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The Small Business Tax Hike and the 97% Fallacy

The president's plan to raise top marginal rates is holding back the very people who should be leading the economic recovery.

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When Congress returns from its summer recess, members will face a pivotal decision about the expiring Bush tax cuts. President Barack Obama has called for their permanent extension for singles with incomes below \$200,000 and married couples with incomes below \$250,000, but has proposed that most of the tax cuts for households with higher incomes be allowed to expire.

To buttress this position, the president and his supporters have repeatedly asserted that the expiration of these cuts will have little impact, because they affect only a tiny fraction of the wealthiest Americans, people who "can afford it."

Recently, for example, Vice President Joe Biden harshly rejected House Minority Leader John Boehner's assertion that the hikes would harm small businesses, saying that "he has created this myth that a tax cut for millionaires is actually a tax cut for small business. There aren't 3% of small businesses in America that would qualify for that tax cut." House Speaker Nancy Pelosi flipped the number around, saying that the planned tax increases would exempt "98% of American families and about 97% of small businesses."

The impact is far more severe than Mrs. Pelosi and Mr. Biden suggest. In fact, the sound bite about 3% of small businesses, which has been picked up by numerous pundits, is one of the more misleading statements in the long history of economic propaganda.



The 3% figure, which is computed from IRS data, is based on simply counting the number of returns with any pass-through business income. So, if somebody makes a little money selling products on eBay and reports that income on Schedule C of their tax return, they are counted as a small business. The fact that there are millions of people in the lower tax brackets with small amounts of business income may be interesting for some purposes, but it is irrelevant for the assessment of the economic impact of the tax hikes.



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David Klein

The numbers are clear. According to IRS data, fully 48% of the net income of sole proprietorships, partnerships, and S corporations reported on tax returns went to households with incomes above \$200,000 in 2007. That's the number to look at, not the 3%. Would Mrs. Pelosi and Mr. Biden deny that the more successful firms owned by individuals in the top income-tax bracket are disproportionately responsible for investment and job creation?

It's clear that business income for large and small firms will be hit by the higher tax rates. And in point of fact, firms of all sizes contribute to the nation's prosperity. So it's a mistake to focus only on the impact of increased tax rates on small business. But will the higher rates actually cause a significant reduction in business activity?

Economic research supports a large impact. A pair of papers by economists Robert Carroll, Douglas Holtz-Eakin, Harvey Rosen and Mark Rider that were published in 1998 and 2000 by the National Bureau of Economic Research analyzed tax return data and uncovered high responsiveness of sole proprietors' business activity to tax rates. Their estimates imply that increasing the top rate to 40.8% from 35% (an official rate of 39.6% plus another 1.2 percentage points from the restoration of a stealth provision that phases out deductions), as in Mr. Obama's plan, would reduce gross receipts by more than 7% for sole proprietors subject to the higher rate.

These results imply a similar effect on proprietors' investment expenditures. A paper published by R. Glenn Hubbard of Columbia University and William M. Gentry of Williams College in the *American Economic Review* in 2000 also found that increasing progressivity of the tax code discourages entrepreneurs from starting new businesses.

Because marginal tax rate increases impede long-run growth, they should be avoided in good times and bad. But now is a particularly inopportune time to raise rates, as small businesses are still struggling from the recession. According to the ADP National Employment Report for July, goods-producing small businesses have reduced their total payroll employment by 117,000 jobs since January of this year, and they were still posting declines in July.

Taxes appear to be part of the story. When the National Federation of Independent Business asked small business owners in June to list the most important problem they faced, 20% named taxes, making that the second most cited concern after weak sales. The expectation of tax increases, such as those in Mr. Obama's plan, is on the minds of the people who should be leading the recovery.

The administration defends its desire to increase taxes by citing concerns about the deficit. Treasury Secretary Timothy Geithner recently asserted that "borrowing to finance tax cuts for the top 2% would be a \$700 billion fiscal mistake."

The administration is right to view the deficit as a serious issue, but this sudden commitment to fiscal responsibility is bizarrely inconsistent. The administration professes deep concern about the \$700 billion revenue loss from extending the tax cuts at the top, but apparently views the revenue loss of nearly \$2 trillion from extending the tax cuts for the middle class as too inconsequential to mention. Nor has the administration's concern about the deficit driven it to reduce federal spending.

For those who are determined to tax the rich at all costs, and are therefore willing to accept the claims of the Obama administration without scrutiny, the tax hikes may well make sense. But the evidence is clear that lifting the top rates will hamper the business investment upon which our nation's prosperity depends. That affects all Americans, not just 3%.

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