

# Report for Congress

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## **Small Business Tax Relief: Proposals in the 108<sup>th</sup> Congress and Their Economic Justification**

**Updated May 9, 2003**

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# Small Business Tax Relief: Proposals in the 108<sup>th</sup> Congress and Their Economic Justification

## Summary

Congress has a perennial interest in the federal tax burden on small firms and its effect on their performance and growth. This concern lies behind the initiatives being considered in the 108<sup>th</sup> Congress to expand current small business tax preferences or create new ones. So far, 19 such bills have been introduced: H.R. 2 (as approved by the Ways and Means Committee on May 7, 2003), H.R. 22, H.R. 179, H.R. 224, H.R. 450, H.R. 714, H.R. 1079, H.R. 1126, H.R. 1222, S. 2 (as approved by the Senate Finance Committee on May 8, 2003), S. 53, S. 86, S. 106, S. 158, S. 414, S. 513, S. 842, S. 850, and S. 906.

While the federal revenue cost of existing preferences is not known, estimates by the Joint Committee on Taxation suggest that it exceeds \$5 billion in fiscal year 2003. The small business tax preferences outside farming with the broadest impact are the taxation of small firms as passthrough entities, the graduated rate structure for the corporate income tax, the expensing allowance for equipment under section 179 of the Internal Revenue Code, the exemption of some small corporations from the corporate alternative minimum tax, cash basis accounting, and the exclusion from taxation of capital gains on the sale or disposition of certain small business stock.

Proposals to expand small business tax preferences or subsidies raise several interesting and important policy issues. For public finance economists, a key issue is whether or not they can be justified on economic grounds. They argue that in the absence of such a rationale, such proposals may adversely affect efficiency and equity.

In general, proponents of small business tax subsidies cite the special economic role played by small firms and the barriers to their formation and growth as the main economic justifications for such subsidies. More specifically, they assert that there are compelling economic reasons to favor small firms through the tax code: namely, the national income, jobs, technological innovations, and opportunities for economic renewal and structural change generated by small firms; the constraints on their ability to raise capital in debt and equity markets; and the formidable competitive advantages held by large, established firms.

While acknowledging the significant contributions made by small firms to national output and employment, critics of small business tax subsidies argue that there appears to be no sound economic rationale for doing so. More specifically, they note that these subsidies lessen the progressivity of the federal individual income tax and appear to produce net efficiency losses. Moreover, critics assert that regardless of their economic rationale, some current tax subsidies are either inappropriate or poorly designed.

The discussion presented here underscores the need for the development of a robust economic model of the formation of small firms and their contributions to the performance and growth of the economy over time. The report will be updated to reflect significant legislative activity.

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# Small Business Tax Relief: Proposals in the 108<sup>th</sup> Congress and Their Economic Justification

Some policy issues receive continuing attention from Congress. One such issue is the federal tax burden of small firms and its effects on their performance and growth. In the 108<sup>th</sup> Congress, a variety of bills have been introduced to lessen this burden, either by enhancing current small business tax preferences, creating new ones, or simplifying tax administration and compliance for small firms. While some of the proposals are attracting widespread bipartisan support, their prospects for passage have become entangled with mounting concern in Congress over the re-emergence of a sizable and growing federal budget deficit and the deteriorating outlook for the federal budget in the next few years.

In general, proposals to expand small business tax subsidies raise some important economic policy issues. These issues carry significance for policymakers because substantial resources are transferred to small firms through such subsidies. Among public finance economists, a key issue is whether they can be justified on economic grounds. If such a rationale cannot be found or is deemed tenuous at best, they assert, measures to expand small business tax preferences may end up inflicting harm on economic performance in the long run or fostering undesirable shifts in the distribution of the federal tax burden among income classes.

This report explores this issue by examining the economic arguments for and against small business tax subsidies in the context of current congressional proposals to expand them. It begins with a brief description of current federal tax subsidies for small firms, moves on to consider the principal economic arguments for and against these subsidies, and concludes with a discussion of proposals in the 108<sup>th</sup> Congress to expand small business tax subsidies and their likely economic effects. It will be updated to reflect important legislative activity.

## Current Federal Tax Benefits for Small Business

The federal tax code makes no explicit or formal distinction between the taxation of small and large firms. There are no separate sections in the code for the tax treatment of small and large firms. Instead, it contains numerous provisions scattered throughout which confer preferential treatment on relatively small firms but not on relatively large firms.<sup>1</sup> Most of these provisions take the form of deductions,

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<sup>1</sup> See CRS Report RL30827, *Federal Tax Benefits for Small Businesses: A Brief Overview*, (continued...)

exclusions and exemptions, credits, deferrals, and preferential tax rates. Tax preferences such as these have the effect of lowering the marginal effective tax rate on the returns to new investment for small firms relative to large firms. A few other provisions benefit small firms by reducing the cost and administrative burden of complying with tax laws or tying tax relief to the offering of certain fringe benefits to employees.

There is no uniform definition of “small business” or “small firm” in the federal tax code — or, for that matter, in the many federal data series on the economic condition and role of small firms. The result is a lack of consistency in defining the firms eligible for small business tax benefits. For instance, some small business tax preferences may be claimed by firms with annual gross receipts below a certain size (e.g., \$7.5 million), while others are crafted to apply only to firms below a certain asset size (e.g., \$25 million). Employment size is rarely used as a criterion for determining which firms are eligible for these preferences. By contrast, the Small Business Administration (SBA) relies heavily on employment size to classify firms for the data it collects and publishes on the economic condition of small business.

The small business tax subsidies with the broadest reach outside agriculture are described below. Excluded from the list are subsidies targeted at small firms in specific industries, such as life insurance, banking, and energy production or distribution. While it is unclear what the exact total budgetary cost of these subsidies is, recent estimates by the Joint Committee on Taxation (JCT) and the Treasury Department indicate that it probably exceeded \$5.0 billion in fiscal year (FY) 2003.<sup>2</sup>

## Taxation of Passthrough Entities

Business enterprises operate in a variety of legal organizational forms. For tax purposes, five forms are widely used: subchapter C corporations, subchapter S corporations, sole proprietorships, partnerships, and limited liability companies (LLCs). These distinctions relate to the analysis of small business tax preferences because of important differences in their tax treatment. The earnings of C corporations are taxed twice: once at the corporate level and again at the individual level when the earnings are distributed to owners (i.e., shareholders) either as dividends or realized capital gains. By contrast, the earnings of the other business entities are taxed only once: at the individual level of their owners. For this reason, these entities are often referred to as passthrough entities. The vast majority of businesses operate as sole proprietorships: in 1999, they accounted for 72% of federal business tax returns. Next in importance were S corporations (11% of

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<sup>1</sup> (...continued)  
by Gary Guenther.

<sup>2</sup> This estimate applies to the following four small business tax preferences only: (1) expensing of depreciable business property; (2) reduced rates on the first \$10 million of corporate taxable income; (3) cash accounting outside agriculture; and (4) the treatment of losses from sales of small business corporation stock as ordinary income. See U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2002-2006* (Washington: GPO, 2002), p. 23.

business tax returns in 1999), followed by C corporations (9% of returns), partnerships (5% of returns), and LLCs (2% of returns).

