IPI Insights
JUNE 1999

# Turning Lemonade Into Lemons

## How Government Puts the Squeeze on Entrepreneurs

*by Naomi Lopez*

America's strong entrepreneurial tradition has been for many the pathway to the American dream. In fact, most people at some point in their lives have envisioned owning and running their own businesses. But instead of fostering entrepreneurship, intrusive Big Government makes it difficult to attain such goals.

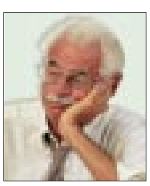
Already the vast majority of U.S. firms is composed of "small" businesses, employing fewer than twenty. These firms account for more than one-third of all American jobs. Almost half (49%) of all new jobs created between 1990 and 1995 were by firms with fewer than 20 employees. Firms with fewer than 500 employees were responsible for more than three-quarters (76.5%) of net new jobs.

In the next century, America's economic growth will rely even more heavily on the growth of smaller, technology-based firms that retain an innovative advantage over larger firms. When legislation is imposed that adversely affects this segment of business, repercussions are felt through many levels of the economy.

Today, the unchecked proliferation of federal, state, and local tax and regulatory requirements is impeding new business formation and expansion across the nation.

*continued on page 2*


**INSIDE:** Taxing the Internet



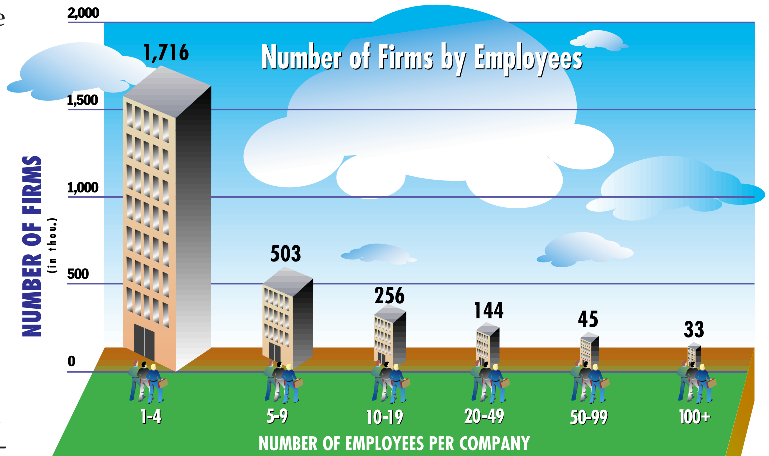
**ALSO:** Punishing Seniors who Work

# Turning Lemonade Into Lemons *continued*

Even well-intentioned government-sponsored programs that aim to spur business formation and economic development are destroying economic opportunity for our nation's families.

## The Tax Nightmare

The old adage, "Two things in life are certain: death and taxes," rings particularly true for our nation's entrepreneurs. Due to excessive taxation, businesses' cost of labor far exceeds the actual wages paid to their employees. Between 40 and 47 percent of an employer's expense in hiring and keeping a worker on the payroll is due to taxes and both mandated and optional benefits. Legally-mandated costs include Social Security/Medicare, federal and state unemployment insurance, and worker's compensation. Other costs can include paid leave, supplemental pay, insurance, and retirement plans.



The vast majority of U.S. firms are small businesses, employing fewer than twenty.
Source: U.S. Bureau of the Census data

In addition to the countless forms of taxation small business owners must face during their lifetimes, they must also anticipate the estate tax, which can exceed a rate of 50 percent. One-third of small businesses will be fully or partially liquidated to pay this tax. Half of those which liquidate will eliminate 30 or more jobs in the process.

> "One third of small businesses will be fully or partially liquidated to pay [the estate tax]."

The capital gains tax imposes additional penalties. It places a heavy financial burden on private investments, thereby actively discouraging individuals from shifting capital to start-up businesses or discouraging investment altogether. Moreover, taxing capital gains — after already taxing corporate and individual income — creates a "double" tax on those who invest in business formation and expansion.

As payroll, income, and capital gains taxes rise, less money is available in the capital markets, "crowding-out" wealth and job creation in the private sector. When available resources in capital markets dwindle, entrepreneurial endeavors are hindered.

