AMERICAN ACTION FORUM

The Future of Tax Policy: Implications for Small Business and Entrepreneurs

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Executive Summary

With tax day fast approaching, there is a considerable lack of clarity about what the tax code will look like this time next year. Small businesses and entrepreneurs are especially sensitive to current and expected tax policy given that they must make important, long-term decisions today on investment, hiring, and expansion. Accordingly, the highly uncertain outlook for U.S. tax policy has high stakes for their growth and survival. This paper examines the elements of three possible scenarios:

- The "autopilot" scenario failure of White House leadership that defaults to large tax increases at the end of 2012;
- Enactment of the president's policies that include higher taxes and large deficits; and
- The House-passed budget containing tax and entitlement reforms.

The autopilot scenario - the most immediately threatening of these three scenarios - would hurt overall economic growth and harm small business directly, resulting in a loss of between 300,000 and 2.9 million jobs. The higher marginal tax rates come 2013 would reduce the probability that a small business entrepreneur would add to payrolls by roughly 18 percent and diminish the growth in payrolls by over 5 percent. The probability that a small business undertakes expansion falls by nearly 15 percent, and reduces the capital outlays of those that do by almost 20 percent.

The president's proposals would also result in the damaging effects of higher marginal tax rates in the autopilot scenario. However, they would also result in diminished incentives for saving and investment, reduced international competitiveness, and a more complex and manipulated tax code. The prospect of this policy future already hampers the current performance of the small business sector.

Only the House budget option provides an improved climate for growth, expansion, hiring and investment by small businesses and entrepreneurs
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Introduction

Tax policy is a central aspect of the economic landscape for entrepreneurs and small businesses. Empirical evidence shows that increases in marginal tax rates strongly affect the growth, hiring, investment, and survival of those enterprises.[1] At the same time, small businesses are the foundation of the nascent economic recovery. According the *ADP National Employment Report* since January 2010 total payroll employment has expanded by 3.4 million jobs. Only 184,000 – under 6 percent – of those jobs were created in firms with greater than 500 workers. And nearly half, 1.6 million, were created by firms with fewer than 50 employees. Thus, at this juncture tax policy toward entrepreneurs and small business is crucial. Unfortunately, America's small businesses and entrepreneurs have never faced a more challenging and uncertain tax environment.

One possible future is "autopilot," in which a failure of leadership permits in December 2012 the sunset of the 2001 and 2003 tax laws, the payroll tax holiday, and numerous annual extenders. A second possibility is that the proposed policies of President Obama are fully implemented. A final scenario is that reforms embedded in the House-passed budget resolution are implemented.

The evidence suggests that doing nothing or pursuing the president's agenda would be damaging to small businesses and entrepreneurs. In contrast, fundamental tax and entitlement reforms in the House budget would provide a beneficial economic environment for emerging enterprises.

Potential Tax Futures

The future of tax policy is fundamentally unknowable and the range of possible paths is quite large. In this section, I review the possible futures and their implications for small businesses and entrepreneurs.

Autopilot

The list of tax provisions that will expire at the end of December 2012 is daunting: the temporary payroll tax holiday, the estate tax, the alternative minimum tax, and the research and development tax credits. Given the potential for marginal tax increases, the damage from each possible tax increase is clear.[2] With a divided Congress, White House leadership is essential to avoiding this threat. The most significant threat arises from the potential sunset of the Economic Growth Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA).

The future of EGTRRA and JGTRRA is central to small business tax policy.