There is no legal requirement that corporations be large in income, asset or employment size and that passthrough firms be small. Yet such a distinction seems to hold in practice. In 1999, for example, the average C corporation's asset size was nearly three times greater than that of the average partnership and 14 times greater than that of the average S corporation.<sup>3</sup>

Whether a business owner would be better off operating as a C corporation or as a passthrough entity can be a complicated question. The answer depends on a host of tax and non-tax considerations. Among the tax considerations, a few stand out: the relative tax rates for corporate and personal income and capital gains, the investment horizon of owners, the holding period for corporate stock, and the rate at which corporate profits are paid out as dividends.

For investors in the upper tax brackets, the current mix of individual and corporate tax rates appears to favor passthrough entities by a small margin. A few simple calculations illustrate this point. In 2003, the top personal tax rate is 38.6%; most corporate profits are taxed at 35%; and the top tax rate on long-term capital gains is 20%.<sup>4</sup> Given an investment horizon of one year, tax considerations alone dictate that these investors would be better off investing in a business enterprise operated as a partnership rather than a corporation. Under such a scenario, pre-tax returns to a partnership would be taxed at a marginal tax rate of 38.6%, whereas the pre-tax returns to a corporation would be taxed at marginal rate of 48%.<sup>5</sup> Extending the investment horizon to five years does not alter the outcome. Assuming all after-tax income earned during that period is reinvested in the business, and individuals in the top tax bracket could earn average annual pre-tax rates of return of 20% on the same investment in both partnerships and corporations, partnerships would earn a higher after-tax rate of return than corporations: 12.2% versus 10.8%.<sup>6</sup>

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<sup>3</sup> Internal Revenue Service, *Statistics of Income Bulletin: Spring 2002* (Washington: 2002), pp. 95, 295, and 297.

<sup>4</sup> As a result of the recently enacted Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16), the top individual income tax rate dropped from 39.6% to 38.6% on July 1, 2001 and is scheduled to remain at that level through the end of 2003.

<sup>5</sup> These tax rates are derived from the following formula:  $(1 - tp) \leq (1 - tc) \times (1 - tcg)$ , where  $tp$  is the highest personal tax rate,  $tc$  is the highest corporate tax rate, and  $tcg$  is the maximum tax rate on long-term capital gains. See Myron S. Scholes, et. al., *Taxes and Business Strategy: A Planning Approach*, 2<sup>nd</sup> edition, (Upper Saddle River, NJ: Prentice-Hall, Inc., 2001), p. 67.

<sup>6</sup> The after-tax rate of return for a partnership is derived from the following formula:  $\$1[1 + R \times (1 - tp)]^n$ , where  $R$  is the expected pre-tax rate of return,  $tp$  is the highest personal tax rate, and  $n$  is the investment horizon. The after-tax rate of return for a corporation is derived from the following formula:  $\$1[1 + R \times (1 - tc)]^n (1 - tcg) + (tcg \times \$1)$ , where  $R$  and  $n$  are the same as the previous formula,  $tc$  is the highest corporate tax rate, and  $tcg$  is the maximum tax rate on long-term capital gains. See Myron S. Scholes, *Taxes and Business Strategy*. p. 66.

Nonetheless, these tax advantages do not mean that the taxation of passthrough entities should be considered a small business tax benefit. Firms that are relatively large in employment, revenue, or asset size operate as S corporations or LLCs, and firms that are relatively small in these attributes are organized as C corporations. In addition, any tax advantage held by passthrough entities could prove ephemeral, as it has in the recent past. For instance, their present advantage would vanish if legislation were enacted sharply reducing the top corporate and long-term capital gains tax rates relative to the maximum individual income tax rate.

## **Graduated Corporate Income Tax Rates**

Corporations with less than \$10 million in taxable income are subject to graduated federal income tax rates. The rate is 15% on the first \$50,000 of income, 25% on the next \$25,000, and 34% on selected amounts up to \$10 million. Corporations with taxable incomes of over \$10 million up to \$15 million pay a marginal rate of 35%. What is more, in two income ranges, corporations face marginal tax rates greater than 35%. A corporation with taxable income between \$100,000 and \$335,000 pays a marginal rate of 39%, which is 5 percentage points greater than the marginal rate on taxable incomes just above and below that range. And a corporation reporting taxable income of more than \$15 million up to \$18.3 million pays a marginal rate of 38%. These higher marginal rates are intended to offset the tax benefits firms reap from the lower tax rates they paid when their revenues were smaller. All corporate taxable income above \$18.3 million is taxed at a flat rate of 35%. As a result, the benefits of the graduated rates from 15% to 34% are limited to corporations with taxable incomes under \$335,000.

This graduated rate structure largely benefits corporations that are small in employment or asset size, since their taxable incomes are likely to remain below the \$335,000 threshold. It also gives owners of closely held small firms an incentive to incorporate in order to shelter profits from higher individual tax rates. Not all small corporations, however, are allowed to take advantage of the reduced rates. Specifically, the taxable incomes of corporations providing services in the fields of health care, law, engineering, architecture, accounting, actuarial science, the performing arts, and consulting are taxed at a flat rate of 35%, regardless of amount. One significant drawback to a graduated rate structure is that it gives smaller corporations a disincentive to grow beyond a certain size; indeed, it could be considered a tax on growth.

The revenue loss associated with the reduced rates on the first \$10 million of corporate taxable income totaled an estimated \$4.4 billion in FY 2003.<sup>7</sup>

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<sup>7</sup> U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, committee print, 107<sup>th</sup> Cong., 2<sup>nd</sup> sess. (Washington: GPO, 2002), p. 267.

## **Expensing Allowance for Certain Depreciable Business Assets**

In essence, expensing is the treatment for tax purposes of a business cost as an ordinary and necessary expense rather than a capital expenditure. Ordinary and necessary costs are deducted in the year in which they are incurred, whereas capital costs typically are recovered over longer periods at allowable depreciation rates.

Under section 179 of the Internal Revenue Code (IRC), firms may expense up to \$25,000 of the cost of qualified business property — mainly equipment — in 2003 and succeeding years and depreciate the remainder (if any) under current cost recovery rules. But because of a phase-out rule, not all firms are able to take advantage of this allowance. The allowance is phased out, dollar for dollar, once spending on qualified property exceeds \$200,000 in a given tax year. This means that in 2003, no portion of an investment in qualified property may be expensed if the total cost is \$225,000 or more. As a result, most of the firms able to take advantage of the allowance are relatively small in asset, employment, or revenue size.