## Regulating the Dream

Like taxes, the regulatory burden on small business has increased dramatically over the past few decades. For example, in 1992, the per-employee cost for complying with all federal regulations for a firm of between 1-19 employees was $5,545, but only $2,921 for a company with 500 or more employees. The total economic burden for regulatory compliance *on the federal level alone* is now $700 billion annually, or $7,000 per household. Absent any meaningful reform, that figure will continue to rise. In fact, absent the regulatory buildup since the beginning of the Johnson administration, the nation's Gross Domestic Product (GDP) could have been 20 percent higher today.

Regulations fall under the following three main categories: paperwork, environmental and risk reduction, and price and entry controls. Of the latter, wage laws comprise one of the most significant burdens on entrepreneurs, especially minimum wage laws. This is because small businesses provide the majority of entry-level jobs in America. Yet with every $1 increase in the federal minimum wage, it's estimated that 345,000 fewer jobs will be created in the year 2000. And it may be surprising to learn that environmental regulations can be more daunting to small businesses than taxes.

Laws that govern hazardous waste cleanup, known as Superfund, actually encourage owners of contaminated sites to warehouse space that might otherwise be used for entrepreneurial activity. The Occupational Safety and Health Administration (OSHA) issues mandatory workplace standards, conducts on-site inspections for compliance, and imposes fines for even minor noncompliance. This costs business $11 billion per year, while the economic benefits of preventing injuries and fatalities may be no higher than $3.6 billion, and possibly as low as zero. These costs are not only passed on to consumers, they may also squeeze-out a firm's spending in other areas,

> "With every $1 increase in the federal minimum wage, it's estimated that 345,000 fewer jobs will be created in the year 2000."

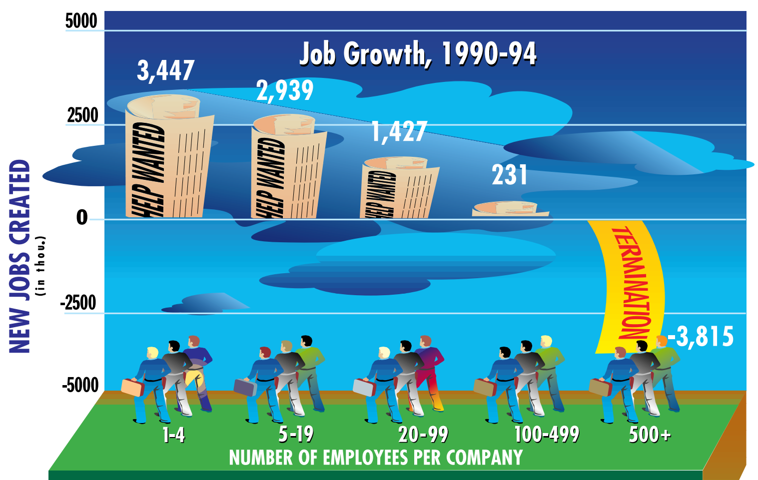
such as investing in technology or hiring more workers.

Lawmakers must understand the impact regulation has on both small business and the economy. A substantial regulatory rollback could provide a down payment on limiting the size and scope of government, while allowing America to fully unleash its entrepreneurial potential. Unfortunately, government intrusion is not limited to taxation and regulation.

## "Thanks, But, No Thanks"

An equally detrimental obstacle to the growth and development of new businesses is the practice of the government "helping" certain selected businesses and industries at the expense of others. This process works through transfer payments and subsidies that encourage business to seek gains through government largesse, rather than through productivity.

These counterproductive measures take the form of grants, direct payments, trade barriers, special tariffs, direct loans, government loan guarantees, management training, counseling, advisory services, and preferential tax rates. If they are directed at, or provide a special benefit to, one company or industry, it is corporate welfare. This is often used to protect U.S. companies from foreign competition at the expense of American consumers. The net effect of all this government meddling and intrusion into the private sector is to create economic distortions that misallocate resources from their most productive and rational uses. While the true annual costs are probably incalculable, this intrusion drains the economy of billions and reduces economic activity and growth.




