



Testimony before the House Committee on Small Business

The Tax Outlook for Small Businesses: What's on the Horizon?

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*The views expressed in this testimony are those of the author alone and do not necessarily represent the views of the American Enterprise Institute.*

Chairman Graves, Ranking Member Velazquez and Members of the Committee, I am honored to be invited to testify on the topic of small businesses and tax policy. This testimony documents the impact of higher tax rates, higher health care costs and policy uncertainty on entrepreneurs and small businesses. The academic literature suggests that higher taxes and new taxes (such as those outlined in the Patient Protection and Affordable Care Act) not only affect the formation of new businesses, but also adversely impact the growth and survival of existing businesses. Moreover, uncertainty in policies relating to government spending and taxes further constrains business activity. This policy lesson is particularly relevant in the current economic climate when we have seen limited hiring and capital investments by not just small businesses, but also large businesses. Raising taxes on these businesses will negatively affect the weak economic recovery. To get the economy on the path to sustainable growth, we need to understand that raising taxes and health care costs on these businesses is the wrong policy prescription for these times.

### 1. The Importance of Small Businesses to the Macroeconomy

I would like to begin my testimony by stressing the importance of small businesses in the U.S. economy. Small businesses, typically defined as firms with fewer than 500 employees, contribute almost 50 percent of U.S. GDP.<sup>1</sup> According to the Census Bureau, they account for about half of all private sector employment and represent more than 99 percent of all employer firms.<sup>2</sup> In terms of job creation, they account for 65 percent of net new jobs over the previous 17 years, and they pay approximately 43 percent of all private wages and salaries.

The topic of job creation by small businesses has generated heated debate among academic economists. Much of the previous literature, and even some recent papers such as by Neumark, Wall and Zhang (2009), finds an inverse relationship between firm size and job creation rates. In other words, small firms contribute disproportionately to net job growth. Haltiwanger et al. (2010) further qualify this argument by suggesting that firm size is a proxy for firm age. Young firms, or new start-ups, contribute substantially to both gross and net job

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<sup>1</sup> <http://www.sba.gov/sites/default/files/sbfaq.pdf>

<sup>2</sup> <http://www.census.gov/econ/smallbus.html>. In 2009, there were 27.5 million businesses in the United States. Of these, 5.9 million were employer firms and the rest were non-employers. Small firms represented 99.7 percent of all employer and non-employer firms. Further, of the 120.9 million nonfarm private sector workers in 2008, small firms employed 59.7 million and large firms employed 61.2 million.

creation. Since young firms tend to be small, the inverse relationship between firm size and job creation is in fact, an inverse relationship between firm age and job creation. Business startups account for roughly 3 percent of U.S. total employment in any given year. While this is a reasonably small share of the stock, it is large relative to the net flow which averages around 2.2 percent per year.

However, as per the Small Business Administration, Office of Advocacy, the current recession has had a negative impact on small businesses. Between 2007 and 2010, employer establishment births dropped 12 percent from 844,000 to 742,000.<sup>3</sup> Of the total number of firm births, about 85 percent are new employer firms, or start-ups, that are small businesses, while the remaining 15 percent tend to be new locations for existing businesses that expanded their operations. In the second quarter of 2008, the establishment start-up rate fell below 3 percent for the first time since figures were recorded in the early 1990s. The latest startup rate for which data is available is 2.7 percent in the second quarter of 2011. Moreover, the start-ups being created now are smaller on average than they were in 1999. In other words, they are creating fewer jobs. Given the important role that start-ups play in job creation, this recession has been particularly bad for small employer firms.

When considering these statistics, we need to question what role policy can play in helping small businesses recover from the effects of the recession and get them hiring again.

