How Would a Flat Tax Affect Small Businesses?

By John E. Golob

The U.S. Congress is considering several strategies to reform the federal income tax system. The most widely discussed strategy, a flat tax, would tax income received by businesses and individuals at the same low, flat rate. Flat tax proposals would eliminate most tax deductions and tax credits but would increase the personal exemption for individual taxpayers. While the debate continues over whether a flat tax would be fair to individual taxpayers, assessing the effect of a flat tax on economic growth and business activity is also important.

Most economists who analyze tax incentives conclude that a flat tax would encourage economic growth, which would have a positive effect on businesses in general. The effects on businesses would not be uniform, however, and many small businesses would be affected differently than large businesses. Small businesses are an important component in the U.S. economy, producing about half of private sector output and employing over half of the work force, so tax reformers need to understand how a flat tax would affect the small business sector of the economy.

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This article examines the effects of a flat tax on businesses in general and on small businesses in particular. The first section of the article describes the goals and features of a flat tax and how a flat tax would affect businesses overall. The second section describes how a flat tax would affect small businesses differently from large businesses.

The article concludes that businesses in general are likely to benefit from a flat tax and that small businesses are likely to benefit more than large businesses. Most businesses would benefit from higher economic activity associated with a flat tax. Small businesses would benefit even more than large businesses, due in part to reduced compliance costs. In addition, a flat tax would eliminate tax deductions and tax credits less widely available to small businesses, thereby leveling the playing field between large and small businesses. Moreover, lower interest rates under a flat tax would offset more of the loss of interest deductibility for small businesses than for large businesses.

OVERVIEW OF FLAT TAX AND BUSINESS EFFECTS

Proponents of a flat tax have two primary goals. The first goal is to simplify the tax system to reduce the costs of keeping records and filling out tax forms. The second goal is to encourage economic activity by reducing the disincentives to work, savings, and investment in the current tax system.[1]

This section begins with an overview of the flat tax and then discusses how a flat tax would simplify compliance and encourage economic activity. The section concludes that businesses generally would benefit from lower compliance costs and increased economic activity. Although the tax bill on business income would tend to increase, the increase would be mitigated by eliminating the second layer of taxes owners pay on capital income. Many, but not all, businesses would benefit on net.

What is a flat tax?

Flat tax proposals are so named because they would tax all business and individual income at a single flat rate. To compensate for the loss of revenue from reducing tax rates, the proposals would broaden the tax base by eliminating many tax deductions and tax credits. The proposals would also increase the personal exemption and allow businesses to deduct the cost of new investments in the same year they incur the expense.

Economists agree that lower tax rates would encourage economic activity, but uncertainties remain about the minimum rate needed to generate the same revenue as the current system. The "revenue-neutral" rate depends, of course, on the size of the personal exemption for individuals and on how many deductions and credits remain. Proposed rates vary between 17 and 20 percent. The Treasury Department estimates these rates would be too low and that a 20.8 percent rate would be required for revenue neutrality in a flat tax as proposed by House Majority Leader Armey and Senator Shelby. In contrast, others estimate the Armey-Shelby proposal with a 17 percent rate would increase tax revenues (Seldon and Boyd).

Tax reformers have introduced several flat tax proposals. In addition to the aforementioned Armey-Shelby proposal, three presidential candidates, Senator Gramm, Senator Spector, and Steve Forbes, each offered their own version of a flat tax during the 1996 primary campaign.[2] The National Commission on Economic Growth and Tax Reform, chaired by Jack Kemp, also recommended a flatter tax system. The proposals share many similarities because all are based on earlier work by two senior fellows at the Hoover Institution, Robert Hall and Alvin Rabushka.

Flat tax proposals differ primarily in their treatment of individual income rather than business income. For example, some proposals would disallow individual deductions for home mortgage interest or charitable contributions, while other proposals would only reduce the amount of these popular deductions. The proposals contain no substantial differences, however, regarding business tax deductions and tax credits. Because the business features and business effects of the proposals are so similar, this article focuses on the proposals' similarities rather than their differences (Table 1). Numerical examples are based on the Armey-Shelby plan, which is both the first and the most widely cited flat tax proposal.

Tax simplification

The most universal complaint about the current income tax system is its complexity. The income tax code contains approximately 480 IRS forms, 280 IRS information pamphlets, and thousands of pages of supplementary documentation. Although single taxpayers can file the simple 1040EZ forms if almost all of their income is from wages, this option is chosen by only 17 percent of taxpayers (Internal Revenue Service

Table 1

FEATURES OF FLAT TAX PROPOSALS

- Individuals and businesses are taxed at same flat rate (varies from 17 to 20 percent in different proposals)
- Business income is taxed only once; taxes on dividends and capital gains are eliminated for both businesses and individuals
- Businesses are allowed immediate deductions for investments in plant and equipment
- Taxes are eliminated on interest income
- Business deductions are eliminated for employee compensation in the form of fringe benefits
- Tax deductions and credits are reduced or eliminated
- Personal exemption for individuals is increased

1992b). The complexity of the tax code forces most other individuals and businesses to seek professional assistance (Schmedel). The tax code is so complex that IRS helplines frequently give incorrect information and even tax experts can interpret the code in different ways (Tritch). When businesses are asked how the tax system could be improved, they respond overwhelmingly in favor of tax simplification. Individual taxpayers also plead for tax simplification in both opinion polls and public forums.[3]