A large swath of U.S. economic activity is organized in sole-proprietorships, partnerships, and other pass-thru entities that are directly affected by the individual income tax. The Joint Committee on Taxation estimates that roughly $1 trillion in business income will be reported on individual income tax returns in 2011. Notably, of that $1 trillion, nearly one-half, $470 billion, will be reported on returns that will be subject to the top two rates of 36 percent and 39.6 percent if EGTRRA and JGTRRA are allowed to sunset.[3]

This has direct effects on employment. According to the Small Business Administration, there are almost 120 million private sector workers in the United States. 60 million of those workers work for small business. About two-thirds of the nation's small business workers are employed by small businesses with 20 to 500 employees. According to Gallup survey data conducted for the National Federation of Independent Business (NFIB), half of the small business owners in this group fall into the potential

[1] See, for example, Carroll, Robert, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen. 2000. "Income Taxes and Entrepreneurs' Use of Labor." *Journal of Labor Economics* 18(2) (April):324-351; or Carroll, Robert, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen. 2001. "Personal Income Taxes and the Growth of Small Firms." In James M. Poterba (ed.), *Tax Policy and the Economy*, Volume 15. Cambridge, MA: MIT Press.

[2] See, for example, "Changing Views Of The Estate Tax: Implications For Legislative Options," Douglas Holtz-Eakin and Cameron T. Smith, The American Family Business Foundation, 2010.

[3] The Joint Committee on Taxation analysis does not take into account the impact on small, non-publicly-traded "C" corporations. There are several million of these entities, which will likely be adversely affected by the marginal rate increases on ordinary and capital income.

36 percent and 39.6 percent tax brackets. This means there is a pool of more than 20 million workers in those firms directly targeted by the higher marginal tax rates. This is a conservative estimate as it ignores flow-through entities with one to 19 workers.

Allowing EGTRAA and JGTRAA to sunset would be an enormous tax increase – roughly 2.5 percent of Gross Domestic Product (GDP) – and a direct threat to the small business sector. According to the Congressional Budget Office (CBO), a rough estimate[4] of the impact on the economy, would be slower GDP growth between 0.3 and 2.9 percent. Using the administration's own multipliers, this would result in the loss of between 300,000 and 2.9 million jobs. Given that small business drives this economic recovery, they would be hit particularly hard.

In the other direction, a temporary extension of EGTRRA and JGTRRA will merely defer resolving the uncertainty over the tax policy outlook. In contrast, a permanent extension would set expectations, permit long-range business planning, and support long-term economic growth. Notice that at the same time, there would be *immediate* economic benefits as businesses step up their spending to match the improved long-run outlook.

In thinking about the possible sunsets in EGTRRA and JGTRRA, it is useful to recognize that not all the components are equal from a growth perspective. Innovation, investment, and saving decisions are directly affected by structure of marginal tax rates, the taxation of returns to equity investment in the form of dividends and capital gains, and provisions for capital cost recovery (e.g., Section 179 expensing). In contrast, provisions for refundable tax credits, marriage penalty relief, and other targeted incentives make no contribution to growth incentives.

Indeed, the impact of phase-outs of refundable credits may have even more perverse growth consequences. As noted in Brill and Holtz-Eakin (2010), some provisions (exacerbated by the phase-outs in the recently-passed Patient Protection and Affordable Care Act (PPACA)) contribute to high marginal tax rates.[5] The effect is to raise to as high as 41 percent the effective marginal tax rate on some lower-income U.S. workers. This has implications for the ability of families to rise from the ranks of the poor, or to ascend toward the upper end of the middle class. This growth and mobility is the heart of the American dream and is the most pressing issue at this time.

In addition, a broad spectrum of provisions creates more complexity that is costly for small businesses and individuals. In some other cases they effectively raise marginal rates: Ways and Means GOP tax staff calculate that the net effect of these non-rate provisions is to raise effective marginal tax rates by 2 percentage points.

A picture emerges in which permanently preserving certain aspects of the tax code – low marginal tax rates, low taxation of dividends and capital gains, – is central to a successful growth strategy. What is at stake? If the top rates are permitted to rise the marginal tax rate on the return to small businesses will rise to roughly 42 percent (39.6 plus the roughly 2 percent hidden marginal rates. Note that this excludes the 3.9 percent tax in the PPACA.). This will diminish incentives to expand payrolls and establishment size, as well as tilt the playing field in favor of corporate investments that will face a 35 percent rate. Less dramatic effects in the same direction are posed by higher tax rates on capital gains. However, the most striking blow on growth-oriented investment is the increase in taxation of equity returns in the form of dividends from 15 percent to the top effective rate of 42 percent.