The allowance can be regarded as an influential tax subsidy for business investment because expensing effectively taxes the returns on investments in qualified property at a marginal effective rate of zero. In practice, the allowance has the effect of deferring income tax on a portion of the first-year returns to investment in depreciable assets that are expensed. This deferral translates into the zero marginal effective tax rate through the standard economic model for the determination of the user cost of capital.<sup>8</sup>

In FY 2003, the allowance resulted in an estimated revenue gain of \$0.7 billion.<sup>9</sup> In periods of rising business investment, the allowance typically contributes to a revenue loss. However, when a slump in business investment follows a period of sustained growth, the allowance can lead to a net revenue gain. This is because of the timing of depreciation deductions under expensing.

## **Exemption of Certain Small Corporations From the Corporate Alternative Minimum Tax**

Under current federal tax law, many corporations must compute their income tax liability under both the regular tax and the alternative minimum tax (AMT) and pay whichever is greater. Each tax has its own rates, allowable deductions, and rules for the measurement of income. In general, the AMT applies a lower marginal rate to a broader tax base.

Since 1998, corporations with average annual gross receipts of \$5 million or less in the three previous tax years have been exempt from the AMT. Some believe that this exemption may give some small corporations a slight advantage over larger

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<sup>8</sup> See Jane G. Gravelle, "Effects of the 1981 Depreciation Revisions on the Taxation of Income From Business Capital," *National Tax Journal*, vol. 35, no. 1, March 1982, pp. 2-6.

<sup>9</sup> Senate Budget Committee, *Tax Expenditures*, p. 259.



competitors who pay the AMT. A 1997 study found that firms investing heavily in machinery and equipment and intangible assets like research and development (R&D), financing the bulk of their investments through debt, and paying the AMT for five or more successive years had a higher cost of capital than comparable firms paying only the regular income tax in the same period.<sup>10</sup> In addition, the exemption gives owners of small firms an incentive to incorporate, since the taxable income of owners of passthrough entities is subject to the individual AMT as well as the regular income tax.

It is not known how much revenue is lost as a result of exempting small corporations from the AMT.

## **Amortization of Business Start-Up Costs**

Normally, costs paid or incurred before the start of a trade or business are not deductible, whereas ordinary and necessary costs incurred in conducting a trade or business are deductible under IRC section 162. Business start-up costs are considered expenditures made to acquire or create an asset with a useful life extending beyond a single tax year and thus should be capitalized and added to the taxpayer's basis in the business. They normally are recovered upon the sale or cessation of the business.

Under IRC section 195, however, taxpayers who incur business start-up costs and then enter the trade or business have the option of deducting (or amortizing) these costs over a period of not less than five years, beginning in the month when the business becomes active. To claim the deduction, the taxpayer must have an equity interest in the trade or business and actively participate in its management. To qualify for amortization, the costs must meet two criteria. First, they must be paid or incurred as part of an investigation into creating or acquiring an active trade or business, or the start-up of a trade or business, or any activity done to produce income or profit in advance of starting a trade or business but in anticipation of becoming an active trade or business. Second, the costs must be costs that would be deductible if they were paid or incurred as part of an existing active trade or business in the same commercial activity entered by the taxpayer.

The option to amortize business start-up costs benefits fledgling small firms because it permits them to deduct expenses that otherwise would not be recovered until the taxpayer sold his or her interest in the business. In effect, it serves as a form of accelerated depreciation, and it encourages the formation and growth of new firms by reducing their cost of capital and increasing their cash flow at a time when their access to capital may be very restricted.

According to an estimate by the Joint Tax Committee, the amortization of business start-up costs led to a revenue loss of \$0.6 billion in FY 2003.<sup>11</sup>

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<sup>10</sup> Andrew B. Lyon, *Cracking the Code: Making Sense of the Corporate Alternative Minimum Tax* (Washington: Brookings Institution, 1997), pp. 77-97.

<sup>11</sup> Senate Budget Committee, *Tax Expenditures*, p. 263.

## Cash Basis Accounting

Under IRC section 446, firms must compute their taxable income under the method of accounting they regularly use in keeping their books. Two methods of financial accounting are widely used in the private sector: cash basis and accrual basis. Under cash-basis accounting, which is the preferred method for self-employed individuals, income generally is recorded when it is received in the form of cash or its equivalent, and expenses generally are recorded when they are paid, regardless of when the income is actually earned and the expenses actually incurred. Under accrual-basis accounting, by contrast, income and expenses generally are recorded when the transactions giving rise to them are completed or nearly completed, regardless of when cash or its equivalent is received or paid. More specifically, a firm adhering to the requirements of accrual-basis accounting records income when its right to receive it is established, and expenses when the amounts are fixed and its responsibility to pay is established. On the whole, cash-basis accounting is much simpler to administer, but accrual-basis accounting tends to yield a more accurate measure of a firm's economic income because of mismatches between the timing of income and expenses. Whichever accounting method is used for tax purposes must clearly reflect income.

Current federal tax law requires certain firms to use the accrual method in computing taxable income: namely, firms required to maintain inventories, C corporations with average annual gross receipts above \$5 million in the last three tax years, partnerships with C corporations as partners, trusts that earn unrelated business income, and authorized tax shelters.

The cash method may be used if a firm is not a tax shelter and meets one of the following three criteria: (1) is engaged in farm or tree raising, (2) is a qualified personal service corporation, or (3) is a firm (including C corporations) with \$5 million or less in average annual gross receipts during the previous three tax years. Moreover, under recent rulings by the IRS, firms in the following two categories may use the cash method: (1) most sole proprietorships, S corporations, and partnerships with average annual gross receipts of \$1 million or less in the three previous tax years, and (2) firms with average annual gross receipts of \$10 million or less whose main business activity is providing services or fabricating products according to customer designs or specifications but that provide some merchandise along with these activities. As these rules suggest, many of the firms using the cash method for tax purposes are small in income, asset, or employment size.

Cash-basis accounting can confer the same tax benefit on small firms as the section 179 expensing allowance: the deferral of income tax payments. In principle, a firm earns income when the legal obligation to be paid first comes into existence. Under the cash method of accounting, however, a firm may delay the recognition of income until cash payments are received, thereby postponing the payment of tax on that income.

The Joint Committee on Taxation estimates that the use of cash accounting outside agriculture cost the U.S. Treasury \$0.5 billion in forgone tax revenue in FY 2003.<sup>12</sup>

## **Exclusion of Gains on Certain Small Business Stock**

Under IRC section 1202, long-term capital gains on the sale or exchange of certain small business stock are taxed at a preferential rate. Provided all the requirements are satisfied, this rate is 14%. By contrast, the maximum long-term capital gains tax rate on the sale or exchange of stock held longer than one year is 20%; it drops to 18% if the stock is held more than five years. The preferential rate for small business stock results from excluding 50% of the gain from taxation and taxing the remainder at a maximum rate of 28%. For individuals subject to the AMT, 42% of the excluded gain is treated as an individual AMT preference item, which means that it must be included in the calculation of AMT taxable income.

To qualify for the exclusion, the stock must be held more than five years, must have been issued after August 10, 1993 by a C corporation that has gross assets valued at \$50 million or less when the stock was issued and uses 80% or more of its assets in the active conduct of a trade or business (with some exceptions), and must have been acquired by individual taxpayers at its original issue in exchange for money or property or as payment for services rendered to the issuing corporation. The capital gain eligible for the exclusion is limited to the greater of \$10 million or 10 times the taxpayer's basis in the stock..