Almost half of all new jobs created between 1990 and 1995 were a result of employment by firms with fewer than twenty employees. Source: Office of Advocacy, U.S. Small Business Administration, based on Cognetics, Inc. data.

## The Dream Potential

During this period of sustained economic growth it is easy to overlook the detrimental effects of government regulation and taxation on our nation's entrepreneurs. But the success of small firms and entrepreneurs is critical for continued economic prosperity. Policymakers should realize that there is always a need for positive policy change and that money directed to taxation, for example, is not available for private investment critical to business formation and job creation.

Today, lawmakers have a unique opportunity to fully unleash America's entrepreneurial potential. The current strong economy, coupled with a large budget surplus, provides lawmakers with many options, including:

- **Cutting taxes.** This will allow individuals and businesses to divert more money into capital formation.
- **Regulatory moratorium and rollback.** It is not enough to merely hold the line on new regulations. Lawmakers should commit to reducing the regulatory burden on entrepreneurs by sunsetting regulations through automatic termination.
- **Cutting government spending.** The greater the opportunity individuals have to keep more of their own money, the more conducive this will be to business formation and expansion.

If America is to remain competitive, innovative, and vibrant over the next century, we must be willing to fully foster small business formation and expansion. This means allowing individuals to direct their resources as they see fit, and allowing entrepreneurs to succeed or fail on their own merits, without stifling taxes, regulations, or government favoritism. IPI

*Naomi Lopez is director of the Center for Enterprise and Opportunity at the California-based Pacific Research Institute. This article was taken from* IPI Policy Report #149, Barriers to Entrepreneurship: How Government Undermines Economic Opportunity for Working Americans, *by Naomi Lopez. Copies are available upon request, and also are available on our website at www.ipi.org*

# TAXING OUR WORLD, BIT

*By Tom Giovanetti*

The other day, between lawnmowing chores, my neighbor and I were chatting over the fence about the various trials and tribulations of homeownership. During the course of the conversation I requested a piece of information from him, a phone number or something. As we returned to our respective mowers, he shouted back across the fence to me, "I'll email it to you."

Few recent innovations have affected our lives as thoroughly and as quickly as the Internet. Some services, such as Internet telephony, have the potential to revolutionize whole businesses. Long-distance phone calls through the Internet, at a fraction of the cost of going through the major long-distance carriers, is now a reality.

Bits are bits, and anything that can be converted to bits can traverse the globe at light speed and at almost no cost through the Internet. And at such speeds, there are no geographical limits on bits. Practically speaking, bits aren't limited to distance, time and speed, or to states and nations. Someday soon you won't pay any more for a long-distance call than you do for a local call. Once your voice has been converted to bits, it doesn't matter to anyone whether those bits land next door or in Zimbabwe.

Well, that's not exactly true. It does seem to matter to the government. Governments seem terribly concerned about anything they can't control, regulate and tax. And the government is getting terribly concerned about the Internet.

And that should concern us. Beyond making things much more expensive, taxes and regulation slow down innovation and distort the path of technological development. Does anyone believe that the Internet would have progressed as quickly and as efficiently if the government had directed its development?

Today, the government is getting involved in the Internet in a big way, and it is doing so through back-channel programs, hidden taxes, and a deceptively-named program called the FCC's Universal Service Program.

> "...taxes and regulation slow down innovation and distort the path of technological development..."

## Lessons from the Past

Here's a lesson in why a government program should be eliminated once it's finished. The Universal Service Program was instituted in 1934 to provide subsidized telephone service to rural communities.