[4]Congressional Budget Office. The Budget and Economic Outlook 2012-2022. January 2012. http://www.cbo.gov/sites/default/files/cbofiles/attachments/01-31-2012_Outlook.pdf
Of note – CBO's estimates include some spending effects not taken into account here.

[5] Brill, Alex and Holtz-Eakin, Douglas, "Another Obama Tax Hike." *Wall Street Journal,* February 4, 2010. See also, Douglas Holtz-Eakin and Cameron Smith, "Labor Markets and Health Care Reform, 2010. http://americanactionforum.org/files/LaborMktsHCRAAF5-27-10_0.pdf

An increase in the top effective income rate from 35 percent to 42 percent would lower the probability that a small business entrepreneur would add to payrolls by roughly 18 percent. Similarly, for those that do manage to hire, the growth in payrolls would be diminished by over 5 percent. Put differently, the heavier burden of taxation would be shifted toward workers by hiring less, paying less, or some combination of both. Other things being the same, this is neither a progressive shift nor supportive of growth.

The same tax hike also affects incentives for capital expenditures, reducing the probability that a small business undertakes expansion by nearly 15 percent, and reducing the capital outlays of those that do by almost 20 percent. As these expansionary incentives are muted, the demand for capital goods is diminished – thereby shifting the burden to workers and investors in those firms.

To summarize, a failure to take action and permit EGTRRA and JGTRRA to sunset poses a large economic threat, and a body blow to small and entrepreneurial businesses.

President Obama's Policies

Over the course of his election campaign and years in office, President Obama has enunciated many policy goals. Some – e.g., a windfall profits tax on oil companies – appear to have been tailored for the politics of the moment. Others, however, are staples of his economic philosophy and thus key elements of the landscape that the small business community and entrepreneurs will have to navigate.

Large debts. The president has run 4 years of deficits over $1 trillion dollars, and the federal government faces enormous budgetary difficulties, largely due to long-term pension, health, and other spending promises coupled with recent programmatic expansions.

Over the next ten years, according to the CBO's analysis of the President's Budgetary Proposals for Fiscal Year 2013, the deficit will remain near or above $500 billion. Ten years from now, in 2022, the deficit will remain at 3 percent of GDP, roughly $730 billion and rising. The federal government will devote $4.8 trillion to interest payments alone, in part because debt in the hands of the public will rise from $11.4 trillion in 2012 to $18.8 trillion in 2022.

The U.S. federal debt has already suffered a downgrade and a fiscal crisis is now a threatening reality. Financial markets no longer can comfort themselves with the fact that the United States has time and flexibility to get its fiscal act together.

For the small businesses and innovators of Main Street America, it would be devastating if lenders revolt over the outlook for debt and cut off U.S. access to international credit. Getting spending under control in such a crisis will be much more painful than a thoughtful, pro-active approach. There will be a greater pressure to resort to damaging tax increases. The upshot will be a threat to the ability of the United States to bequeath to future generations a standard of living greater than experienced at the present.

Indeed, the price is already being paid. Historically, when gross federal debt exceeds 90 percent of GDP, growth falls by an annual average of 1 percentage point. With U.S. debt now larger than the size of the economy – over $15 trillion – this growth penalty is the equivalent of 1 million jobs annually.

Higher taxes and marginal rates. The president has been unrelenting in the pursuit of higher taxes and higher marginal tax rates. His budget proposes to raise overall taxes to nearly 20 percent of GDP by 2022 – well above the historic norm. His healthcare reform contained $500 billion in new taxes, including a 3.8 percent increase in the marginal tax rate on the return to saving, innovation and investment. He has consistently fought for a higher estate tax, with commensurate damage to wealth accumulation and the expansion of small and family businesses.

