Testimony of

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Good morning. My name is Robert E. Berney. I am currently Chief Economist and acting Director of Economic Research for the Office of Advocacy, U.S. Small Business Administration (SBA).

The Office of Advocacy, created by Congress in 1976 to serve as an independent office for data gathering, analysis and advocacy regarding the role of small business in the economy, is a unique government agency. Although housed in the Small Business Administration, the office is headed by a separate presidentially appointed, Senate-confirmed Chief Counsel for Advocacy. The Chief Counsel in turn appoints professional staff to renewable annual appointments based on needed expertise, not political or civil service status. In addition, Congress expects the Office of Advocacy to present testimony, reports, conferences, etc. that are independent of review by SBA, the Office of Management and Budget and the White House.

As of today President Bush has yet to nominate a Chief Counsel for Advocacy. Therefore, my testimony today presents my own views, based on research conducted or sponsored by the Office of Advocacy as well as my 38 years as a Ph.D. trained economist. I have been either the chief economist or chief economic advisor for Advocacy three times while on leave from Washington State University, where I spent most of my academic career. My primary areas of teaching at the graduate and undergraduate levels and research interests were macroeconomics, public finance as well as money and banking. Since my first stint with Advocacy, my research interest has centered on small business economic issues.

This testimony will stress two important aspects about small business. First, given current economic conditions, what will be the impacts on the most dynamic sector of the economy if it slips into a recession? Second, given the push for tax reduction, which provisions would be most helpful for small business and, therefore, the economy?

Introduction

I sincerely believe that economics is the all-important academic discipline for making the world a better place. That is why I am a teacher of economics and why I have brought my economics training into government.

At a simplified level, microeconomics teaches us that to have perfect competition there must be many buyers and sellers in each market; as well as ease of entry and exit in these markets. Therefore working for the Office of Advocacy has been a significant part of my career of teaching and researching economics. While teaching college students has appeal, improving the environment for small firms by increasing our understanding of the importance of small firms in the U.S. economy and what is needed to nurture them to improve the competitive environment is a higher calling.

My understanding of the causes of the dramatic expansion in our economy in 1980s and 1990s was that entrepreneurship was unleashed, increasing the amount of competition in not only the high tech but also the low tech areas of our economy. Because of this, a wave of what economists call “creative destruction” took place with large firms reorganizing and downsizing, and small firms with some great new ideas becoming the rapidly growing firms or the ‘gazelles’ in the economy as well as becoming the dominant firms in their industries (e.g. Wal-Mart and Microsoft). Advocacy’s research has shown that some 75 percent of the net new jobs created in our economy have come from small firms (firms with fewer than 500 employees); and some two-thirds of these net new jobs were created by firms with fewer than 20 employees.1

It is a fact that in the past two decades the U.S. has had the most vibrant economy in the world and I believe that is due to the entrepreneurial nature of our economy. The Global Entrepreneurship Monitor (GEM) is a research effort that puts entrepreneurial activity into a global perspective. Two recent GEM reports show how the U.S. has a more supportive entrepreneurial environment than any of the countries with whom we compete. (Japan typically comes in last in GEM’s rankings.)2

From a public policy perspective it is important for the economic success of this country to:

ensure there is a level playing field for firms of different sizes and ages, that is to ensure that tax and regulatory policy do not create undue burdens on start ups and on existing small firms, ensure that market failures do not discourage start ups and the expansion of existing small firms (e.g. the availability of debt and equity financing for small firms) .

With the changing economic conditions in the U.S. today, one area where the playing field may not be level is the impact of a recession on small firms.

The Effects of a Recession on Small Business

The Office of Advocacy turned out a number of studies in the 1980s exploring the impacts of recessions on small business.3 More recent information (early 1990s) has been generated on the impacts of a credit crunch on small business.4 Given the current changing economic conditions, the Office of Advocacy has this topic in our draft Request for Proposal to see if researchers have developed new information on the impacts.