The costs of tax compliance are especially onerous for businesses. A study of 1985 tax returns commissioned by the IRS, Arthur D. Little, Inc. estimated that tax preparation and record keeping costs were $50 billion for individuals and $100 billion for businesses. The compliance cost to businesses was about the same as their $96 billion in income taxes and about 45 percent of their $225 billion pre-tax profits for 1985. Economists have estimated that a flat tax could reduce compliance costs by up to 90 percent, which could lead both to higher profits for many businesses and to lower prices for their customers (Laperriere).[4]

Tax incentives

Although taxpayers typically view tax complexity as the most annoying feature of the current system, many economists believe the disincentives in the tax code are even more costly. Taxes discourage the activity being taxed. Taxing wages discourages work, and taxing business income discourages savings and investment. Although almost all taxes distort economic behavior, some tax systems distort less than others.[5] Flat tax proposals are designed to minimize the economic disincentives in the federal tax system by reducing tax rates as much as possible and by eliminating the bias favoring consumption over savings.

Work incentives. When workers consider whether to enter the work force or decide whether to work overtime, the after-tax wage is an important factor in their decision. The marginal tax rate determines how much of the worker's wages will be left after taxes. For example, consider a worker offered an option of working overtime for $20 per hour. If the worker is in a 28 percent tax bracket, he would keep

$14.40 of the $20 after federal income taxes.[6] If the worker's marginal tax rate were reduced to 20 percent, he would keep $16 after federal taxes. The worker would be more willing to work overtime when offered $16 than when offered $14.40.[7] Thus, by increasing after-tax wages for workers making incremental labor supply decisions, a flat tax would increase the supply of labor. Workers would earn more and buy more of the goods and services businesses produce.

Empirical analyses of past tax reforms confirm that changes in marginal tax rates affect the supply of labor. For example, marginal tax rates increased for many taxpayers in 1993 and declined for many taxpayers in 1986. Feldstein and Feenberg show that high-income taxpayers responded to the 1993 increase by reducing their taxable income.[8] Eissa shows that many married women entered the labor force after the 1986 reduction in marginal tax rates.

Savings incentives. Many economists identify the low savings rate as the single most important problem facing the U.S. economy. The U.S. savings rate has been trending downward since the 1960s. The savings rate is lower than most other industrialized countries and is less than half the rate in Japan. Countries that save less also tend to invest less, which ultimately restrains their growth in labor productivity and living standards.[9]

The tax code discourages savings by taxing capital income twice. When taxpayers invest in a business, taxes are first assessed on the business's income. When the after-tax income is paid to the business owners as dividends, taxes are then assessed on the dividends.[10] Alternatively, if the business retains its income to expand its operations, the subsequent increase in value is taxed as a capital gain when the taxpayers sell their shares in the business. With two layers of taxation, marginal tax rates on capital income can be over 60 percent.[11]

A flat tax would eliminate double taxation by eliminating the taxes paid by shareholders on dividends and capital gains.[12] The same rules would apply to both business and individual shareholders. Business income would be taxed once, at the same tax rate individuals pay on wages. Although Hall and Rabushka estimate that business income taxes would generally increase, eliminating the second layer of taxes would partially compensate for the increase.

Investment incentives. Flat tax proposals would encourage businesses to invest by allowing them immediate deductions for all new investments in plant and equipment. Businesses currently spread these deductions over several years, corresponding to the useful life of each investment. Immediate deductions would encourage businesses to invest because investing would reduce their taxes.[13] Also, immediate deductions are more valuable than deductions spread over several years because inflation reduces the value of deductions taken in later years.

Economists generally agree that a flat tax would encourage economic activity, but they do not agree on how large the effect would be. Auerbach and Kotlikoff calculate that GDP would increase by about 6 percent, most of which would occur within seven years (Hall and Rabushka). Jorgenson argues that GDP would be 15 to 20 percent higher within a decade. Critics such as Krugman, however, contend that the economy would respond only marginally to improved tax incentives.

In summary, a flat tax would benefit businesses by reducing compliance costs and by stimulating economic activity. Income taxes would increase for many businesses, but eliminating the second layer of taxes on capital income would partially compensate business owners for the increase. Economists' estimates of lower compliance costs and increases in economic activity suggest these factors would be more important than the tax increase.[14] That is, a flat tax would generally be positive for businesses.

FLAT TAX EFFECTS FAVOR SMALL BUSINESSES

Flat tax effects would vary widely for different businesses. Businesses that lose substantial tax deductions and tax credits would less likely benefit from a flat tax. Businesses in growing industries with solid investment opportunities would likely benefit more from the investment incentives of a flat tax than businesses in mature industries. Accounting and legal firms that specialize in unraveling the tax code's complexity would most likely be hurt by a flat tax. While these differential effects are fairly obvious, it is less clear how a flat tax would affect small businesses compared with large businesses.

This section discusses why a flat tax would affect small businesses differently than large businesses. The section begins by describing what a small business is and then considers how both the benefits and adverse effects of a flat tax would vary with business size.

What is a small business?