Most significantly, he insists that the EGTRRA and JGTRRA laws be modified to raise the top two marginal tax rates. As noted above, it is precisely these two rates that affect an enormous amount of small business economic activity, would raise the effective tax rate on saving and investment, and would deter small-business job creation.

Higher taxes on saving and investment. The U.S. suffers from subpar economic growth and would benefit from permanent, pro-growth policies. As a corollary, it is important that taxes do not deter innovation, business-start ups, saving or investment, the building blocks of a higher standard of living in the future. In addition to higher marginal tax rates, the president proposes higher taxes on certain capital gains and reductions in depreciation – both serving to raise the effective tax rate on investment.

Less Internationally Competitive. For many years the president has proposed to reduce or eliminate deferral of tax on overseas profits. More recently, he proposed to add a new "minimum tax" on overseas profits.

These proposals push reform in the wrong direction. The corporate income tax harms our international competitiveness in two important ways. First, the 35 percent rate is far too high: when combined with state-level taxes, American corporations face the highest tax rates among our developed competitors.[6] The rate would need to be reduced to 25 percent or lower to match the competition. The president proposes a reduction to only 28 percent.

Second, the United States remains the only developed country to tax corporations based on their worldwide earnings. Our competitors follow a territorial approach in which, say, a German corporation pays taxes to Germany only on its earnings in Germany, to the U.S. only on its earnings here, and so forth. If we were to adopt the territorial approach, we would place our firms on a level playing field with their competitors.

The president argues that because his proposals don't let American firms enjoy lower taxes when they invest abroad, they give no incentive to send jobs overseas. Imagine two Ohio firms, they say: one invests $100 million in Ohio, the other $100 million in Brazil. The worldwide approach treats the profits on these two investments equally, wisely giving the company that invests in Brazil no advantage over its competitor.

But this line of reasoning ignores three points. First, because firms all over the world will pay lower taxes than the two Ohio companies, the likeliest outcome of the scenario is that both firms will fail, unable to compete effectively with global rivals. Second, when American multinational firms invest and expand employment abroad, they tend also to invest and expand employment in the United States. In the end, healthy, competitive firms grow and expand, while uncompetitive firms do not, meaning that our goal should be to make sure that American companies don't end up overtaxed, uncompetitive, and eventually out of business.

And finally, because the U.S. is the holdout using a worldwide approach, it is at a disadvantage as the location for the headquarters of large, global firms. As the U.S. loses headquarters, it will lose as well the employment, research and manufacturing that typically is located nearby.

Small businesses have a stake in the future of corporate tax reform because small businesses are important suppliers to large, global corporations and *vice versa*. Improving global competitiveness has benefits for all.

A more complicated tax code. The president has created and continues to propose numerous targeted and temporary tax provisions for select constituencies including energy suppliers, particular new hires, manufacturers and others. This approach increases the complexity of the code and threatens to ensnare entrepreneurs and small businesses in its web. The Buffet rule is a leading example of such dangers.

First, as the Congressional Research Service documents, the average effective tax rate among

[6] Some defend the high corporate tax rate by arguing that the effective corporate tax rate is much lower. This misses an important point. Every country's effective tax rate is also lower than its statutory rate. A recent study by two economists at the University of Calgary (http://www.cato.org/pubs/tbb/tbb_64.pdf) concludes that the marginal tax rate in the U.S on new investment is 34.6 percent, higher than any other country in the OECD.

millionaires is already 30 percent.[7] The President is solving a problem that does not exist.

The future of the Buffett rule is also problematic for small businesses. Recall that the Alternative Minimum Tax (AMT) was born in 1970 to make sure that 155 high-income Americans paid more taxes. Forty years later, it has transformed to a perennial threat to the middle class, annually consumes Congress in a struggle to protect the middle class, complicates the code enormously, and stands as a testament to the need for tax reform.