## II. Demographic Characteristics of Small Businesses

Although policy debates often focus on “small business owners”, there is little consensus about what distinguishes a small business from other businesses. Previously, any individual who reported receiving flow-through business income would count as a small business owner. However, a 2011 report issued by the Office of Tax Analysis at the Department of Treasury, provides a clearer picture of who exactly is a small business owner. The OTA (2011) report looks at six tax forms and schedules filed by individuals or firms that could potentially represent business activity. Using various criteria, they find that 54 percent of taxpayers who file one of the six forms or schedules would qualify as small businesses for the tax year 2007. Further, these businesses represented 17 percent of total and net business income. Slightly more than 20

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<sup>3</sup> <http://www.sba.gov/sites/default/files/Startup%20Rates.pdf>

percent of these small businesses are employer firms. In the aggregate, there are 20 million filers who qualify as small businesses and they report \$376 billion in net business income.

In terms of the marginal tax rates that apply to these businesses, the OTA report shows that 11 percent of small business owners have adjusted gross incomes higher than \$200,000 and these businesses reported 64 percent of the total small business income.

The income distribution within small businesses is as follows: Slightly more than 50 percent of firms reported less than \$50,000 in total income, 30 percent earned between \$50,000-\$250,000 and the rest earned between \$250,000-\$10 million. Only 6 percent of small businesses reported more than \$1 million in income and less than 1 percent earned between \$5 million -\$10 million. Hence the distribution is highly skewed.

In terms of employment, employer firms were considerably larger than non-employers with employer firms reporting average total income of \$922,100 compared to \$99,000 for non-employers. Employer firms paid a total of \$945 billion to workers, an average of \$174,200 per small business that reported any wage expense. Relative to all business entities regardless of size, small businesses reported 23 percent of total labor payments made to employees who were not owners/officers of the firm.

Conducting the analysis in terms of adjusted gross income, 11 percent of small business tax returns reporting 64 percent of all small business income had AGIs over \$200,000. This represents 1.6 percent of all taxpayers and 50 percent of all taxpayers with AGIs above \$200,000. Moreover, this represents about 8.5 percent of all income in the brackets above \$200,000. Within employer businesses, the distribution of business owners and income is more concentrated in the upper income ranges. For instance, nearly 24 percent of all owners are above the \$200,000 AGI cutoff and they reported 76 percent of all income from these businesses.

This has implications for the marginal tax rates faced by small businesses. As per the report, approximately 4 percent of small businesses in 2007 faced the high marginal tax rates of 33 and 35 percent. However, nearly 32 percent of small business income was subject to this tax. If we include the businesses subject to the AMT, another 12 percent of returns reported paying AMT rates of 26 and 28 percent, and the income subject to AMT was 26 percent. For employer businesses in particular, 10 percent of returns and 38 percent of income was subjected to the high marginal rates of 33 and 35 percent. For those subject to AMT, the corresponding numbers were 21 percent and 30 percent, respectively.

Therefore, these numbers are important to keep in mind when considering the impact of proposed tax changes on taxpayers and particularly small business owners. Future tax policy changes (discussed in the next section) will result in increases in marginal tax rates on small businesses at the higher income ranges, and employer businesses in particular. Further, new taxes and tax increases under health care reform will impact all small businesses more generally.

### III. Policy Challenges for Small Businesses

The National Survey of Small Business Finances is a survey of U.S. small businesses conducted by the Board of Governors of the Federal Reserve. The survey collects information on firm and owner characteristics, an inventory of small businesses' use of financial services and of their financial service suppliers, and income and balance sheet information. A part of the survey is questions relating to typical problems faced by small business owners. In every year of the survey, small business owners listed taxes and health care costs as the two major problems facing businesses.

Tax policy is perhaps one of the first factors to consider when discussing the issues of concern to small businesses. Entrepreneurs face a complex and ever-changing web of federal, state, and local (and sometimes international) tax rules and burdens. However, even aside from the complexity, one of the major issues facing businesses today is the impending tax hike as a result of the expiration of the Bush tax cuts for individuals earning more than \$200,000 (families earning more than \$250,000) as well as the taxes imposed as part of the Patient Protection And Affordable Care Act (PPACA). In his budget proposal for 2013, President Obama has proposed raising the top marginal income tax rate on individuals earning more than \$200,000 (and couples earning more than \$250,000) from 35 to 39.6 percent. Many small employers pay taxes using the individual tax brackets, and as we explained above, a large share of small employer profits are taxed in the top bracket.