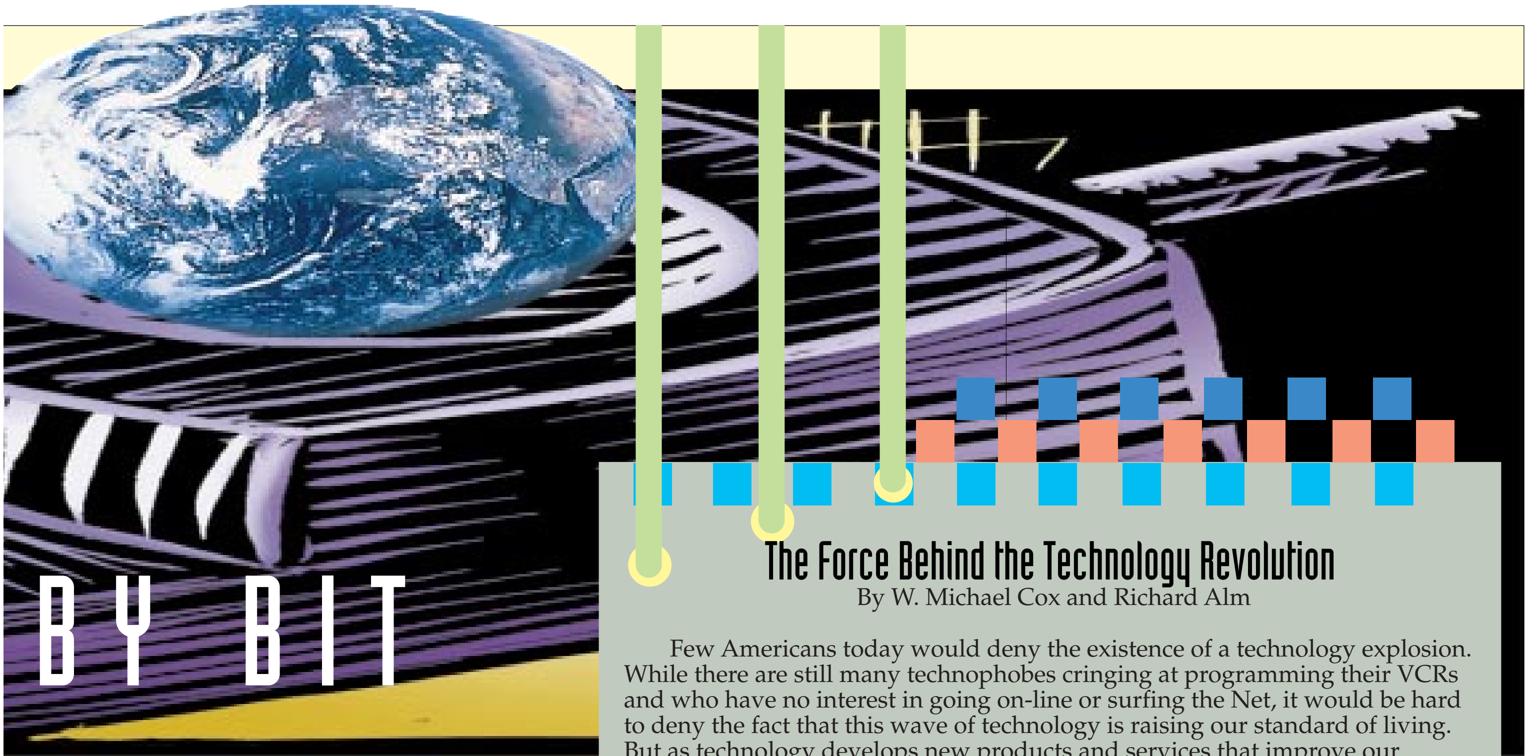
Today, I'm confident that everyone in America who wants phone service has phone service. Yet the Universal Service Program has no intention of shutting itself down, so yet again it has invented a cause for itself: wiring schools and libraries nationwide for the Internet.

This expansion of the Universal Service Program was implemented with great gusto by the Clinton administration. Rather than using existing Universal Service Funds, and rather than using education funding, the FCC imposed a new excise tax on phone carriers, who pass the charge onto consumers. This "e-rate," better known as the "Gore tax," is in the neighborhood of 5% of your phone bill.

That's bad enough. But when phone companies itemized the tax on their phone bills, the FCC was livid, and demanded that they hide the tax from consumers. But that is not the only troubling thing about the Gore tax.

First, why is the FCC imposing taxes at all? The FCC has no constitutional authorization to impose taxes. Second, if the cause is noble and has public support, why demand that the tax be hidden? And third, what about the dubious premise of the e-rate in the first place? Granted, having schools and libraries wired for the Internet is probably a good thing. In fact, 78% of schools already had Internet access before this new program started.