What have we learned:

1980s

Small businesses suffered more than proportionately in recessions and benefited more than proportionately in expansions. Small businesses tended to dominate the most cyclically sensitive industries-- wholesale trade and construction-- and were more cyclically sensitive than large firms in the service, manufacturing, finance, insurance and real estate industries.
Business starts appeared to vary cyclically and therefore tended to decline in a recession while business dissolutions appeared to be random.
During business cycles, small business tended to have longer recession phases and shorter recovery phases than large business or the economy as a whole.
Self-employment appeared to be counter-cyclical. When people lost their jobs, they often become self-employed. When jobs become plentiful and wage and benefits packages were increasing, self-employment declined.
Survival rates for the self-employed were lower in a recession, partially due to the lower availability of capital for starting or acquiring a business. This was particularly true for women.

1990s

Loan losses at commercial banks, forced banks to reduce the supply of bank credit. Since small businesses are more dependent on commercial banks for their credit needs, real economic activity of small business shrank by more than large business, confirming the results in 1.
Small banks shrank their loan portfolios considerably more than large banks during the credit crunch, so small businesses that

rely on small banks for credit were most vulnerable.
Bank regulators toughened their standards during the recession/credit crunch period, reducing the amount of bank lending.

The evidence is suggestive that small firms are affected more severely in a downturn.
And once a recession has started it can be made worse by inappropriate bank regulatory policies or perverse fiscal policies. A strong counter-cyclical public policy of reducing interest rates, lowering taxes and increasing federal expenditures is appropriate. Countercyclical measures that are specifically focused on small firms would level the playing field of negative impacts and would likely reduce some of the negative employment effects.5 But the lags in the impacts reaching the economy need to be considered in selecting appropriate policies.

Supporting Entrepreneurship

The entrepreneurial small firms that are so important for the economic health of the nation tend to be starved for growth capital. Every dollar of profit or tax relief tends to be re-invested in the firm. Consequently, if one expects the federal budget to be in surplus of over the longer run so that tax adequacy is not a concern, tax relief for entrepreneurs will provide desirable supply-side benefits.

Besides adequate capital, what tends to limit the growth of entrepreneurial firms is the inability to find and keep qualified employees. Policies to help fund and simplify needed health care and pension plans is crucially important to help the small entrepreneurial firms that I am concerned with grow and prosper.

Small businesses provide many workers with their first jobs. Small firms also are better able to accommodate workers needing flexible, part-time or other special schedules. However, small businesses have difficulty competing with large employers on benefits, in part because of the complexity and frequent changes in law regarding many types of employee benefits. Small firms cannot afford to devote the resources needed to administer, and keep abreast of changes in benefits tax laws and regulations. As a result, small businesses are at a competitive disadvantage in attracting and retaining the large numbers of workers for whom pensions, health coverage and other benefits are important.

Provisions that would give small businesses a tax credit or other incentive to start providing pension or health coverage for workers can help offset the steep “learning curve” and startup expenses of putting a plan in place and making the owner familiar with the necessary law and procedures. To be effective, such provisions must offer small businesses a degree of certainty that they can continue to rely on the law. In addition, they must be relatively simple and have broad enough eligibility that they do not create further distinctions among otherwise similarly situated small businesses.

Taxation

Before discussing specific categories of tax policies that are important for small business, I'd like to make a couple of observations. First, I would note that approximately 90 percent of small businesses are taxed at the individual, not the corporate, level. A recent fact sheet from the Treasury Department's Office of Tax Policy states:[6]

There were in 1998, (the most recent year for which data are available) about 24 million businesses organized as flow through entities:[7]
17.1 million sole proprietorships,
2.1 million farm proprietorships,
1.9 million partnerships, and
2.6 million S corporations.

Therefore, tax changes to keep small businesses healthy and competitive should focus on the individual income tax.

Second, in every public finance class that I have ever taught, whenever I would talk about tax reform or tax change, I would discuss the concepts of equity, efficiency, and adequacy. Briefly, equity deals with treating equals equally[8] and treating those with more ability to pay differently from those with less ability to pay. Efficiency deals with minimizing the burdens and costs of collecting taxes both to the government and to the taxpayer. Thus, a basic rule of improving both equity and efficiency in tax reform, is to
broaden the base on which taxes are calculated so that the marginal rates can be lowered and
simplify the calculations.
Adequacy has to do with raising the necessary revenue to cover the services that government provides. Currently this does not seem to be an important issue in the public finance of the federal government.