The small business sector of the economy is difficult to characterize because it is both large and diverse. Small businesses are not required to register with any government agency, so economists are uncertain about how many are operating in the United States. Some economists estimate the number of small businesses from IRS data (Kirchoff). Over 15 million taxpayers filed Schedule C, "Profit or Loss From Business," in 1992. Because many taxpayers use Schedule C as a tax shelter vehicle, however, this IRS statistic certainly overstates the number of businesses. A narrower definition of small businesses counts only firms having employees, as determined by filings for unemployment insurance. This criteria reduces the total to about 5 million. The U.S. Small Business Administration defines businesses with less than 500 employees as small. By this definition, over 99 percent of businesses are small and approximately 53 percent of employees are employed by small businesses (Table 2).[15]

The heterogeneity of the small business community precludes economists from making generalizations about small businesses. For example, although employees of small businesses tend to receive lower wages and fewer fringe benefits than employees of large businesses, physicians employed by small medical clinics are typically well compensated. Also, although manufacturing businesses are typically large and service businesses are typically small, many small businesses are classified as manufacturers. Thus, this article does not attempt to draw any conclusions applicable to all small businesses. Rather, the article identifies some business characteristics that often vary with business size and then analyzes how flat tax effects depend on these characteristics.

How would flat tax benefits vary with business size?

Three benefits of a flat tax would favor small businesses over large businesses, while one benefit would favor large businesses. First, because small businesses spend proportionately more on tax compliance, they would benefit more from tax simplification. Second, because many small businesses are taxed at rates based on their owners' returns, they would benefit from the large individual exemption. Third, the combined effect of lower interest rates and the

Table 2

BUSINESS SIZE AND EMPLOYMENT

Size of business (by employees)	Number of firms in category (thousands)	Percent of firms in category	Percent of employment in category
1-9	3,978	78.8	12.3
10-99	991	19.6	26.6
100-499	68	1.3	14.2
Total small	5,037	99.7	53.1
500+ (large)	14	.3	46.9
Total	5,051	100.0	100.0

Source: U.S. Small Business Administration, Table A.7.

loss of interest deductions would be more likely to benefit small businesses. The final benefit, eliminating double taxation, would favor large businesses. Large businesses are subject to double taxation under the current tax code more often than small businesses.

Simplification. When the Small Business Administration asked small businesses how the tax system could be improved, the overwhelming response was for tax simplification (Glover). The simplicity of a flat tax would benefit small businesses more than large businesses because small businesses typically spend proportionately more of their revenues on tax preparation and record keeping. Small businesses often spend more money on tax preparation than they pay in taxes (Kiplinger). Several small business owners testified to the National Commission on Economic Growth and Tax Reform that they had either reduced business operations or curtailed expansion plans because they refused to become further entangled in the complexity of the tax code. Thus, lower tax preparation and record keeping expenses would be especially valuable to small businesses.

Increase in personal exemption. Many small businesses would benefit from an increase in the personal exemption for individual taxpayers under a flat tax. The personal exemption is important because the taxes paid by many small businesses are determined by the tax rates applicable to their owners. When business income is taxed on the owners' returns, the income up to the personal exemption is not taxed. Flat tax proposals would increase the size of this exemption.[16] For example, under the Armey-Shelby flat tax proposal the personal exemption for a family of four would be $36,800, compared with only $10,000 today.

IRS data confirm that many small business owners would benefit from a high personal exemption. Registering a business as a Subchapter S corporation is one way a business can transfer income to its owner's individual return.[17] For example, 3.2 million individual taxpayers declared income from S corporations in 1992 and 1.1 million of these returns showed total income of less than $40,000 (Internal Revenue Service, 1992b). Thus, the large personal exemption under a flat tax would lead to very low taxes for many Subchapter S businesses.[18]

Lower interest rates. Many economists anticipate that a flat tax would reduce interest rates.[19] A flat tax would eliminate deductions for interest expenses, which would make borrowing less attractive and thereby reduce the demand for credit. A flat tax would also eliminate taxes on interest income, which would make lending more attractive and thereby increase the supply of credit. Thus, reduced demand for and increased supply of credit would lead to a decline in the price of credit, that is, a decline in interest rates (Golob).

The impact of a flat tax on a business's borrowing costs depends on the combined effects of lower interest rates and the loss of interest deductions. Although lower interest rates would reduce business borrowing costs, the elimination of interest deductions would raise borrowing costs. The importance of these effects would vary across different businesses. Lower interest rates would be more important to businesses paying low tax rates, while losing interest deductions would be more important to businesses paying high tax rates.

The effect of a flat tax on business borrowing costs can be illustrated by comparing two businesses borrowing at 10 percent, a small business earning $40,000 annually and a large business earning $4 million. Under the current tax law, the small business pays a 15 percent marginal tax rate, while the large business pays a 35 percent rate (Chart 1). Deductible interest rates reduce the after-tax cost of borrowing for both of these businesses. Under the small business's 15 percent tax rate, the interest deduction reduces the tax bill by 15 percent of the interest expense. Given this tax reduction, the 10 percent pre-tax interest rate is essentially reduced to 8.5 percent after taxes. Similarly, for the large business the interest deduction reduces the after-tax interest rate by 35 percent of the interest expense, so the 10 percent pre-tax rate becomes 6.5 percent after taxes. Thus, the interest deduction is worth more to the large business paying a higher marginal tax rate than to the small business paying a lower rate.