The exclusion benefits some small firms because it gives investors a tax incentive to purchase and hold the stocks of eligible small firms which otherwise may be unable to raise equity capital.

An estimated \$130 million in revenue was forgone in FY 2003 because of the exclusion.<sup>13</sup>

## **Tax Credit for Pension Plan Start-Up Costs of Small Firms**

Under IRC section 45E, certain small firms may claim a non-refundable tax credit for some of the start-up costs involved in setting up new retirement plans for employees. The credit was enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 and, like many of its provisions, is scheduled to disappear (or "sunset") after 2010. It is equal to 50% of the first \$1,000 in eligible costs incurred in each of the first three years of a qualified pension plan's existence. Eligible costs are defined as ordinary and necessary expenses related to the administration of the plan and the education of employees about the plan's benefits and requirements. Firms with fewer than 100 employees who received at least

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<sup>12</sup> Senate Budget Committee, *Tax Expenditures*, p. 285.

<sup>13</sup> U.S. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2004: Analytical Perspectives* (Washington: GPO, 2003), table 6-1, p. 103.

\$5,000 in compensation in the previous year are eligible to claim the credit; but in order to do so, at least one highly compensated employee must participate in the plan.

The credit is intended to give owners of small firms that never have offered retirement benefits an incentive to establish pension plans for employees by reducing the after-tax cost of setting up and administering these plans in their early years. Recent surveys suggest that these costs constitute a formidable barrier to the creation of these plans among small employers. An estimated \$20 million in revenues was forgone in FY 2003 because of the credit.<sup>14</sup>

## Magnitude of Small Business Tax Benefits

This partial description of existing small business tax preferences amply illustrates the varied ways in which the current federal tax code favors the formation of small firms and fosters their growth, at least up to a certain size. But it also raises the question of to what extent smaller firms are favored by the tax code.

One way to address this question is to compute and compare the user cost of capital for firms that are able and unable to expense part or all of their investments in qualified assets under IRC section 179. While not all small firms are able to claim the expensing allowance, it is one of the most significant tax preferences available to these firms because of its impact on small business investment. Expensing stimulates this investment by reducing the required rate of return (or user cost of capital) for investments in qualified assets.

**Table 1. Estimated User Cost of Capital Calculations Under Expensing (%)**

Corporate Tax Rate	Expensing	Regular Depreciation	Subsidy
15	17.95	20.23	2.28
25	17.05	21.13	4.08
35	16.15	22.40	6.25

**Source:** Douglas Holtz-Eakin, "Should Small Business Be Tax-Favored?," *National Tax Journal*, Sept. 1995.

<sup>a</sup> The calculations assume that the interest rate is 9%, inflation 3%, and the rate of economic depreciation 13.3%. The following formula is used to compute the user cost of capital:  $c/q = (p - \pi + d/1-t) \times (1-tz)$ , where  $c$  is the annual value of revenue from the investment,  $q$  is the purchase price of the capital good,  $p$  is the after-tax financial cost of capital,  $\pi$  is the rate of inflation,  $d$  is the rate of geometric depreciation,  $t$  is the marginal tax rate, and  $z$  is the present value of depreciation allowances per dollar of investment. In the case of expensing,  $z = 1.0$ ; and in the case of regular depreciation,  $z = 0.2814$ .

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<sup>14</sup> Ibid., table 6-1, p. 105.

Table 1 summarizes the results of an analysis by Douglas Holtz-Eakin of the effect of expensing on the user cost of capital.<sup>15</sup> The first column gives the corporate tax rate; the second shows required pre-tax rate of return if the entire cost of the investment can be expensed; the third column provides the required pre-tax rate of return if the entire cost is recovered through normal depreciation allowances allowed under the Modified Accelerated Cost Recovery System; and the final column displays the effective tax subsidy arising from expensing, expressed as the difference in percentage points between the required rates of return shown in columns three and two. What stands out among the figures in the table is that expensing delivers a significant tax subsidy for investment, and that the magnitude of the subsidy rises with a firm's marginal tax rate. For example, at a tax rate of 15%, expensing lowers the user cost of capital by about 11%; but at a rate of 35%, the reduction leaps to 28%. At the same time, the user cost of capital under expensing rises together with the tax rate because tax deductions become less valuable at lower tax rates.

## **Legislative Initiatives in the 108<sup>th</sup> Congress to Enhance or Expand Current Small Business Tax Subsidies**

Underscoring the enduring appeal of small entrepreneurial firms and the political influence of small business owners, a number of legislative initiatives to enhance or expand existing small business tax subsidies have already been introduced in the 108<sup>th</sup> Congress. At least 19 bills (some of which are identical), in whole or in part, have such a purpose.<sup>16</sup> They vary in scope from something as seemingly minor as relaxing the eligibility requirements for S corporations (H.R. 714 and S. 850) to something as seemingly major as creating new permanent tax credits for some of the costs to small firms of offering health insurance coverage to their uninsured employees (e.g., H.R. 450 and S. 906).

In the 107<sup>th</sup> Congress, many proposals to enhance or expand small business tax benefits were considered. But only one measure containing such benefits was enacted: the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16). Among other things, the act established a new 10% tax bracket and put in place a timetable for the gradual reduction in the 28% bracket to 25%, the 31% bracket to 28%, the 36% bracket to 33%, and the 39.6% bracket to 35%, between July 1, 2001 and July 1, 2006. These rate reductions increased the tax advantage of operating a small firm as a passthrough entity rather than a corporation and shrank the tax burden on owners of such entities.<sup>17</sup> There is some fresh evidence

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<sup>15</sup> Douglas Holtz-Eakin, "Should Small Businesses Be Tax-Favored?," *Tax Notes*, vol. 48, No. 3, Sept. 1995, p. 389. (In 2003, Dr. Holtz-Eakin was named the Director of the Congressional Budget Office.)

<sup>16</sup> This total excludes bills that would have boosted tax benefits for small firms in particular industries such as property and casualty insurance or small firms investing in specific geographic regions such as federally designated empowerment zones.

<sup>17</sup> In early 2001, President Bush proposed lowering the top individual tax rate from 39.6% (continued...)

that tax rate reductions can set the stage for faster growth in small business output in the short run.<sup>18</sup> EGTRRA also created a 50% non-refundable tax credit for the first \$1,000 in administrative and educational expenses incurred by certain small employers in setting up new qualified pension plans for employees.