But taxing consumers to pay for dubious Internet-related government programs is only the tip of the iceberg. The Universal Service Program is an example of how the government will use any device at its disposal to get its hands on new sources of revenue, including the burgeoning field of Internet telephony.




## Taxes for the Future

The FCC has already announced that it "might" tax Internet telephony through its Universal Service authority by imposing access charges. Taxing Internet telephony would be another example of government standing between people and the technological solutions to their problems.

More important, the FCC would be adding taxes and regulations to the Internet, a previously tax-free environment that is generating jobs, innovation, and new forms of commerce for our economy. The Internet Tax Freedom Act shields much of the Internet but leaves a gaping hole for the FCC to impose charges on Internet telephony.

Congress should protect the Internet from taxes, fees, and regulations that will stifle its development. One way would be to declare the Universal Service Program a success, and shut it down.

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*Tom Giovanetti is president of the Institute For Policy Innovation (IPI).*

**UPDATE**: ***On May 27th, the FCC voted to increase the Universal Service Charge ("Gore tax"), by almost $1 billion. In addition, the FCC adopted a rule that would bar telephone companies from separately itemizing this tax so as to hide their actions from the taxpayers.***

## The Force Behind the Technology Revolution

By W. Michael Cox and Richard Alm

Few Americans today would deny the existence of a technology explosion. While there are still many technophobes cringing at programming their VCRs and who have no interest in going on-line or surfing the Net, it would be hard to deny the fact that this wave of technology is raising our standard of living. But as technology develops new products and services that improve our everyday lives, it propels the dynamics of economic growth. After all, every innovation must pass the most basic test of the marketplace: if people don't want it, they won't buy it. This marketing reality is tested every Saturday in retail establishments across the country. There, the most desirable technology is being consumed with a voracious appetite.

But where are all the new products coming from? The evolution of technology doesn't just happen. New products don't just suddenly appear in the marketplace. Ideas are sterile until an entrepreneur or a company transforms them into new goods and services or better production methods. The long, arduous process involves all the steps of the marketing plan, but comes with no guarantee of the product's success. However, there is one single incentive that continues to motivate the business community to take the monetary risk and bring us these new technological advances. It's called profit.

Capitalism provides the most tangible incentives to innovate by bestowing profit on those who bring successful products to market. Equally important to future economic growth, capitalism readily shifts money, people and other resources from producing yesterday's goods and services to what consumers will buy today and tomorrow. Its ability to unleash innovation and invention lies at the very heart of the great legacy of the American experience—economic progress.

By its very nature, capitalism seeks progress. Understanding this fact helps us see what speeds it up or slows it down. Because technology in large part drives growth, stepping up the pace of invention and innovation increases the speed of economic progress. As with most economic activities, putting technology to work has a lot to do with incentives. An economy will produce technological change faster when the costs of doing so go down or the benefits go up. Several factors influence the speed of the process: the breadth and depth of a society's existing endowment of technology, the introduction of inventions with wide-ranging uses, the time it takes for products to spread throughout society, and overall market size.

We are in the throes of one of history's great bursts of technology, put to use quickly and effectively by a vibrant market economy. Rising incomes add to the number of people who can afford to splurge on the latest bells and whistles. Falling transportation costs and quickening information flows can enlarge markets. The dismantling of trade barriers can open whole new markets to U.S. producers. For many products yet to come, the market will be global, so the rewards for successful innovation figure to be even greater in the next century.

In the meantime, free enterprise continues to be America's greatest welfare program. For more than two centuries, the system has worked to make our lives better. Whatever we've wanted—new and improved products, more leisure, better jobs, easier lives—it has provided in abundance.