Under PPACA, the first tax increase on small employers is a Medicare payroll tax hike. The Medicare payroll tax for wages and self-employment earnings in excess of \$250,000 for couples (\$200,000 for singles) will rise from 2.9 percent to 3.8 percent. This is a direct tax hike in the marginal income tax rate paid by the self-employed and general partners.

The Affordable Care Act also imposes a 3.8 percentage point hospital insurance tax on investment income over \$250,000 starting in 2013. Some of this so-called “investment income”

is actually small business profits. Notably, investors in small businesses (limited partners and passive shareholders in Subchapter-S corporations) will face this tax. Active trade or business income is excluded, but of course most of that will face the higher Medicare tax described above. This provision will make it harder for employers to raise capital in order to create jobs and expand business operations.

Next is the employer mandate. The employer mandate, which takes effect in 2014, will apply to all firms with 50 or more employees. If an employer fails to provide “qualifying health insurance”, these employers will have to pay a per-employee excise tax fine. The tax is \$2,000 per employee (\$3,000 if an employee receives coverage through an exchange). If the employer has a waiting period to get into the plan, there is an additional tax of \$400-\$600. A small employer with 100 employees could easily find himself paying a tax of \$300,000 per year. Even if an employer provides health insurance, it can be deemed “unqualified” by HHS.

Finally, we again turn to the individual mandate. Many self-employed people choose not to have health insurance — because either they would rather self-insure, they have a mini-med plan or they want to retain capital in their small businesses. This choice is stripped of them by the Affordable Care Act. Starting in 2014, everyone must obtain “qualifying” health insurance or face an excise tax of at least 2.5 percent of adjusted gross income. If they are an employee of their own firm which has at least 50 employees, the firm would also be subject to the employer mandate excise tax described above.

In the next section, I will present the academic literature on the topic of taxes, health care costs and entrepreneurship. Following that discussion, I will also emphasize the effect of policy uncertainty on the business decisions of small firms.

#### IV. Taxes and Entrepreneurship

What are the effects of high taxes on entrepreneurship? There is a vast academic literature studying this topic. Many papers have studied transitions from wage and salary employment to entrepreneurship as a function of the different tax rates faced by individuals and firms. This option is valuable to the extent that personal income is taxed at a higher rate than corporate income. In recent years in the U.S., the corporate tax rate for a small firm could be as low as 15%, which is below the marginal personal (plus payroll) tax rate faced by effectively all individuals. As a result, a firm generating tax losses will prefer to be noncorporate so that the

entrepreneur can deduct these losses against other personal income, saving on personal income taxes. When and if the firm generates profits, in contrast, for tax purposes the entrepreneur will prefer to incorporate so that these profits are taxed at the lower corporate tax rate. The paper by Cullen and Gordon (2002) shows that reducing the minimum corporate income tax by 5 percentage points leads to a doubling of entrepreneurial activity in different quintiles and in the aggregate. If personal income tax rates were cut by 5 percentage points, this would lead to a nearly 30 percent drop in entrepreneurial activity, with larger percentage drops in the highest earning quintiles. Finally, a flat tax of 20 percent would increase self-employment activity by 15 percent. Such a tax cut reduces the taxes saved from deducting business losses, while profits remain largely taxed at the corporate tax rate. As a result, risk taking is discouraged. In addition, as emphasized by Domar and Musgrave (1944), a lower personal tax rate implies less risk-sharing with the government, in itself making self-employment less attractive to risk-averse individuals. The potential tax savings from going into business simply to reclassify earnings as corporate rather than personal income for tax purposes also falls when personal tax rates fall.

