabulation of IRS data that excludes multiple reports of small business ownership. The extent to which small business owners were subject to the higher tax rates is important, given the central role of entrepreneurs in a market economy.

Small Business and Entrepreneurship

For many years the role of entrepreneurship in the economy did not receive the attention it deserved. The underlying forces which bring supply and demand into balance were often thought of in mechanical terms, with complications such as imperfect knowledge and foresight simply assumed away. However, in recent decades the pivotal role of the entrepreneur has become better recognized.

As Nobel Laureate F.A. Hayek pointed out many years ago, the market economy provides the only way to utilize the knowledge divided among many people.[1] This knowledge is incorporated in a market process that provides entrepreneurs the incentives to discover and correct imbalances in the economy. Entrepreneurs engender the innovation, creativity, and dynamism in the market economy.

In one sense then, the small business owners can be regarded as the nerve center of the market economy. Furthermore, as economist Israel Kirzner has pointed out, entrepreneurial discovery leads to unforeseeable breakthroughs that would not occur in a punitive tax environment.[2] Thus policies that target or disproportionately hinder small business will have damaging effects that undermine innovation and creativity throughout the economy.

Small Business and the 1993 Tax Increase

This report relies on data from the Statistics of Income (SOI) division of the Internal Revenue Service. Taxpayers with Adjusted Gross Income (AGI) in excess of $200,000 are assumed to have taxable income high enough to be affected by the 1993 tax rate increases. To what extent are these taxpayers engaged in small business activities?

One test is the proportion of these taxpayers participating in partnerships or S corporations. Partnerships and S corporations are typical forms of small business; however, taxpayers reporting ownership in these entities may also participate in other forms of small business reported in the SOI data. This creates the problem that the same taxpayer could be counted several times as a small business owner, exaggerating the proportion of small business ownership. To eliminate this problem, a 1993 JEC report included only partnership and S corporation data so as to avoid the double counting of taxpayers. Consequently, the 1993 report reflected a lower level of small business activity than if data on proprietorships (and other forms of small business) were also combined. This conservative methodology tended to understate small business activity among affected taxpayers.

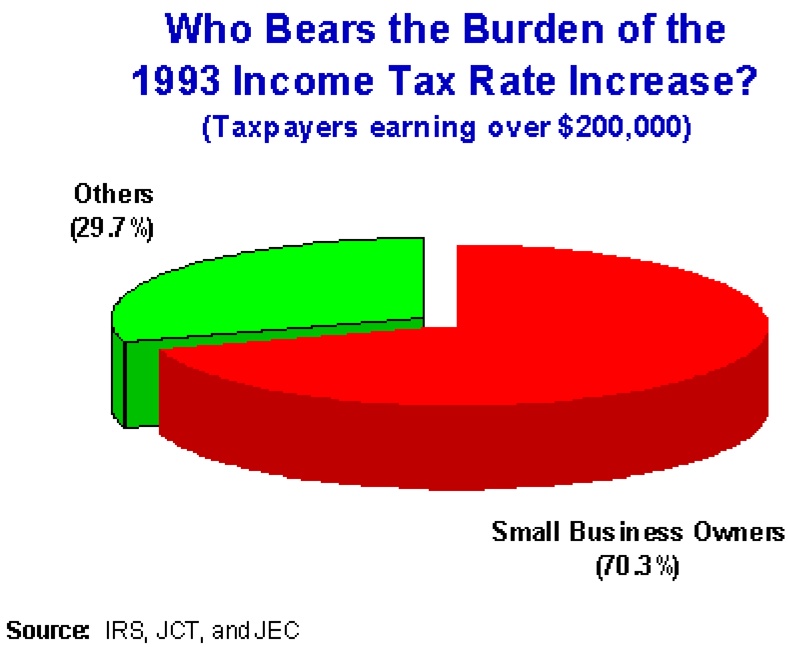
The 1993 JEC report found that 65.7 percent of taxpayers with AGI over $200,000 filed returns with partnership or S corporation net income or losses in 1990. In sum, two-thirds of these taxpayers were involved with these types of small businesses. Another test of the vulnerability of small business to the 1993 tax increase is the degree of exposure of total small business income in the affected tax brackets. Of the $104.9 billion of partnership and S corporation net income reported on taxable returns, taxpayers with AGI in excess of $200,000 accounted for $69.4 billion, or 66 percent, of this small business income.

Clearly, Administration efforts to increase income tax rates would subject most partnership and S corporation income to the higher tax rates. The Administration argument that its tax increase policy would have only a minimal effect on small business is contradicted by the fact that so many affected taxpayers are small business owners.

New Data Show More Small Business Impact

Recently the JEC requested a special tabulation of the SOI data to eliminate the problem of double counting in calculating the proportion of small business owners among taxpayers with AGI over $200,000. The JEC request was processed by the Joint Committee on Taxation (JCT) using 1994 SOI data, the most recent available. Small business ownership is defined as ownership in a sole proprietorship, partnership, S corporation, or farm.

The results of this tabulation were informative. The SOI data indicate that the total number of taxpayers with AGI over $200,000 in 1994 was 1,096,353. Of these taxpayers, 770,555 reported income attributable to a sole proprietorship, partnership or S corporation, or farm. As the graph shows, 70.3 percent of the taxpayers affected by the income tax rate increase were small business owners. This compares with a proportion of small business owners amounting to 18.4 percent for all tax returns.



Relative to the 1993 JEC report, the new SOI data show a somewhat higher proportion of small business owners among taxpayers affected by the 1993 tax increase. The conservative method used in the 1993 JEC report tended to understate this proportion of small business owners, though they still comprised a large majority.

Conclusion

The special tabulation of 1994 SOI data confirms earlier findings that the vast majority of taxpayers affected by the 1993 tax rate increase were small business owners. The new data show that 70.3 percent of the affected taxpayers were small business owners, a proportion somewhat higher than indicated in earlier research using a conservative method to avoid double counting of taxpayers. The special tabulation used here provides the most accurate source of data for this purpose currently available. The SOI data indicate that the Clinton tax rate increase, by targeting entrepreneurs and small business owners, undermined flexibility, innovation, and dynamism in the U.S. economy. This may explain at least part of the lack of opportunity and income growth in recent years.

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Endnotes

1. Hayek, F.A. *Individualism and Economic Order,* Chicago, 1948.

2. Kirzner, Israel. *Discovery and the Capitalist Process,* Chicago, 1985.