Of course, some will have effective rates below 30 percent. But tax policy reflects the balance between objectives of economic growth, ease of compliance, cost of administration, social policy, and fairness. The fact that some millionaires have tax liability below the "fair" level means that they are contributing to these other objectives.

The Buffett rule also gets in the way of real tax reform. Real tax reform would mean raising the desired revenue with a broader base and the lowest rates possible. The Buffett rule goes in the wrong direction, targeting a narrow base (millionaires) with higher rates.

Finally, the Buffett rule is estimated to raise only $46 billion, when the deficit annually exceeds $1 trillion. In contrast, real tax reform could raise the average growth rate by at least 0.3 percentage points annually, which would raise federal revenues in the range of $80 to $100 billion. Put differently, pursuit of the Buffet rule at the cost of real tax reform makes the deficit $35 to $55 billion worse every year.

House Budget

The U.S. suffers from the dual problems of poor growth and high current and projected debt.

Selected Complex and Targeted Provisions of the President's Tax Policies

Provide additional tax credits for investment in qualified property used in a qualified advanced energy manufacturing project

This 30 percent investment tax credit for the construction, re-equipping, or expansion of a favored manufacturing facility first appeared in the American Recovery and Reinvestment Act of 2009. The President's 2013 budget requests an additional $5 billion, on top of the original $2.3 billion, which has been spent.

Target the domestic production activities deduction to domestic manufacturing activities and double the deduction for advanced manufacturing activities

The proposal is a disguised energy policy that excludes any gross receipts derived from the production of oil and gas, coal and other hard mineral fossil fuels, and certain other nonmanufacturing activities. At the same time it is an industrial policy that increases the deduction rate for manufacturing activities involving certain advanced technology property to approximately 18 percent.

Extend and modify certain energy incentives

This proposal beefs up subsidies for the President's favored energy sources. Current law provides production and investment tax credits for wind facilities, but this proposal would extend the credits an additional year. In addition, for property placed in service after 2012, the proposal would replace the grant program with a refundable income tax credit and make the credit available for property on which construction begins between 2009 and 2013.

Deny deduction for punitive damages

A basic principle of taxation is that costs are deducted prior to computing tax. Here, in order to *raise $319 million over ten years*, this proposal removes a deduction for punitive damages in the wake of a settlement or lawsuit paid or incurred by the taxpayer, even if paid by insurance.

Eliminate special depreciation rules for purchases of general aviation passenger aircraft

This provision targets the depreciation schedules of corporate jets; raising it from five years to seven years.

Financial Crisis Responsibility Fee

In order to recoup Troubled Asset Relief Program (TARP) losses in the wake of the recession, this proposal assess a fee on U.S.-based bank holding companies, thrift holding companies, certain broker-dealers, companies that control certain broker-dealers, and insured depository institutions effective January 1, 2014. The fee applies to firms, including the American International Group (AIG), which have paid nearly all of their TARP loans, yet exempts U.S. automakers and Fannie Mae and Freddie Mac.

Historically, countries that have a simultaneous growth problem have found that the successful

[7] See http://www.fas.org/sgp/crs/misc/R42043.pdf

strategy has been to keep taxes low and then cut spending on transfer programs and government employment.

The House-passed budget contains a fundamental tax reform that lowers marginal rates, eliminates unfair subsidies, and improves the competitiveness of U.S. global firms. If enacted, this would be a tremendous improvement in the policy toward entrepreneurs and small businesses.

That budget also contains fundamental reforms of broken entitlement programs – Social Security, Medicare, and Medicaid – thereby ensuring that they survive to the next generation of seniors and low-income Americans. In this process, it stems the flow of red ink that threatens another downgrade of the U.S. and ensuing financial crisis. By taking sharp tax increases and credit market freezes off the table, this provides a much-improved policy outlook for small businesses.