Bills in the current Congress to enhance or expand small business tax preferences or to simplify their tax accounting and compliance are identified below:

## **IRC Section 179 Expensing Allowance**

A majority of the bills, which number 12 so far, would make the expensing allowance available under IRC section 179 more generous, either temporarily or permanently.<sup>19</sup> Some of the bills are modeled after a proposal made by President Bush in his budget request for fiscal year 2004, which calls for increasing the expensing allowance from \$25,000 to \$75,000 and the phase-out threshold from \$200,000 to \$325,000, indexing both amounts for inflation, and including off-the-shelf computer software in the depreciable assets eligible for expensing; the changes would take effect on January 1, 2003 and be permanent.<sup>20</sup> Notable legislative initiatives to implement this proposal include S. 2, as passed by the Senate Finance Committee on May 8, 2003. A version of the bill passed by the House Ways and Means Committee a day earlier (H.R. 2) would raise the allowance to \$100,000 and the threshold to \$400,000 in 2003 through 2007. By contrast, some bills would temporarily expand the allowance, mainly as part of a package of measures intended to stimulate faster economic growth. For example, S. 414, introduced by Senate Minority Leader Thomas Daschle, would raise the expensing allowance to \$75,000 and the phase-out threshold to \$325,000 in the 2003 tax year only, among other things.

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<sup>17</sup> (...continued)

to 33% between 2001 and 2006. The Treasury Department's Office of Tax Analysis estimated that 800,000 small business owners and entrepreneurs would benefit from this cut. It also estimated that these same individuals would receive 77% of the tax relief provided by this reduction. See Patti Mohr, "O'Neill Gives Small Businesses Reassuring Tax Cut Prognosis," *Tax Notes*, vol. 91, no. 7, May 14, 2001, pp. 1053-1055.

<sup>18</sup> In a recent analysis of the impact of personal income tax rates on the growth of small firms using tax return data from just before and just after the Tax Reform Act of 1986 took effect, Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen found that when a sole proprietor's marginal tax rate rose by 10%, his business receipts went up 8.4%. This implied that a reduction in the marginal tax rate levied on a sole proprietor from 50% to 33% would lead to a 28% increase in his or her receipts. See Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen, *Personal Income Taxes and the Growth of Small Firms*, Working Paper 7980, National Bureau of Economic Research (Cambridge, MA: Oct. 2000).

<sup>19</sup> The bills are H.R. 2, H.R. 22, H.R. 179, H.R. 224, H.R. 1079, H.R. 1126, S. 2 (identical to H.R. 2), S. 106, S. 158 (identical to H.R. 179), S. 414, S. 513, and S. 842.

<sup>20</sup> For an assessment of the likely economic effects of such a proposal, see CRS Report RL31852, *Small Business Expensing Allowance: Proposals in the 108<sup>th</sup> Congress to Enhance It and Their Likely Economic Effects*, by Gary Guenther.

## **Exclusion of Gains on Certain Small Business Stock**

Two bills (S. 106 and S. 842) would expand the partial exclusion of long-term capital gains on the sale or exchange of small business stock under IRC section 1202. The former would increase the share of gains that can be excluded from 50% to 75% for firms not classified for tax purposes as “empowerment-zone businesses.” It would also shrink the minimum holding period for small business stock to qualify for the exclusion from five years to three years, repeal the current requirement that 42% of any excluded gain be treated as an individual AMT preference item, relax existing restrictions on working capital held by qualified small firms, increase the cap on the gain eligible for the exclusion from \$10 million to \$20 million for married couples filing joint tax returns, and expand the range of business activities eligible for the exclusion to include biotechnology and fish farming.

S. 842 would also allow taxpayers to exclude 75% of the capital gains on qualified small business stock, but it would create a 100% exclusion for stock issued by “critical technology” corporations and specialized small business investment companies. A corporation would be considered a “critical technology corporation” if, during the minimum holding period for the exclusion, “substantially all” the firm’s active business is focused on technologies related to national defense, homeland security, transportation, anti-terrorism, environmental improvement, or improved energy efficiency. In addition, the bill would reduce the minimum holding period for qualified small business stock from five to four years, allow corporations to claim the exclusion, and double the asset size (from \$50 million to \$100 million) of C corporations eligible to issue qualified small business stock and index the amount for inflation beginning in 2005.

## **Expanded Eligibility for S Corporation Status**

Two bills (H.R. 714 and S. 850) would expand the range of firms eligible to become S corporations and thus avoid paying the corporate income tax. Among other things, each measure would exclude certain investment income from the definition of passive income for an S corporation, increase from 75 to 150 the maximum number of shareholders an S corporation may have, allow trusts that are individual retirement accounts to become S corporation shareholders, allow a bank director to own stock in an S corporation without the stock being considered a disqualifying second class of stock, and allow S corporations to issue qualified preferred stock.

## **Tax Credit for Small Firms Offering Health Insurance to Employees**

At least five bills would establish a refundable or non-refundable tax credit for part of the cost to small employers of offering health benefits to employees: H.R. 450, S. 53, S. 86, S. 414, and S. 906. While they differ in such important details as the size of the credit rate and eligibility criteria for firms and eligible employees, they share the policy aim of expanding health insurance coverage by giving small employers who currently do not offer health insurance coverage to employees an incentive to do so. For example, H.R. 450 would establish a refundable tax credit

equal to 50% of employer health insurance contributions for firms with 10 or fewer employees; the credit rate drops to 25% for firms with 11 to 15 employees; and it reaches 0% for firms with 16 or more employees. The credit applies only to health insurance premium payments made on behalf of employees who work at least 400 hours and earn \$40,000 or less in a calendar year. In addition, the employer must cover at least 75% of the cost of the insurance coverage. By contrast, S. 53 would create a non-refundable tax credit equal to 25% of the cost of individual health insurance coverage up to \$750 per eligible employee and 35% of the cost of family coverage up to \$2,450 per eligible employee. The credit may be claimed only by firms employing an average of 25 or fewer workers in either of the two preceding calendar years.

### **Special Amortization Deduction for Intangible Assets Acquired from Certain Small Firms**

H.R. 1222 would change IRC Section 197 to permit taxpayers to claim a special amortization deduction for any intangible assets acquired from an eligible small firm. Under current law, the value of these assets must be amortized over 15 years. Assets eligible for this treatment include goodwill, covenants not to compete, patents, copyrights, licenses, permits, and trademarks. The bill would allow the owner of the acquiring firm to write off the first \$5 million in intangible assets acquired from an eligible firm in the year of purchase, and the remainder would be amortized over 14 years, including the year of purchase. An eligible firm is defined as one with annual gross receipts of \$5 million or less in each of the three previous tax years.

## **Economic Arguments For and Against Small Business Tax Subsidies**

Current small business tax preferences and congressional initiatives to expand them pursue a variety of policy goals. Among the noteworthy goals are simplified tax accounting for small firms, improved access to long-term equity capital for small firms, increased investment by small firms, and expansion of the proportion of Americans covered by health insurance. But regardless of this diversity of aim, current and proposed small business tax benefits find common ground in their use of preferential tax treatment targeted at small firms.