In another paper, Gentry and Hubbard (2000) show that the less progressive is the income tax schedule, the greater the incentive to entrepreneurial entry. Gentry and Hubbard (2000) emphasize a different effect of the tax system on risk-taking that arises even if investors are risk-neutral. If the marginal tax rate under the personal income tax is an increasing function of taxable income, then entrepreneurs are able to save little in taxes on any losses they incur but can owe substantial taxes on any profits. The more progressive the tax schedule, therefore, the more risk-taking lowers the expected after-tax return from the project. As a result, a progressive rate schedule discourages risk-taking.

Bruce (1998) similarly finds that taxes have significant effects on the probability that an individual will leave a wage and salary job to become self-employed. Estimates indicate that a five percentage point increase in the difference between an individual's expected marginal tax rates in wage and salary employment and self-employment reduces his transition probability by about 2.4 percentage points.

A different strand of literature focuses on the effect of the entrepreneur's own taxes on their ability to hire workers and expand investment. Carroll et al. (1998) analyze the income tax returns of a large number of sole proprietors before and after the Tax Reform Act of 1986 and determine how the substantial reductions in marginal tax rates associated with that law affected

their decision to hire labor and the size of their wage bills. The authors find that raising the entrepreneur's "tax price" (one minus the marginal tax rate) by 10 percent raises the probability of hiring workers by about 12 percent. Further, conditional on hiring employees, taxes also influence total wage payments to workers. A 10 percent increase in the tax price would increase the median wage bills of entrepreneurs by 3 to 4 percent. These effects are more pronounced for high income sole proprietors. Therefore, raising tax rates on high income entrepreneurs could result in lower wages for workers employed at these firms.

Using a similar dataset, Carroll et al. (1998) also study capital investment decisions by entrepreneurs. Taxes affect the demand for investment through their impact on the user cost of capital. An increase in the personal tax rate raises the user cost and negatively affects investment. Another channel through which taxes affect investment is liquidity constraints. An increase in taxes reduces the entrepreneur's cash flow. To the extent that liquidity constraints are present, this leads to a reduction in the demand for capital. The authors investigate both channels and find that the substantial reductions in marginal tax rates for the relatively affluent had quantitatively significant influences on their investment decisions. A 5 percentage point increase in marginal tax rates reduced the proportion of entrepreneurs who made new capital investments by 10.4 percent, and decreased mean expenditures by 9.9 percent.

In another closely related paper, the authors find that income taxes exert a statistically and quantitatively significant influence on firm growth rates. Raising the proprietor's tax price by 10 percent increases gross receipts by about 8.4 percent. This finding is consistent with the view that raising income tax rates discourages the growth of small businesses.

## V. Health Care Costs and Entrepreneurship

A number of papers have focused on the effect of health care costs on entrepreneurship. Gruber (1992) finds that health insurance mandates reduce coverage of employees in small firms by as little as 1%. This is similar to the finding by Gabel and Jensen (1989), though in a 1992 survey, they showed that 19% of sampled small firms did not offer coverage due to state mandated benefits. Of the papers linking health insurance and entrepreneurship, Gruber and Poterba (1994) analyze the impact of the Tax Reform Act of 1986 which allowed self-employed individuals to deduct a certain percentage of their cost of health insurance from their taxable



income, thus bringing them closer to the tax treatment afforded to employer provided health insurance. The results of their paper suggest that a 1% increase in the cost of health insurance coverage would reduce the probability for coverage for self-employed households by 1.8%. Perry and Rosen (2001) find a statistically negative effect of self-employment on the probability of being insured.