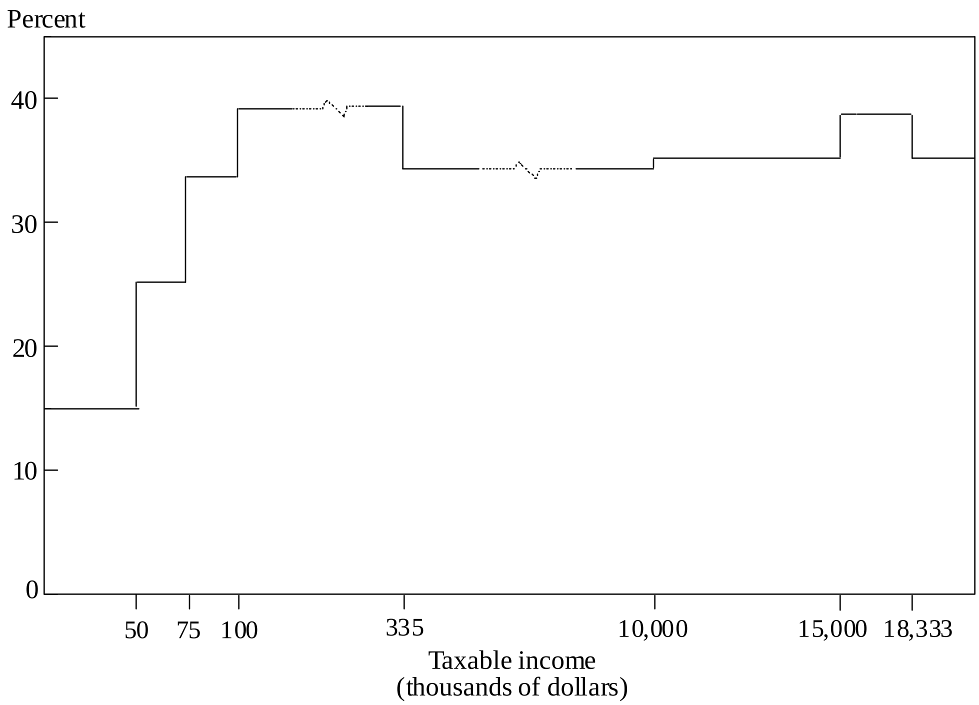
Economists estimate interest rates would decline about 20 percent under a flat tax (Golob; Hall and Rabushka). Continuing with the above example, a 10 percent interest rate under the current tax laws would fall to 8 percent under a flat tax. Because interest expenses would no longer be deductible, the effective after-tax rate would also be 8 percent. Thus, a flat tax would reduce the after-tax cost of debt finance for the small business from 8.5 to 8 percent. In contrast, a flat tax would increase the after-tax cost of debt finance for the large business from 6.5 to 8 percent. That is, the net effect of lower interest rates and the loss of interest deductions would reduce debt financing costs for businesses in low-tax brackets, while increasing debt financing costs for businesses in high-tax brackets. Small businesses, of course, are more likely to be in the low brackets.

The largest beneficiaries of the interest rate reduction under a flat tax would be businesses without profits. Businesses that do not pay taxes do not benefit from interest deductions but would benefit fully from the decline in interest rates under a flat tax. Small businesses are more likely to be unprofitable than large businesses, so a larger fraction of small businesses would benefit from lower interest rates (Chart 2).[20]

Eliminating double taxation. In contrast to the aforementioned benefits, large businesses would benefit more than small businesses from the elimination of double taxation under a flat tax. Many small businesses already avoid double taxation, either by not incorporating or by

Chart 1

MARGINAL TAX RATES FOR BUSINESS INCOME



Source: Internal Revenue Service, 1995.

registering as S corporations. These options are not available to large businesses, so their income is more likely to be taxed twice.

How would adverse effects of a flat tax vary with business size?

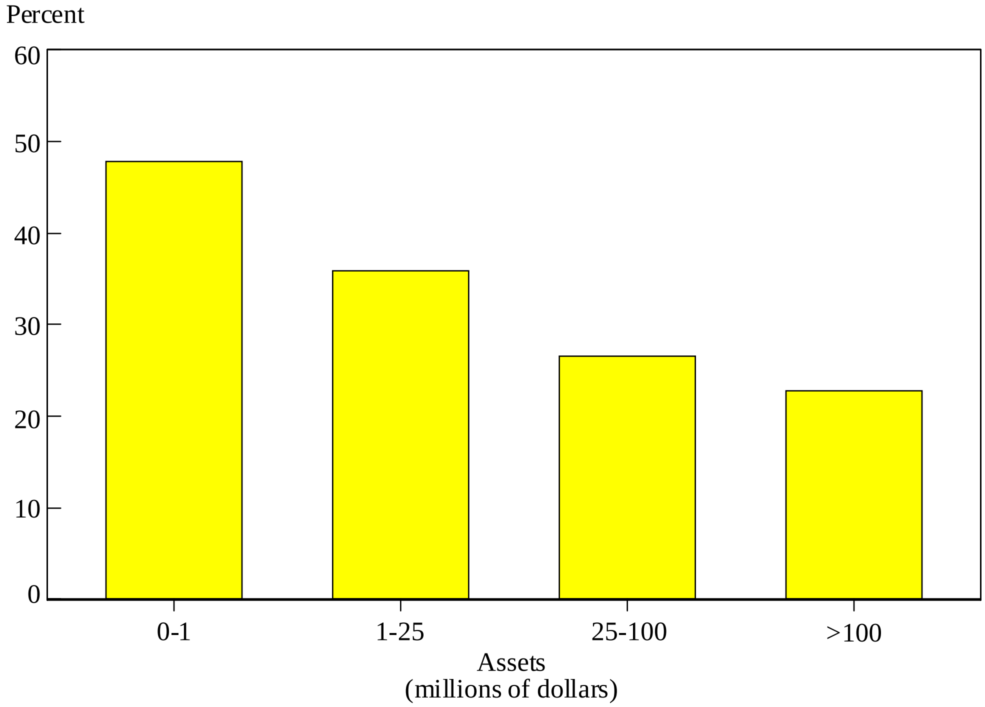
In addition to reducing marginal tax rates on business income, a flat tax would broaden the tax base by eliminating many tax deductions and tax credits. Businesses would lose deductions for fringe benefits and many other special deductions and credits. Also, flat tax proposals would eliminate depreciation deductions for past investments. These adverse effects would tend to hurt large businesses more than small businesses.