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*Dr. Cox is senior vice president and chief economist at the Federal Reserve Bank of Dallas. Mr. Alm is a business reporter at the* Dallas Morning News. *They are authors of the new book* Myths of Rich And Poor *by Basic Books.*

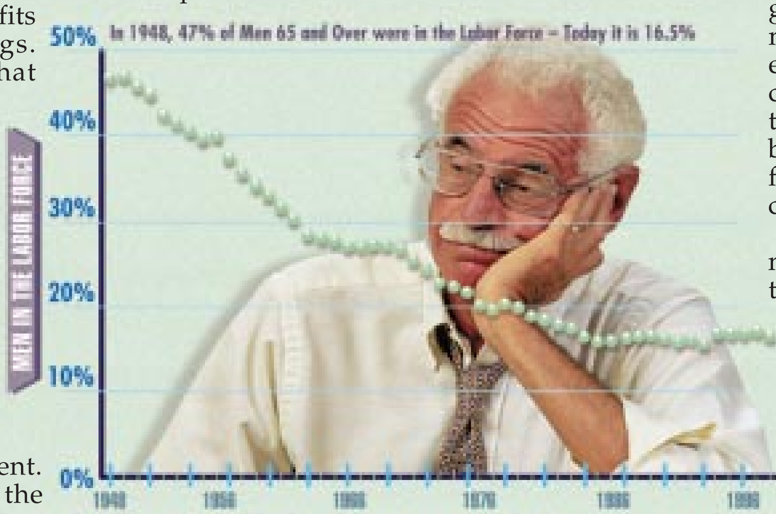
# The Earnings Test is Not Working


As you walk down the streets of America today you will notice that nearly every storefront features a"Help Wanted" sign. The classified section of the newspaper is overflowing with pleas for qualified help. Yet the government continues to enforce an archaic system that robs our country of the talents of some of its most experienced workers.

This archaic policy is called the *retirement earnings test,* an original feature of Social Security. It was spawned during the Great Depression as a way to keep older workers out of the work force to free up jobs for younger workers. Here's how it works.

"The long-run cost of eliminating the earnings test is almost nothing."

In 1998, workers between the ages of 65 and 69 lost $1 in Social Security benefits for every $3 in wages above the earnings limit of $14,450. People under 65 could earn up to $9,120 before losing $1 in benefits for every $2 in earnings. There is no limit on what people 70 and over can earn.




This puts a huge tax on wage income. Someone between 65 and 69 — paying no income tax but earning over the limit — would lose 33 cents out of the next dollar in wages. Add the Social Security and Medicare payroll tax and the marginal tax rate rises to 41 percent. For someone under 65, the tax rate is 57.65 percent. And for those who also pay federal income tax, marginal tax rates can reach well over 80 percent.

With rates this high, is it any wonder why fewer than 17 percent of men 65 and over are in the labor force today?

In 1996, Congress recognized that the earnings test was a disincentive to work, and responded by passing the "Senior Citizens Right to Work Act." It allowed for a higher earnings limit for workers between 65 and 69, who by 2002 will be able to earn up to $30,000 without penalty. Moreover, recently there have been calls to abolish the earnings test altogether. President Clinton did just that in his last State of the Union address, and legislation has been introduced in both houses of Congress to repeal it.

But so far the main obstacle to repeal the earnings test is cost. Under the current system $3.9 billion would be withheld from beneficiaries ages 65 to 69 in fiscal year 1999. However, with the increase in the earnings limit passed in 1996, combined with the delayed retirement credit, which increases benefits for people who postpone retirement past 65, the long-run cost of eliminating the earnings test is almost nothing.

On the other hand, the benefits of repeal are many. The increase in employment would mean more total output for the economy. It would help relieve the current labor shortage. And the extra growth would mean new federal payroll, income and excise taxes, which by 2010 would fully offset the cost.

The retirement earnings test is a relic from a time when jobs were scarce. It has no place in today's economy. In light of its negligible cost, our current federal budget surplus and the country's need for talented workers, there is no better time than now to totally repeal the earnings test. IPI

*This article was taken from the IPI Issue Brief entitled* Retiring the Social Security Earnings Test, *by Gary and Aldona Robbins. Copies are available upon request, and are also available on our website at www.ipi.org.*

# IMPACT









## IPI's Estate Tax Press Conference Garners National Attention

On March 17th in the Mansfield Room of the U.S. Senate, IPI released its study entitled "The Case for Burying the Estate Tax," by IPI Senior Research Fellows Gary and Aldona Robbins. Conference participants Senators Jon Kyl and John Ashcroft, as well as Representatives Jennifer Dunn and Jerry Weller, applauded the historical examination and statistical evidence presented in the study while calling for repeal of this section of the tax code.