For small business, equity generally means that the tax rates paid by owners are not distorted by hidden phase-outs, limitations and alternative minimum tax (AMT) calculations. In addition, tax rates should be low enough and graduated gently enough from one bracket to the next so that the tax system does not introduce unreasonable distinctions between competitors at different income levels.

Efficiency implies that business owners are not forced to spend undue amounts of money or time (which would otherwise be devoted to the business) on learning the law, record keeping, filing returns and planning tax strategies. Moreover, the tax system should not drive owners to choose one legal form of organization over another, for instance by having lower rates and relief from AMT only for C corporations.

In the current surplus environment, reducing revenue adequacy would insure small business receive an appropriate share of the tax relief that goes to businesses taxed at the individual level.

In addition, the Tax Foundation continually points out that for most small business the cost of record keeping is greater than the taxes paid by them, a clear inefficiency.9 So any tax reform proposal that simplifies the record keeping requirements for small businesses will improve efficiency in two ways. First, it will make the tax system more efficient and secondly, and more importantly, it will make the economy more competitive, and therefore more efficient. A number of tax proposals that simplify the tax preparation and provide direct benefits to the entrepreneurial small firms have been discussed over the past few years by various small business tax experts:

Alternative Minimum Tax Relief

For individual taxpayers, the individual AMT has become an increasingly burdensome stealth or backdoor tax, raising the marginal tax rates on those taxpayers that must pay it. For the sole proprietors, partners, and S corporation shareholders, the individual AMT increases their tax liability by limiting depreciation and depletion deductions, net operating loss write-offs, the deductibility of state and local taxes, and expensing of research and experimentation costs. In addition, because of its complexity, this tax forces small business owners to waste precious funds on tax professionals to determine whether the AMT even applies.

Clarification of Cash Accounting Rules for Small Businesses

It has been suggested that section 446 of the Internal Revenue Code should be amended to provide a clear threshold for small businesses to use the cash receipts and disbursements method of accounting, instead of requiring accrual accounting. To qualify, the business must have, say, $5 million or less in average annual gross receipts based on the preceding three years. In addition, a taxpayer meeting the average annual gross receipts test should not be required to account for inventories under section 471. The taxpayer should be required to treat such inventory in the same manner as materials or supplies that are not incidental. Accordingly, the taxpayer could deduct the expenses for such inventory that are actually consumed and used in the operation of the business during that particular taxable year.

Increase in Expense Treatment for Small Businesses

Section 179 of the Internal Revenue Code could be amended to increase the amount of equipment purchases that small businesses may expense each year beyond the current $24,000. This change would eliminate the burdensome record keeping involved in depreciating such equipment and free up capital for small

businesses to grow and create jobs.
Another proposed change would raise the phase-out limitation for equipment expensing from the current $200,000 to some higher figure, thereby expanding the type of equipment that can qualify for expensing treatment. This limitation along with the annual expensing amount should be indexed for inflation.
Following the recommendation of the National Taxpayer Advocate, a related change would amend section 179 to permit expensing in the year that the property is purchased or the year that the property is placed in service, whichever is earlier. This would eliminate the difficulty that many small firms have encountered when investing in new equipment in one tax year (e.g., 2000) that cannot be placed in service until the following year (e.g., 2001). In addition, expensing of computer software up to, say, $50,000 might be desirable.
Modification of Depreciation Rules
The outdated depreciation rules that permit taxpayers to depreciate computer equipment and software over a five-year and a three-year period need to be amended. With the rapid advancements in technology, these depreciation periods are sorely out of date and can result in small businesses having to exhaust their depreciation deductions well after the equipment or software is obsolete. A change to two years would make the tax code in this area more consistent with the technological reality of the business world.
A related change would amend section 280F of the Internal Revenue Code, which limits the amount of depreciation that a business may claim with respect to a vehicle used for business purposes. Under the current thresholds, a business loses a portion of its depreciation deduction if the vehicle placed in service in 2000 costs more than $14,400. Although these limitations have been subject to inflation adjustments, they have not kept pace with the actual cost of new cars and vans in most cases. For many small businesses, the use of a car or van is an essential asset for transporting personnel to sales and service appointments and for delivering their products.
Simplification of Estimated Tax Rules
The current rules for calculating the level of estimated taxes necessary to avoid the interest penalty for underpayment of estimated taxes needs to be changed. Currently, small business owners can avoid the interest penalty if they pay estimated taxes equal to at least 90% of their tax liability for the current year. Alternatively, for taxable year 2001, small business owners who earned more than $150,000 in income for taxable year 2000 can avoid the interest penalty if they pay estimated taxes equal to 112% of their 2000 tax liability. For taxable years 2002 and beyond, the threshold will be 110%. In contrast, taxpayers earning $150,000 or less, can avoid the penalty by paying estimated taxes equal to 100% of their prior year's tax liability.
The proposed change being discussed simplifies the estimated-tax rules by providing a consistent test for avoiding the interest penalty: taxpayers must deposit estimated taxes equal to 90% of the current year's or 100% of the prior year's tax liability.

