ECONOMIC ANALYSIS

When Should Small Businesses Get a Tax Break?

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If you listen to the politicians, you might think all would be right with the world if we just had more small businesses. There would be more innovation. More jobs. More entrepreneurship. More growth. If you sign on to this worldview — as most of the public is inclined to do — it naturally follows that you should be in favor of providing more tax relief to small businesses.

Of course, small businesses are important. By some estimates, they are about one-quarter of the whole economy and provide half of all jobs. But in justifying extra tax benefits, the question is whether there is something special about them. If not, the case for providing targeted tax relief falls apart. If not, small business tax breaks will not create jobs. In fact, they will do exactly the opposite.

Taking the Shine Off

Let’s begin with some unflattering facts about small businesses. We are not trying to be mean to America’s hardworking business owners. But in looking for that something special about small businesses that would justify tax breaks, we need a realistic assessment. Too often politicians and the press overstate what is good and avoid the problems. Readers taught by their mothers to always be polite and conditioned by society to always say nice things about small businesses could find the following section offensive.

(1) Small businesses have high rates of tax evasion. On January 6 the IRS released an updated estimate of the tax gap. The IRS estimates that $376 billion of tax was not paid in 2006 because of underreporting. Of that total, $122 billion was income tax due from unreported business income of sole proprietorships, partnerships, and subchapter S corporations; $57 billion was self-employment tax due on unreported income; and $19 billion was corporate tax due from small corporations. Tax evasion by sole proprietors is rampant. These numbers were all significant increases over estimates of the 2001 tax gap. (See Toder; Slemrod. For the IRS estimates, see Doc 2012-357 and 2012 TNT 5-51. For related coverage, see p. 299. Citations are in the endnotes.)

(2) Under current law, small businesses generally are subject to less income tax than large businesses. Several features in the code provide tax benefits to small corporations based on size. They include expensing under section 179, graduated corporate tax rates, and a capital gains exclusion on qualified small business corporation stock. But what probably contributes more to the differential between small and large businesses are the provisions of the law not explicitly conditioned on firm size. Of those, the most important is the corporate tax. America’s largest businesses are usually subchapter C corporations, so their profits are generally subject to both individual and corporation income tax. Small businesses are almost always passthrough entities — subchapter S corporations, partnerships, or sole proprietorships.

It is not easy to compare small and large business taxation because there is a lot of heterogeneity in the tax circumstances of firms. And in some cases the overall effective tax rate on subchapter C income can be less than that on income from passthrough entities. But in general, small businesses pay less tax on their business income than large businesses. That’s why businesses that can avoid subchapter C status are very glad to do so. (See Viard and Roden; Toder.)

(3) Most small business owners are not entrepreneurs. There is no one definition of entrepreneur, but following the seminal work of Joseph Schumpeter, most experts think of entrepreneurship as a willingness to use bold, innovative approaches to exploit new market opportunities. It is commonly assumed that entrepreneurs contribute disproportionately to economic growth. And encouraging entrepreneurship is increasingly considered an essential component of economic strategy.

It is also common for policymakers to equate entrepreneurship with small business ownership.
and management. But that is wrong. New research shows that small businesses are mainly skilled craftspeople, lawyers, doctors, real estate agents, shopkeepers, and restaurateurs. These businesses provide relatively standardized goods and services for existing customer bases. They are responsible for little innovation. Once they are established, they do not grow. Moreover, they do not want to grow. One major reason for this is that many small business owners are motivated by non-pecuniary benefits such as wanting a flexible schedule or to be their own boss. (See Ahmad and Seymour; Carland, Hoy, Boulton, and Carland; and Hurst and Pugsley.)

(4) Small businesses generally provide lower-quality jobs than large businesses. Large firms pay higher wages than small firms. They provide better health and pension benefits. And turnover at large firms — from both employer- and employee-initiated separation — is lower. (See Edmiston.)

(5) Small businesses are not the engine of job creation. Start-ups are. New data from the Census Bureau make it possible to separate start-up small businesses from mature small businesses. Almost all net job creation by small businesses is caused by start-ups. Mature small businesses are net job losers. (See Haltiwanger, Jarmin, and Miranda.)

Good Reasons for Tax Breaks

Now that we have knocked small business off its pedestal, let’s look at reasons for providing small business tax breaks that are based not on popular support but on economic principle.

(1) The market does not adequately reward investment in research and innovation. Unlike most tax breaks, tax subsidies for research and innovation are good for the economy. That’s because any business, left on its own, bears all the cost but gets only a part of the benefit of that investment. And so the private sector will underinvest in research that is productive from the overall economy’s view. That is the economic justification for the research credit.

As already noted, most small firms are not innovative, and the vast bulk of formal research spending is done by big businesses. There is, however, a portion of the business community that is particularly innovative and growth-oriented. For example, small businesses supported by venture capital are technology- and research-intensive. And there is evidence that investment in these firms is a far more cost-effective way of generating innovation than investment in industrial research. So there is a strong economic case to be made for providing special tax incentives for small businesses that innovate. (See Kortum and Lerner; U.S. Small Business Administration.)