A paper that I published (Mathur, 2009) focused specifically on state health insurance mandates and their impact on job creation by small firms. Health insurance is regulated at the state level by the use of state mandated health benefits.<sup>4</sup> These are regulations issued by the state that mandate minimum levels of certain benefits as part of policies offered, eg. chiropractic services, mental illnesses etc.<sup>5</sup> The cost effect of mandates varies due to differences in state laws. For example, Virginia's mandated benefits accounted for about 12 percent of claims costs in 1993, 22 percent of claims in Maryland in 1988 and 5 percent in Iowa in 1987.<sup>6</sup> The studies that reported the highest costs were those for Maryland and Massachusetts, which have more mandated benefits than most states. The study focuses on the period of the 1990s when there was a tremendous increase in the number of mandates passed by states, unlike a lot of earlier studies which focused on the 1980s. The number of states with six or more mandated benefits increased dramatically between 1988 and 1997. The evidence strongly suggests that while some mandates matter more than others in the job creation decision of small firms, the most significant impact on small firms is simply in terms of the total number of mandates in a state. The larger the number of mandates, the lower is the probability of employment generation. Studying the predicted probabilities for different levels of mandated benefits, the data shows a clear negative relationship between the size of the firm and the total mandated benefits. The predicted probability of owning a business with more than 1 employee goes down from 0.45 to 0.34 i.e nearly 10 percentage points as the number of mandates goes up from 0 to 16. The probability of owning a firm with more than 2 employees goes down by nearly 50 percent for the same change in mandated benefits, and by about 35 percent for firms with 6 or more employees.

From a broader perspective, this paper is particularly relevant in the context of today's debates on employer health mandates which form the basis of many health care reform proposals

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<sup>4</sup> There are mandated providers as well, but we have only included mandated benefits in our study.

<sup>5</sup> For example, the mental health illness mandate in Montana specifies that firms must offer minimum 30 days of inpatient services.

<sup>6</sup> General Accounting Office (GAO) (1996)

today. Employer mandates typically stipulate that employers are required to provide health insurance coverage for their employees. If they do not, they may have to pay a penalty. In terms of the framework of our paper, these mandates would essentially force employers to provide coverage to their employees, where coverage is defined in terms of the mandated benefits for each state.

## VI. Effect of Uncertainty on Economic Activity

A recent National Small Business Poll conducted by the NFIB highlighted two principal impediments to small business growth. These are business uncertainty and weak sales.<sup>7</sup> There is a rapidly growing literature that is now focusing on the effect of uncertainty on business or economic activity. A new paper by Baker et al. investigates whether uncertainty about taxes, government spending and other policy matters deepened the recession of 2007 to 2009 and slowed the recovery. They develop a new index of policy-related economic uncertainty and estimate its dynamic relationship to output, investment and employment. The index averages several components that reflect the frequency of news media references to economic policy uncertainty, the number of federal tax code provisions set to expire in future years, and the extent of forecaster disagreement over future inflation and federal government purchases. VAR estimates show that an increase in policy uncertainty equal to the actual change between 2006 and 2011 foreshadows large and persistent declines in aggregate outcomes, with peak declines of 2.2% in real GDP, 13% in private investment and 2.5 million in aggregate employment.

Another recent 2010 paper by Bachmann et al. uses micro data from the Federal Reserve Bank of Philadelphia's Business Outlook Survey and Germany's IFO Business Climate Index to investigate how measures of business uncertainty, which are derived from manager's business expectations, are related to economic activity. They find that increases in business uncertainty are associated with prolonged declines in economic activity.

Rodrik (1991) shows how policy uncertainty can act as a tax on investment and cause firms to forego investments until its resolution. Hassett and Metcalf (1999) analyze the effects of

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<sup>7</sup> <http://www.foxnews.com/politics/2012/02/14/proposed-obama-budget-includes-surge-in-tax-hikes/>

uncertainty about tax credits for new investments. They show that this type of policy uncertainty lowers average government tax collections, because firms time investments to exploit randomness in tax rates.

## VII. Conclusion

This testimony documents the impact of higher tax rates, higher health care costs and policy uncertainty on entrepreneurs and small businesses. The academic literature suggests that higher taxes and costs of health care provision not only affect the formation of new businesses, but also adversely impact the growth and survival of existing businesses. Moreover, uncertainty in policies relating to government spending and taxes further constrains business activity. This policy lesson is particularly relevant in the current economic climate when we have seen limited hiring and capital investments by not just small businesses, but also large businesses. Raising taxes on these businesses will negatively affect the weak economic recovery. To get the economy on the path to sustainable growth, we need to understand that raising taxes and health care costs on these businesses is likely to further slow hiring and expansion, and is the wrong policy prescription for these times.

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