Fringe benefits. Fringe benefits are an important part of employee compensation, but benefits are taxed differently than wages. For an employer, both wages and fringe benefits are tax deductible costs of business. To employees, however, wages are taxed while fringe benefits are not. Through this implicit subsidy, the federal government encourages businesses to compensate their employees with fringe benefits rather than wages. Large businesses have responded to this subsidy by increasing the proportion of fringe benefits in employee compensation (Burke and Morton).

Chart 2

FRACTION OF BUSINESSES WITHOUT PROFITS

In four asset size categories



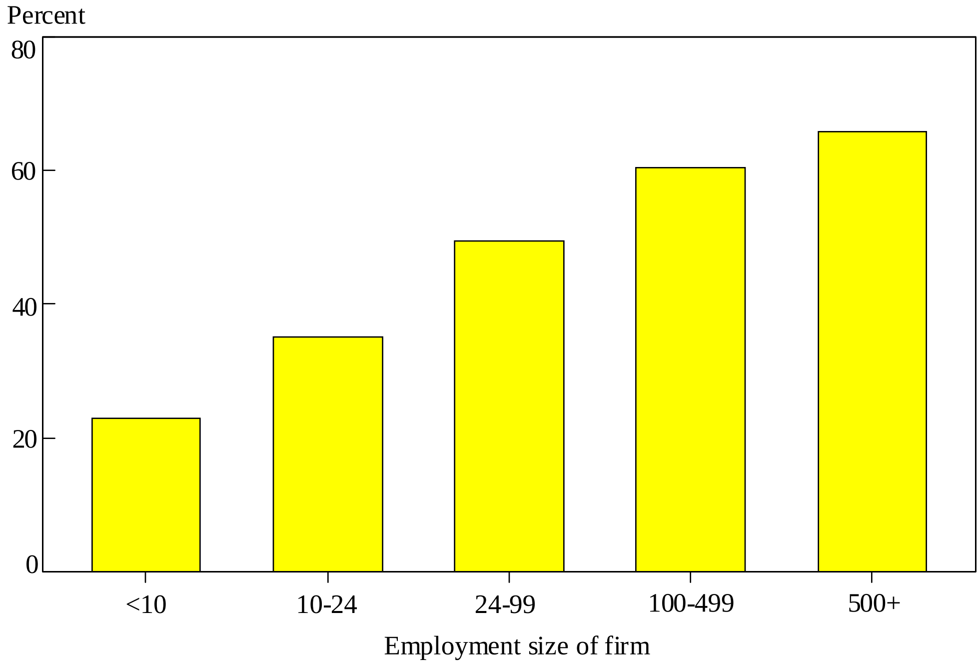
Source: Internal Revenue Service, 1992a, Table 3.

Small businesses typically offer fewer fringe benefits than large businesses. For example, only 23 percent of workers in businesses with less than ten employees have employer sponsored health insurance, compared with 65 percent of those in businesses with more than 500 employees (Chart 3). Pension plans are also less common in small businesses, partly because administrative costs are so high. One recent study found that administrative costs per employee were eight times larger for a pension plan with 15 participants than for a plan with 10,000 participants (Chart 4). Administrative costs can consume over a third of the contributions to a small business pension plan (Utgoff).

A flat tax would remove the federal subsidy of fringe benefits by eliminating employer deductions for fringe benefits. Although all businesses would be treated the same, small businesses would lose less than large businesses. Moreover, small businesses registered as S corporations would lose nothing because they cannot deduct the cost of fringe benefits under the current tax law.