This change will eliminate many complex calculations currently required of small business owners and will ease strains on the business' cash flow.

Exemption from Partnership Rules for Sole Proprietorships Jointly Owned by Spouses

The Internal Revenue Service (IRS) National Taxpayer Advocate's Annual Report to Congress for 2001 identified a problem facing married couples operating a small unincorporated business. Although these couples file a joint tax return, they are currently required to comply with the onerous partnership rules instead of being permitted to treat the business as a sole proprietorship. According to IRS estimates, the additional burden of the partnership rules can add more than 200 hours to the time required to prepare the business' tax return than would be necessary if it were treated as a sole proprietorship. This proposal is not unique in the tax code since spouses owing S-corporation stock can be counted as a single shareholder.

The Code should be amended to permit married couples who file joint tax returns to opt out of the partnership rules and treat their jointly owned business as a sole proprietorship. The self-employment tax rules should also be amended to allow such married couples to receive Social Security credits on an individual basis, which they currently receive when filing a partnership return.

Electronic Filing for Paperwork Reduction but as a Goal, not a Mandate

I believe it makes sense for this Committee and Congress to continue to support efforts to reduce and unify small business tax and wage related reporting requirements. For most small businesses, multiple employment reports made to state and federal agencies are the most burdensome requirement placed on them by the government.

The STAWRS (Simplified Tax and Wage Reporting System) effort seeks to make modern technology (such as computerized forms and internet reporting) available to even the most modest businesses. The goal is to complete one straightforward quarterly employment questionnaire online and then route the appropriate information to the IRS, Social Security Administration, Labor Department and state agencies that need it. Two of the leading experiments in this field have been in Iowa and Montana and they have proved that this kind of advance can show significant results in the paperwork reduction for small businesses. Hopefully, the Committee will continue to support the necessary legislation to allow the STAWRS effort to go forward. (The bill introduced last year by Senator Kerry on this subject helps to move the project along.)

It would also be desirable to amend the IRS Restructuring and Reform Act of 1998 (Public Law 105-206) to clarify that the IRS should set as a goal, but not a mandate, that paperless filing should be the preferred and most convenient means of filing tax and information returns in 80% of cases by the year 2007. Concerns have been raised that in order to reach this goal, the IRS may have to require certain taxpayers to file electronically that are not computer literate which will unnecessrily raise the cost to these firms. Electronic filing should be a voluntary option for taxpayers, not a new government mandate.

Conclusions

Tax reform that

Simplifies the tax structure add to economic efficiency.

Broadens the tax base allowing for a reduction in marginal rates adds both to economic efficiency and tax equity.

Focuses on entrepreneurial small businesses makes the capitalistic system more competitive and therefore more efficient. Such change will increase employment growth and the rate of innovation, leading to increases in productivity.

More broadly, changes in public policy should

Level the competitive playing field between large and small business,

Limit market failures that occur because of a lack of perfect knowledge.

Thank you for the opportunity to present my views on the importance of entrepreneurial small business in the economy. It is always desirable that changes in public policy help or at least not hurt the small business sector as that sector insures that competitive capitalism continues to exist. In addition, small firms will be able to generate the employment growth that is needed as well as a significant share of the exciting innovations.

I will be happy to provide any additional information that is desired by the Committee.