The interests of America's small businesses, farmers, landowners, and seniors were also well represented by various trade and seniors organizations and tax limitation groups. The conference was covered by C-SPAN and GOV-TV, and was cited in several radio and print sources including *The Washington Post*.

During her stay in Dallas, Amity Shlaes of *The Wall Street Journal* (pictured here with Nikki and Dennis McCuistion) also participated in a taping of PBS's nationally televised *The McCuistion Program* segment entitled "Taxing Ourselves into Trouble."

## IPI Brings Amity Shlaes to Dallas

Amity Shlaes, member of *The Wall Street Journal*'s editorial board and author of *The Greedy Hand: How Taxes Drive Americans Crazy and What to Do About It* was the featured speaker at a recent IPI luncheon on May 11 – Tax Freedom Day for 1999.

Ms. Shlaes addressed the historical precedents for our current tax laws. She also expressed her belief that taxes should be "visible," "simple," "lower" and imposed only for the purpose of revenue generation and not as a form of social engineering.

Luncheon guests also enjoyed discussing with Ms. Shlaes the broad range of possibilities for innovative tax relief from candidates in the upcoming presidential and congressional elections.

Bill Beach of The Heritage Foundation, IPI Senior Fellow Gary Robbins, and the Washington Director for the National Tax Limitation Committee, George Pieler, at IPI's Estate Tax Briefing on Capitol Hill.

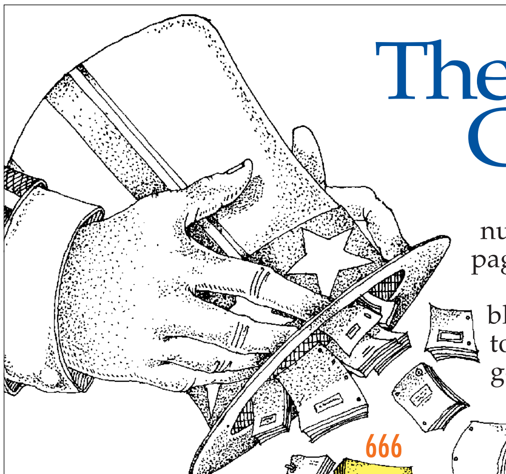
## IPI's Estate Tax Briefing for Hill Staff

At the request of Representative Jennifer Dunn, IPI held a briefing in April for Hill staffers providing information about federal estate taxes. Led by Gary and Aldona Robbins, IPI Senior Fellows and authors of "The Case for Burying the Estate Tax", twelve panelists from the business, legislative and policy communities presented an overview of current estate tax law, examined the human and economic costs, and suggested options for remedy.