Special tax deductions and tax credits. A flat tax would also eliminate many tax deductions and tax credits. Although a flat tax would treat all businesses the same, small businesses would lose less because they take fewer deductions and credits than large businesses. Many tax deductions

Chart 3
HEALTH INSURANCE COVERAGE RATES



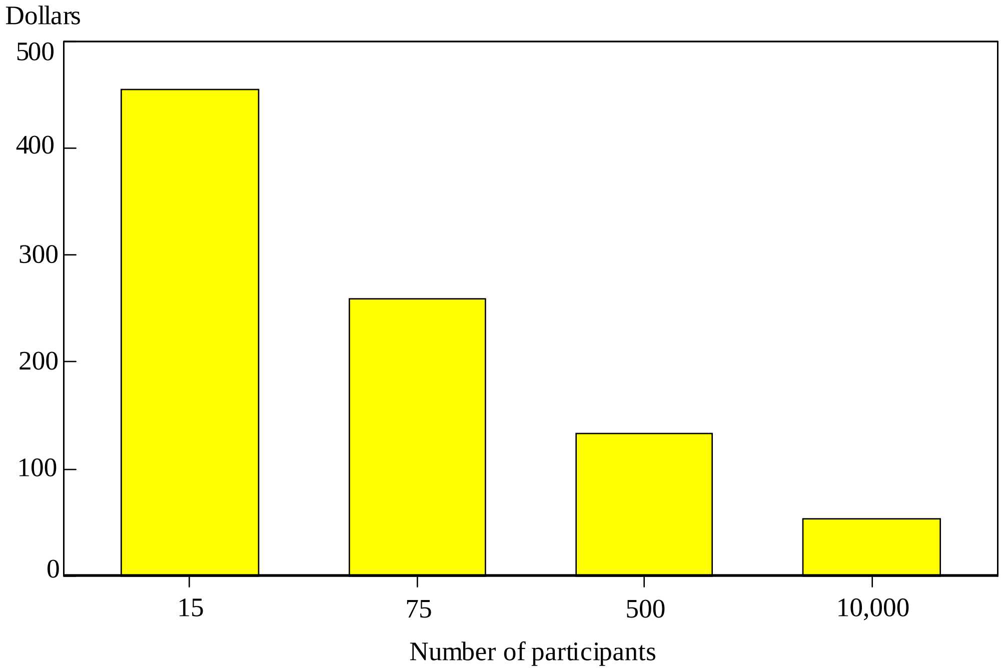
Source: U.S. Small Business Administration, 1994, Table 2.13.

and credits are only available to specific industries, and larger businesses have been more successful convincing Congress they deserve special tax breaks. An example of a special tax deduction is the depletion allowance, in which oil and mining companies deduct more than their costs of exploration and development. Large businesses take greater advantage of this deduction than small businesses (Chart 5). As another example, many electronic and pharmaceutical companies get a tax credit for manufacturing in U.S. possessions, typically Puerto Rico. This credit is ten times more valuable to businesses with revenues over $50 million than to businesses with revenues less than $2.5 million (Chart 6).

In addition to the special deductions and credits that benefit entire industries, the tax code is littered with more targeted tax breaks. The recipients of these breaks are often obscured by language that does not mention them by name but is specific enough to ensure that only one business can take advantage of the special treatment. For example, the tax code grants a special exemption to a public utility with facilities "located at any non-federally owned dam (or on project waters or adjacent lands) located wholly or partially in 3 counties, 2 of which are contiguous to the third, where the rated capacity of the hydroelectric generating facilities at 5 such dams on October 18, 1979, was more than 650 megawatts each. . . . " Only

Chart 4

PENSION PLAN ADMINISTRATIVE COSTS PER PARTICIPANT, 1991



Source: Utgoff, 1991, Table 1, p. 385.

large businesses have enough clout to get such special favors inserted into the tax code.[21]

Loss of depreciation deductions. Although businesses could deduct the cost of new investments immediately under a flat tax, the proposals would take away depreciation deductions for past investments. This provision could increase or decrease a business's tax bill, depending on whether depreciation deductions were greater or less than new investments. Small businesses tend to be less capital intensive than large businesses, so the loss of depreciation deductions would typically hurt them less. Also, small businesses are already allowed immediate deductions for capital investments up to $17,500, which tend to reduce the amount of unused depreciation on their books.[22]

In summary, the benefits of a flat tax would fall more heavily on small businesses than on large businesses. The adverse effects would fall more heavily on large firms.