Existing small business tax subsidies and proposals to expand them raise some interesting and important policy issues. For public finance economists, a key issue is whether or not such subsidies can be justified on economic grounds? Another way to frame the issue is to ask whether a sound argument based on principles of economic equity or efficiency can be made in favor of small business tax subsidies. The answer has important implications for social welfare, since perhaps as much as \$5 billion is transferred annually to small firms through the federal tax code. If the economic rationale for these tax subsidies turns out to be weak or untenable, then it can be argued that channeling these resources into other applications could lead to higher levels of social welfare. At the same time, it is important to keep in mind that small business tax subsidies are supported on a variety of non-economic grounds, and



that these arguments may outweigh purely economic considerations in the minds of policymakers evaluating proposals to expand them.

Nevertheless, the central focus of this section is the economic arguments for and against such proposals and their relative merits. These arguments are explored below.

## **Chief Economic Arguments in Favor of the Subsidies**

In general, proponents of small business tax subsidies cite the special economic role played by small firms, the barriers to their formation and growth, and the opportunities for individual economic advancement offered by small business ownership as the primary economic justifications for the subsidies.

Elements of this rationale surface from time to time in congressional debates on proposals to increase federal support for small business. For example, in the 107<sup>th</sup> Congress, Senator Christopher Bond noted on the floor of the Senate that “small businesses represent more than 99% of all employers, employ 53% of the private work force, create about 75% of the new jobs in this country, ... contribute 47% of all sales in this country, and ... are responsible for 51% of private gross domestic product.”<sup>21</sup> And early in the current Congress, Senator Olympia Snowe stated on the floor of the Senate, in introducing legislation to expand the small business expensing allowance, that “they (small businesses) represent 99 percent of all employers, employ 51 percent of the private-sector workforce, provide about 75 percent of the net new jobs, contribute 51 percent of the private-sector output, and represent 96 percent of all exporters of goods.”<sup>22</sup> Both statements draw on data reported by the Small Business Administration.

Proponents of small business tax subsidies also look beyond the direct and immediate economic contributions of small firms to find justification for them. In particular, they cite the increases in economic efficiency produced by small firms, the dynamic changes in economic structure and important technological innovations generated by small entrepreneurial firms, the valuable opportunities for social and economic advancement created by small firms for minorities, women, and immigrants, and the difficulties faced by promising small start-up firms in raising capital.

In defense of small business tax subsidies, some point to evidence that small firms can supply certain goods and services more efficiently than large firms. As economist Bo Carlsson has noted, this advantage can even be found in industries characterized by large production runs and falling unit costs such as automobiles and

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<sup>21</sup> Sen. Christopher Bond, remarks in the Senate, *Congressional Record*, daily edition, vol. 147, Jan. 25, 2001, p. S576.

<sup>22</sup> Sen. Olympia Snowe, remarks in the Senate, *Congressional Record*, daily edition, vol. 149, no. 6, Jan. 14, 2003, p. S299.

steel.<sup>23</sup> In industries such as these, small and large firms specialize in different products or services and often end up interacting more as collaborators than competitors. In Carlsson's view, the rise in outsourcing among large U.S. firms in the 1990s served to further solidify this division in labor between large and small firms. Among the reputed advantages of small firms in the vast chain of supply undergirding the U.S. economy is greater flexibility in responding to new market opportunities and competitive threats.

The belief that small firms can serve as powerful agents of dynamic economic change and growth appears rooted in the critical roles played by small start-up firms in the growth of certain high-technology industries in recent decades. Two notable findings arising out of the recent literature on firm size and technological innovation is that the contribution of small firms to innovation seems to vary by industry, and that their contributions are likely to be most significant in relatively young industries with relatively low levels of concentration.<sup>24</sup> The same literature offers fresh evidence that in certain industries small start-up firms are more adept than large established firms at identifying promising markets and applications for new technologies and exploiting these opportunities. During the 1980s and 1990s, several dramatic illustrations of this tendency emerged in biotechnology, microelectronics, computer software, and electronic commerce.<sup>25</sup>

Experiences such as these have led some economists to conclude that small entrepreneurial firms serve as a vital and indispensable source of economic growth and renewal. They contend that the growth process is marked by the continuous creation and destruction of jobs and firms, and that small entrepreneurial firms inject needed innovation and competition into this process. Carlsson has claimed that without the "heterogeneity and volatility" provided by small start-up firms, "the economy eventually stagnates or even collapses."<sup>26</sup>

Proponents of small business tax subsidies also cite the many benefits of small business ownership for women, minority groups, immigrants, and the communities where they reside as an important economic justification for the subsidies. They argue that owning and managing a small business gives them access to the social and economic mainstream of the United States. In addition, they claim that women-, minority-, and immigrant-owned small firms benefit their communities and society at large in ways that go beyond direct economic contributions. There is evidence that female small business owners in general encourage greater openness in workplace communication and decision-making and are more likely to hire a diverse workforce, put into place desirable child-care programs, and pay full benefits to employees than male small business owners, and that families including self-employed women who

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<sup>23</sup> Bo Carlsson, "Small Business, Entrepreneurship, and Industrial Dynamics," in *Are Small Firms Important? Their Role and Impact*, Zoltan J. Acs, ed. (Boston: Kluwer Academic Publishers, 1999), p. 100.

<sup>24</sup> Joshua Lerner, "Small Business, Innovation, and Public Policy," in *Are Small Firms Important? Their Role and Impact*, p. 160.

<sup>25</sup> Ibid., p. 160.

<sup>26</sup> Bo Carlsson, "Small Business, Entrepreneurship, and Industrial Dynamics," p. 109.

work out of their homes are more stable than the average family.<sup>27</sup> And in the case of minority and immigrant groups, small business ownership helps to lay the foundation for building tight-knit social networks, providing job and skills training, and creating informal capital markets.<sup>28</sup>

Yet another economic argument made in favor of small business tax subsidies is that they can ease or offset the barriers faced by many small business owners and entrepreneurs in raising funds to start a business and expand it. If capital markets were truly efficient, then every small business investment project offering a rate of return above the cost of capital would obtain funding, regardless of the creditworthiness of the owners. But proponents of small business tax subsidies say that such is not the case. They argue that largely because of a lack of information on the part of investors, too many potential and current entrepreneurs are unable to borrow or attract equity capital, compelling them to finance projects out of their own resources and those of friends and family members or abandon them altogether. Small business owners facing severe liquidity constraints have an elevated risk of failing.

## **Chief Economic Arguments Against the Subsidies**

While acknowledging the significant economic role played by small firms, some economists maintain that their contributions to economic activity do not justify targeting tax subsidies at small firms. Among public finance economists, a conventional rationale for government intervention in the economy is the presence of a market failure. In general, market failures can be thought of as economic conditions that produce undesirable efficiency or equity effects. Foremost among these conditions are a lack of perfect competition, the presence of public goods and positive or negative external effects (or externalities), the existence of incomplete markets, and imperfect information on the part of consumers.<sup>29</sup> Critics of small business tax subsidies say there is no evidence that a market failure hinders the formation or growth of small firms. What is more, they add, such subsidies are likely to result in undesirable or unintended equity and efficiency effects.