(2) Market imperfections deny small businesses adequate credit. Especially since the financial crisis of 2008, the problems that small businesses face in
obtaining finance are well known. But the issue is nothing new. In 1776 Adam Smith, the father of modern economics, wrote that nothing hindered a little grocer from becoming a great merchant except “want of sufficient capital.” Economists will tell you there is nothing wrong with charging a small business higher rates of interest than a large business. That is entirely justified by higher risk and higher administrative costs. The real economic problem with small business finance is the denial of credit that results from information asymmetry (between the borrower and the lender) and moral hazard. That market failure can make credit to small businesses unavailable at any interest rate. As a result, profitable and efficient investment projects are left unsupported. Therefore, it is possible to increase economic growth with government subsidies if the subsides help offset the reduction in business investment because of credit rationing. (See Stiglitz and Weiss.)

(3) Small businesses bear disproportionate compliance burdens. According to the latest estimates, small businesses spent about 1.75 billion hours and $15.5 billion on income tax compliance. Most of the time the burden was from record keeping. And most of the financial burden was in paying for professional help. What about differences in cost by firm size? Estimates shown in the figure confirm what common sense would have us assume: Small businesses face significant fixed compliance costs, and marginal costs decrease with firm size. (See DeLuca, Guton, Lee, O’Hare, and Stilmar.)

Some Policy Implications

The facts provided in the previous two sections provide a foundation for making small business tax policy. In particular, they tell us when subsidies are appropriate and when they are not.

(1) Tax incentives for venture capital. Firms receiving financing from venture capital funds grow far more quickly and are far more innovative than other small businesses. Positive externalities from innovation are enough to justify preferential tax treatment for venture capital funding. Financial market imperfections provide additional justification. Venture capital funding suffers from a double moral hazard problem. Venture capitalists provide funding and experience to companies they fund. Companies funded by venture capital have imperfect knowledge of the effort venture capitalists will provide. That leads to low levels of venture capital that could be remedied by a reduction in capital gains taxes on venture capital investment. (See Keuschnigg and Nielsen.)

So there is a good economic case for extending tax benefits to venture capital. Along these lines, Sens. Jerry Moran, R-Kan., and Mark R. Warner, D-Va., introduced S. 1965, the Startup Act of 2011, on December 8, 2011 (Doc 2012-733). The bill includes a permanent exemption for start-up capital gains and tax credits for qualified small businesses.

In particular, the instability of the code caused by frequent tax changes and expiring tax provisions is a drain on the limited resources of a small firm.

(2) Simplification. Small businesses often have high costs because they cannot purchase in bulk and cannot achieve economies of scale in production or marketing. There is nothing wrong with that, and no policy action is required to improve efficiency. In all industries there are different economies of scale and different efficient firm sizes. However, the inordinately large compliance costs faced by small businesses place a tax penalty on them that is the economic equivalent of a tax surcharge for being small. That distorts the allocation of capital away from small businesses and reduces economic growth. One way to help remedy this problem is for the government to grant small business tax subsidies that are approximately equal to the cost of compliance, as is sometimes suggested for small retailers that collect VAT and as was provided in the Patient Protection and Affordable Care Act.

The more direct method would be to reduce tax complexity. Everybody wants a simpler tax system, but lawmakers need to understand that tax simplification is especially important to small businesses. In particular, the instability of the code caused by frequent tax changes and expiring tax provisions is a drain on the limited resources of a small firm.

Simplification of provisions that particularly affect small businesses should also be a priority. Along these lines, Congress should consider simplifying entity choices. Currently, the small business owner must consider the advantages and disadvantages of choosing among four different forms: sole proprietorship, partnership, subchapter S, and subchapter C. Proposals are already on the table that would give businesses the choice of a simple partnership or, if circumstances warrant, a more complicated partnership regime. Graduated corporate rates should be entirely eliminated, or small businesses simply should not be allowed to adopt subchapter C status. (See Yin and Shakow; Haysworth; and Kwall.)

(3) Allowing the expiration of the Bush tax cuts for upper-income taxpayers. The Bush tax cuts are set to expire at the end of 2012. Republicans want them extended across the board. President Obama
opposes extending them for high-income households. The new research showing that most small business owners are not entrepreneurs and that it is only start-up small firms that generate net job creation greatly weakens the Republican case. Targeted incentives — for example, for start-up and venture capital — would be a far more effective and less costly method of promoting job creation.

Conclusion
There are several widely held misconceptions about small businesses that can mislead policymakers trying to develop tax policies that promote economic growth. In general, job creation is not a strength of small business. Tax incentives should be targeted to the subset of small businesses that are fast-growing and innovative. If Congress really wants to help all small businesses, its best course of action would be to reduce compliance costs.

References