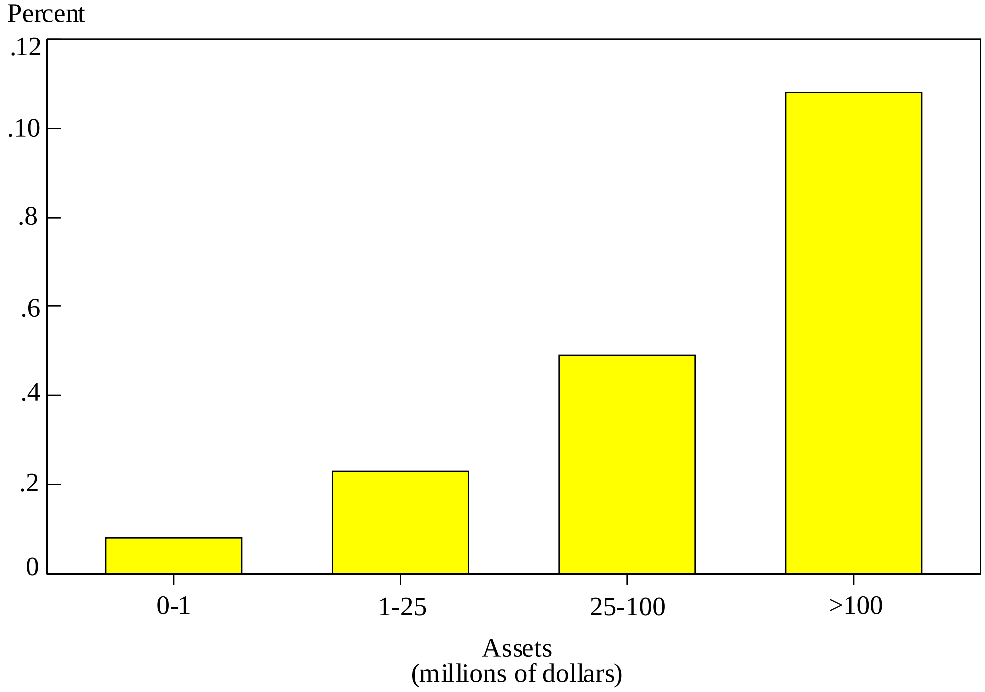
CONCLUSION

A flat tax would help businesses in general by reducing tax complexity and by encouraging economic activity. The net effect of lower rates and fewer deductions and credits, however,

Chart 5

DEPLETION ALLOWANCE

As a percentage of total receipts



Source: Internal Revenue Service, 1992a, Table 3.

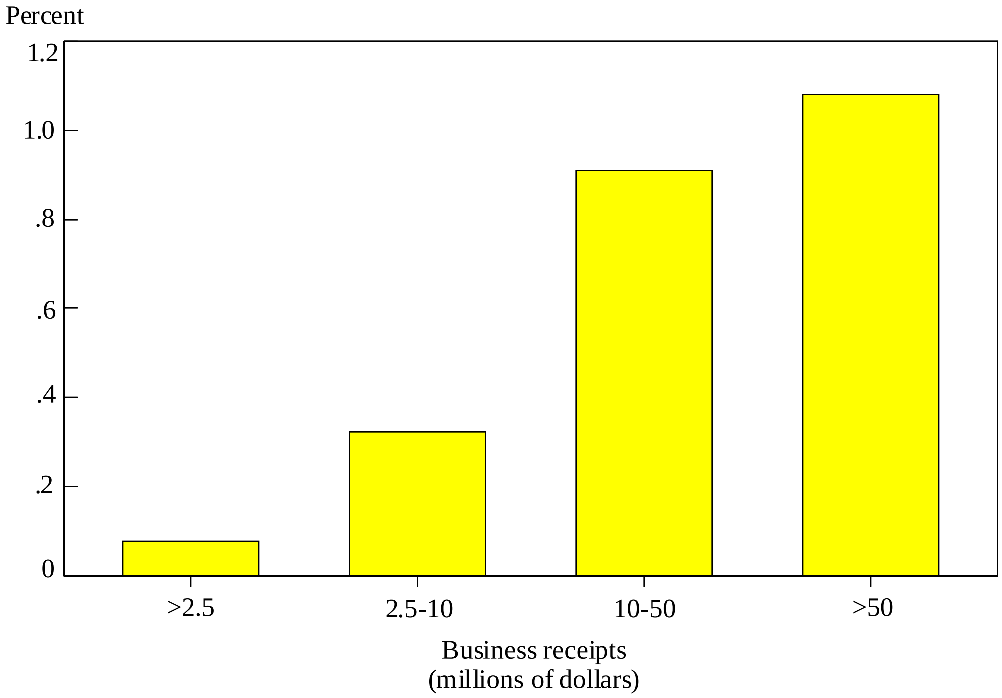
would generally raise taxes on business income. Nevertheless, lower compliance costs and stronger economic growth would be more important than tax increases for most businesses overall.

Flat tax effects would vary widely, and many small businesses would be affected differently than large businesses. Small businesses would benefit more from tax simplification because they spend proportionately more on tax compliance. Many small businesses would benefit from a higher personal exemption because their business income is transferred to their owners' returns. The interest rate effects of a flat tax would also tend to favor small businesses because many of them would gain more from lower interest rates than they lose in interest deductions. Taxing business income once instead of twice, however, would benefit large businesses more than small businesses. Regarding the adverse effects of a flat tax, the loss of deductions and credits would tend to hurt large businesses more than small businesses. On balance, a flat tax would tend to level the playing field that currently favors larger businesses. Thus, by reducing compliance costs, encouraging economic activity, and leveling the playing field, a flat tax would be good for many small businesses.

Chart 6

U.S. POSSESSIONS TAX CREDIT

As a percentage of income subject to tax



Source: Internal Revenue Service, 1992a, Table 5.

ENDNOTES

1 Although flat tax proposals are designed to improve economic efficiency, critics are concerned that a flat tax would increase income inequality by reducing the tax burden on the wealthy while increasing the tax burden on the middle class. Others are concerned that a flat tax would take away tax incentives for buying homes and giving to charities. These equity and incentive considerations will be important in the political debate over tax reform but are beyond the scope of this article on small business effects.

2 Some analysts have classified a proposal by Representative Gephardt as a flat tax because it would reduce the tax rate for most taxpayers to 10 percent. Although it changes the rate structure, the Gephardt proposal differs substantially from other flat tax proposals.

3 The need for simplicity was especially well documented in the final report by the National Commission on Economic Growth and Tax Reform chaired by Jack Kemp.