### **Equity Concerns.**

Critics charge that small business tax preferences undercut the progressivity of the federal individual income tax. Under a progressive income tax, a taxpayer's tax liability hinges on his or her taxable income, and taxpayers with higher taxable incomes pay more in tax than taxpayers with lower taxable incomes. Moreover, it is thought that individuals, and not firms, ultimately bear the burden of business

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<sup>27</sup> See Candida Brush and Robert D. Hisrich, "Women-Owned Businesses: Why Do They Matter?," in *Are Small Firms Important? Their Role and Impact*, pp. 111-127.

<sup>28</sup> See John Sibley Butler and Patricia Gene Greene, "Don't Call Me Small: The Contribution of Ethnic Enterprises to the Economic and Social Well-Being of America," in *Are Small Firms Important? Their Role and Impact* (Boston: Kluwer Academic Publishers, 1999), pp. 129-145.

<sup>29</sup> For more information on market failures, see Joseph E. Stiglitz, *Economics of the Public Sector*, 3<sup>rd</sup> Edition (New York: W.W. Norton & Co., 2000), pp. 76-90.

income taxes. While all owners of capital stand to benefit ultimately from small business tax subsidies, a large portion of those benefits probably end up in the hands of small business owners, whose income and wealth tend to be well above average for U.S. households.<sup>30</sup> In effect, the benefits reduce the tax burden on small business owners.

### **Efficiency Concerns.**

Critics also find fault with small business tax subsidies on efficiency grounds. They point out that, in theory, the tax code should not prevent economic resources from migrating to their most productive uses. In practice, this notion has a number of important policy implications. First, it implies that economic activities, including investment, should be taxed at uniform rates. Second, the theory of neutral taxation also implies that any tax on a factor of production or output that is not uniform across firms may harm social welfare.<sup>31</sup> Finally, it implies that taxes should not distort a firm's choice of inputs or its investment or production decisions. Critics maintain that an efficient allocation of resources can be achieved only if the tax code does not favor small firms over large firms or unincorporated firms over incorporated firms, or interfere with the natural growth and evolution of firms, or encourage firms to attain a particular asset, employment, or revenue size.<sup>32</sup>

Critics also challenge the claim that there is something unique about the economic role of small firms that would warrant the use of targeted tax subsidies. More specifically, they argue there is no conclusive proof that small firms are demonstrably and consistently superior to large firms in creating jobs or hatching important technological innovations.

Critics and proponents alike agree that small firms generally are a fertile source of job creation. According to data from the U.S. Small Business Administration, small firms created between half and three-quarters of all new jobs from 1990 to 1997, depending on how the employment size of a small firm is specified.<sup>33</sup> But critics maintain that for a variety of reasons these data do not necessarily prove that

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<sup>30</sup> According to a 1990 study by Charles Brown, James Hamilton, and James Medoff, the average family owning a small business had an income that was 80% greater and wealth that was five times greater than the average family. (See Charles Brown, James Hamilton, and James Medoff, *Employers Large and Small* (Cambridge, MA: Harvard University Press, 1990), pp. 15-17.) More recently, in a study of the wealth and income of U.S. small business owners, George W. Haynes found that, in 1998, the mean income of households with small business owners was \$101,563, compared to \$43,999 for households with no business owners, and the mean wealth of households with small business owners was \$832,514, compared to \$171,904 for households with no business owners. (See George W. Haynes, *Wealth and Income: How Did Small Businesses Fare from 1989 to 1998?*, Small Business Administration (Washington: May 16, 2001), pp. 24 and 27.

<sup>31</sup> Stiglitz, *Economics of the Public Sector*, pp. 567-569.

<sup>32</sup> Douglas Holtz-Eakin, "Should Small Businesses be Tax-Favored?," *National Tax Journal*, vol. 48, no. 3, Sept. 1995, p. 390.

<sup>33</sup> U.S. Small Business Administration, Office of Advocacy, *Small Business FAQ*, (Washington: Dec. 2000).

small firms are endowed with a greater job-creating prowess than large firms. To begin with, they note that the data raise more questions than they answer. Among the key unanswered questions: What does it mean to be small? When should a firm's size be measured? Is gross or net job creation a better indicator of job-creating prowess? And how long should a job last before it is counted as a new job?

In addition, critics cite what they see as an abundance of evidence that small firms are not demonstrably and consistently better at creating jobs than large firms. First, there appears to be considerable variation over time in the share of new jobs created by small firms: David Birch and James Medoff estimated that the share of total new jobs generated by firms employing 100 or fewer workers varies from about 40% to 140%, depending on the stage of the business cycle.<sup>34</sup> Second, most jobs created by small firms are created by new firms, which typically start out small in employment or asset size; and many of these jobs do not last a long time because most new firms fail within their first few years.<sup>35</sup> Third, few firms accounted for most small business job creation between the late 1980s and early 1990s — Birch and Medoff labeled these firms “gazelles” — and these firms went swiftly from small to large, and, at times, from large back to small, suggesting that their job-creating ability was unstable at best.<sup>36</sup> Finally, during the 1970s and 1980s, large firms and plants dominated job creation and destruction in the manufacturing sector, and there was no strong, systematic relationship between firm size and net job growth rates.<sup>37</sup>

Critics also contend that even if small firms were to create more jobs than large firms over time, there is no reason to think that government support for small business would lead to faster employment growth over time. Economic analysis indicates that the economy generates jobs through the natural processes of growth and structural change, regardless of the size distribution of firms. From this perspective, the level of national employment results from a mix of factors that would swamp the employment effects of any small business subsidies. The key factors are fiscal and monetary policy, overall consumption and investment, and the difference between U.S. exports and imports.

Research and development (R&D) is the lifeblood of technological innovation, which, in turn, serves as an engine of long-term economic growth. Economists generally agree that without government support, private investment in R&D would fall short of the socially optimal amount. Firms are likely to invest too little in R&D for two reasons. One is that they cannot capture all the returns to R&D investment, mainly because other firms are able to exploit the results of research in spite of available intellectual property protection. A second reason is that some firms lack access to sufficient capital to invest in R&D because they are unwilling or unable to

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<sup>34</sup> David Birch and James Medoff, “Gazelles,” in *Labor Markets, Employment Policy, and Job Creation*, Lewis C. Solomon and Alec R. Levenson, eds. (Boulder, CO: Westview Press, 1994), p. 162.

<sup>35</sup> *Ibid.*, p. 8.

<sup>36</sup> Birch and Medoff, “Gazelles,” pp. 162-164.

<sup>37</sup> Steven J. Davis, John C. Haltiwanger, and Scott Schuh, *Job Creation and Destruction* (Cambridge, MA: MIT Press, 1996), pp. 169-170.

provide investors with the information they require to evaluate the potential returns on planned R&D investments.<sup>38</sup> This tendency to invest too little in R&D represents a market failure in that too few resources are allocated to R&D compared to its potential economic benefits. To remedy this failure, many economists advocate government support to encourage private-sector R&D investment.