## *Seattle Times* Invites IPI To Speak at Conference

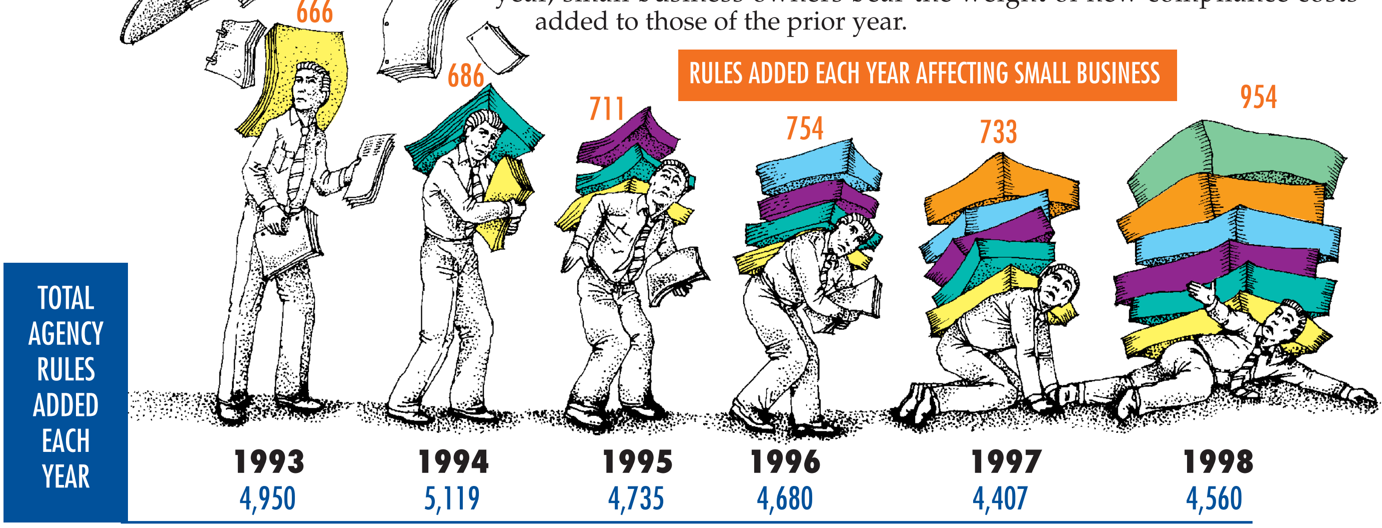
IPI Senior Fellows Gary and Aldona Robbins and Director of External Affairs Kerri Houston (pictured above) spoke at a recent conference on the estate tax held at the Capitol Hill Club in Washington, DC. Co-sponsored by *The Seattle Times*, the U.S. Chamber of Commerce and the Newspaper Association of America, the event was well attended by Congressional members from both Houses and parties, as well as trade associations and members of a national coalition to repeal the death tax.

# The Burden of Government Regulations



**When** it comes to discussions about government regulations, the total number of pages in the *Federal Register* is the most commonly used gauge. Those page counts continue to increase at a consistent pace each year.

But closer scrutiny of what is contained in those pages paints the more troubling scenario. The number of regulations affecting small businesses continues to build at a crushing pace. In 1998, of the 4,560 new rules written by various government agencies and added into the *Federal Register*, 954 regulations (more than 20%) had a direct impact on the way small businesses operate. Each year, small business owners bear the weight of new compliance costs added to those of the prior year.




The *Unified Agenda of Federal Regulations* is released each April and October by the Federal Regulatory Information Service Center and provides a detailed listing of what items of regulation are in the pipeline at those given times. The *Agenda* lists recently enacted rules as well as those anticipated within the upcoming 12 months. You can access this information at: http://cobar.cs.umass.edu/ua/

Source: from the *Unified Agenda of Federal Regulations*

## Parting Shots

The truly covetous are happy only if they are able to harm their neighbor by taking something from him or her. The easiest way to do so, other than to use a sword or gun to heist someone's wallet, is to use political power.

**Doug Bandow** in ***The IRS v. The People***

The Center for the Study of American Business at Washington University in St. Louis has tallied up spending on federal regulatory agency budgets and staffing, concluding that the cost of operating 61 agencies will reach an all-time high of $17.9 billion (in 1999). So much for shrinking the federal government.

**Cindy Skrzycki, *Washington Post***

History tells us that politicians in office during periods of budget surpluses behave like alcoholics in liquor stores—they like to go on a spending spree. There is a statistically significant positive correlation between budget surpluses and federal spending in the following year.

**Richard Vedder** in ***Investor's Business Daily***

The government shoveled out more than $1 billion in food-stamp overpayments in 1998 to ineligible recipients, including prisoners and dead people, according to the Government Accounting Office. Outsized and redundant bureaucratic machinery also gobbles up more than its share. For example, Americans have two federal agencies diligently guarding them from defective frozen pizzas…the Department of Agriculture inspects meat pizzas, while the Food and Drug Administration keeps an eye on cheese-only pies.

***World Magazine***

"The liberals are very emotive, and they're not at all bound by facts. Their purpose is to build bigger government that employs more of their own services. They're very beguiling in wrapping that greed in the language of love. It seems so much more compassionate. But true compassion lies in telling the truth and being honest with people."

**Dick Armey** quoted in ***World Magazine***

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