4 Slemrod also estimates substantial savings from tax simplification, although his estimates are lower than those by flat tax proponents. Critics, however, contend that transition rules would likely keep compliance costs high under a flat tax (Sease and Herman; Slemrod). They also question whether a "clean" flat tax could emerge from the legislative process.

5 Economists note that a "lump sum" tax would not affect economic behavior. Such a tax would be levied on all taxpayers independent of whether or not they worked, invested, or consumed. While a lump sum tax would not

distort economic behavior, the tax would be very regressive and has never been seriously considered.

[6] This analysis ignores other taxes assessed by state and local governments, or other federal taxes for social security and Medicare.

[7] The overtime example illustrates what economists refer to as a substitution effect. This analysis is complete for taxpayers whose final tax bill is unaffected by a flat tax. For taxpayers whose tax bill changes, however, the change in after-tax income would also be important. Those paying fewer taxes might not want to work as much, while those paying more taxes might want to work more.

[8] Critics have suggested that Feldstein and Feenberg's result was caused by taxpayers shifting income from 1986 to 1987 rather than working more. Feldstein has responded, however, that income shifting explains only part of their result.

Economists' estimates of labor supply elasticity vary widely. For more information on this issue see Bosworth and Burtless; MaCurdy, Green, and Paarsch; Mariger; and Triest.

[9] A country can invest more than it saves by attracting foreign investment. Nevertheless, because capital is not perfectly mobile across international boundaries, countries with low savings rates typically invest less than countries with high savings rates.

Economists disagree about how much household savings would increase in response to tax incentives (Bosworth and Burtless; Engen and Gale). Estimating the response from the past tax reforms is complicated by changes in interest rates, changes in the demographic structure of the population, and changes in the tax burden across groups with different savings rates.

[10] By registering as a Subchapter S corporation, some small businesses can avoid double taxation of business income.

[11] After taxing business income at a 35 percent rate, 65 percent remains. Tax rates on the remainder paid to shareholders as dividends can be as high as 39.5 percent, so the taxpayer keeps 60.5 percent of the dividend. Thus, the shareholder ultimately receives 60.5 percent of 65 percent, which is 39.3 percent of the business's income, implying a 60.7 percent tax rate.

[12] The flat tax proposed during Phil Gramm's presidential campaign was the only proposal that would continue to tax dividends and capital gains.

[13] In addition to allowing immediate deductions for new investments, flat tax proposals would disallow depreciation deductions for past investments. This feature could suppress investment as businesses anticipate passage of a flat tax. By delaying investments until the flat tax became effective, businesses could avoid losing depreciation deductions.

[14] Many economists contend that business income taxes are simply passed along to their consumers as higher prices (Fullerton and Rogers). In this view, businesses would be indifferent about compliance costs and tax rates. Nevertheless, businesses would still benefit from increases in economic activity under a flat tax.

[15] Some researchers classify businesses with less than 100 employees as small, while others consider businesses with less than $25 million in assets as small.

[16] Many low-income taxpayers are eligible for an "earned income credit." Most flat tax proposals would repeal this credit, which would counteract some of the benefit of a higher personal exemption.

[17] Many small business owners chose to register their businesses as S corporations. This business structure limits their legal liability, while allowing owners to be taxed at rates applicable to individuals rather than corporations. Subchapter S corporations would not exist under flat tax proposals, but small business owners could still transfer business income to their individual returns in the form of salaries.

[18] An increase in the personal exemption would also benefit small businesses indirectly by increasing the after-tax wages of their low-skilled workers. Higher after-tax wages would encourage those presently employed to keep working, and would encourage those outside the labor force to seek employment. Small businesses employ proportionately more low-wage workers, so they would benefit more from this provision than large businesses (Wiatrowski).

[19] Although most economists find that a flat tax would reduce interest rates, a model by Feldstein is more ambiguous. With plausible parameters, Feldstein's model predicts a flat tax could lead to higher interest rates.

[20] Businesses who eventually become profitable can carry over deductions from previous years, but the value of these deductions still declines.

[21] This egregious example of a special tax break was first noted by Armey (p. 33).

22 A bill passed by the House and Senate would increase the investment deduction from $17,500 to $25,000 for small businesses. The provision is attached to minimum wage legislation and its fate is uncertain at press time.

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Small businesses selling luxury goods will take a mild hit. Who will pay for the basic income? High net worth individuals through higher taxes. As their pocket books take a hit, their spending will decrease. Purveyors of luxury goods like jewelry will see the biggest hitÂ Theoretically, it should be good for small businesses, because it would create new customers for them. It would allow a whole set of people who would not presently, say, buy a $5 latte to do things like that. So, it might increase the supportable number and success rate for small businesses in a way that having more rich people cannot; a billionaire doesnâ€™t buy 1000 $5 lattes a day, he still just buys 1 or 2. Nick Hanauer has written and spoken on the closely related topic of having a higher minimum wage. Small businesses are an important component in the U.S. economy, producing about half of private sector output and employing over half of the work force, so tax reformers need to understand how a flat tax would affect the small business sector of the economy.> Golob examines the effects of a flat tax on businesses in general and on small businesses in particular. He concludes that businesses in general are likely to benefit from a flat tax and that small businesses are likely to benefit more than large businesses. Most businesses would benefit from higher economic activity associated with a ...