But critics of small business tax subsidies maintain that it is far from clear that this support should be targeted at small firms. They point to evidence suggesting both small and large firms are responsible for the innovations driving the processes of economic growth and structural change, and that it is impossible to disentangle the contributions of each group. According to data reported by the National Science Foundation (NSF), larger firms perform the vast share of business R&D: from 1992 to 1997, companies with fewer than 500 employees accounted for 14% of total business R&D spending, on average, whereas companies with 10,000 or more employees were responsible for 59% of this spending, on average.<sup>39</sup> Nonetheless, small firms and large firms each appear to have advantages as agents of technological innovation.<sup>40</sup> In addition, numerous studies have been done of the effects of firm size and market structure on innovation.<sup>41</sup> On the whole, they suggested that no firm size was ideal for generating new and successful commercial technologies. Another finding was that in some industries, small firms were more innovative, but in other industries large firms had the edge.

### **Other Concerns.**

Critics also raise questions about the suitability and effectiveness of some current or proposed small business tax subsidies.

One argument in favor of these subsidies is that a continuous supply of small firms is needed to prevent the development of monopoly power by large firms. But critics claim that it is far from clear that the best way to achieve such a policy goal is to offer tax subsidies to small firms. They point out that only a tiny share of small start-up firms survive and grow to the point that they pose a serious competitive threat to large entrenched firms in the same business. From their perspective, antitrust

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<sup>38</sup> Scott J. Wallsten, "Rethinking the Small Business Innovation Research Program," in *Investing in Innovation: Creating a Research and Innovation Policy That Works*, Lewis M. Branscomb and James H. Keller, eds. (Cambridge, MA: MIT Press, 1998), p. 197.

<sup>39</sup> National Science Board, *Science & Engineering Indicators — 2000*, Vol. 1 (Arlington, VA: 2000), appendix table 2-54, pp. A-97 and A-98.

<sup>40</sup> On the one hand, small firms may have a greater potential than large firms to create or dominate a new industry through R&D and may be more flexible than large firms in the pursuit of promising R&D projects. On the other hand, large firms can more easily cover the substantial sunken costs involved in conducting R&D and are more likely to capture a large share of the returns to R&D investments through marketing campaigns, the protection of intellectual property rights, and the creation of regional, national, and international distribution and service and repair networks. See Wallsten, "Rethinking the Small Business Innovation Research Program," p. 197.

<sup>41</sup> F. M. Scherer and David Ross, *Industrial Market Structure and Economic Performance*, 3<sup>rd</sup> edition (Boston: Houghton Mifflin Co., 1990), pp. 651-657.

law is likely to be a more effective tool than small business tax subsidies for thwarting the rise of monopoly power and other anti-competitive business practices.

Similarly, proponents of small business tax subsidies claim that small firms create a disproportionate share of new jobs. But critics respond that if the aim of public policy is to stimulate employment growth, then it makes little sense to offer small firms tax subsidies that lower the cost of capital, such as the current expensing allowance. Such subsidies have the effect of lowering the cost of capital relative to labor, thereby encouraging small firms to substitute capital for labor.

Furthermore, critics argue that small business tax subsidies impose an implicit or a hidden tax on business growth. This tax has been described as the notch problem, and it is a byproduct of the design of many tax preferences targeted at small firms. Under the typical small business tax subsidy, firms lose the tax benefit when their employment, assets, or receipts surpass a certain limit specified by law. Such a design can create a powerful disincentive to grow beyond that limit. The expensing allowance under IRC section 179 offers an illustration of this pitfall. As a firm raises its investment in assets that qualify for the allowance beyond \$200,000, the amount that may be expensed is reduced dollar for dollar, ultimately to zero starting at \$225,000. In effect, this rule gives firms an incentive to invest no more than \$25,000 in a single tax year. For any investment, the cost of capital depends in part on the investor's marginal tax rate. Jane Gravelle of CRS estimates that the marginal effective tax rate on investment in equipment is 0% on the first \$25,000, 26% on amounts over \$25,000 to \$200,000, 43% on amounts over \$200,000 to \$225,000, and 26% on amounts above \$225,000.<sup>42</sup> Economist (and current Director of the Congressional Budget Office) Douglas Holtz-Eakin has pointed out that this phase-out rule effectively raises a firm's cost of capital at a time when its growth is boosting its capital needs.<sup>43</sup>

## Conclusions

There is no question that small firms make important contributions to the performance and growth of the U.S. economy. Available evidence indicates that, depending on how small firms are defined, they account for a majority of private-sector jobs and private-sector output, commercialize many technological innovations, and serve as agents of renewal and structural change in a variety of industries.

These contributions explain part of the widespread support inside and outside Congress for government policies to assist small business. A concrete manifestation of this support is the preferential tax treatment received by many small firms. The combined revenue cost of current federal small business tax subsidies, excluding the tax treatment of passthrough entities, probably exceeds \$5.0 billion in FY2003. A

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<sup>42</sup> The estimate assumes a rate of inflation of 2% and a corporate tax rate of 35%. It is based on a simulation done by Gravelle with the aid of the CRS capital stock model on May 9, 2003.

<sup>43</sup> Holtz-Eakin, "Should Small Businesses Be Tax-Favored?," p. 393.

variety of initiatives to expand these subsidies — especially the expensing allowance under IRC section 179 — are attracting attention in the 108<sup>th</sup> Congress.

Mainstream economic analysis suggests that it is difficult to justify an expansion of small business tax subsidies on economic equity or efficiency grounds. Small business tax preferences reduce the tax burden on owners of small firms, diluting the progressivity of the federal individual income tax system. In addition, under current market conditions, it appears that there would be no clear efficiency gains from further subsidizing small firms through the tax code. Economic theory holds that the efficiency losses caused by income taxes are minimized when taxes do not distort the production arrangements within firms and all returns to capital are taxed at the same rate. And what is known about the economic activities of small firms does not appear to support the view that their formation and growth are hindered by market failures that would warrant targeted government support.

This is not to imply, however, that government support for small firms would never be justified on economic grounds. There is plenty of evidence that small entrepreneurial firms play critical roles in production, economic growth, and structural change. Measures aimed at simplifying tax accounting and compliance for small firms would have desirable efficiency effects. In addition, the emergence of a market failure that hampers the formation and growth of small firms would establish a sound case on economic grounds for government intervention. A possibility would be capital market imperfections that impede the entry of new small entrepreneurial firms or greatly diminish their chances of survival. Such a market failure could be eliminated or ameliorated through policy measures that increase the supply of capital to small start-up firms without substantially distorting the allocation of capital in the economy at large. Tax subsidies might be one such measure, but to be effective, they would need to address the root causes of the capital market imperfections. A continuing challenge for policymakers is to identify market failures that disproportionately harm small firms and devise appropriate policy responses.

The discussion presented here also underscores the need for the development of a robust model of the formation of small firms and their contributions to the economy. As it now stands, considerable uncertainty surrounds debate on this issue. Holtz-Eakin has noted that the use of such a model would help to determine whether any market failures are hampering the formation and growth of small firms and, if so, to identify the factors that shape these failures and are amenable to correction through policy intervention.<sup>44</sup>

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<sup>44</sup> Ibid., p. 393.