Taxes and Small Business Job Creation

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before the Senate Committee on Finance

February 23, 2010

Mr. Chairman and members of the committee, thank you for inviting me to testify today on taxes and small business job creation.

Numerous provisions affect the tax climate for small businesses, including payroll taxes, capital gains taxes, and the treatment of capital investment. But I will focus on marginal income tax rates because that's where there seems to be the most disagreement and uncertainly about the future direction of tax policy. The Obama administration has proposed increasing the top two individual income tax rates, but that policy would likely have a negative impact on U.S. economic growth.

The administration has offered some narrow and temporary tax breaks for small business job creation, but that is not a promising approach for tax policy. Instead, Congress should focus on creating a simple, neutral, and pro-growth tax structure for all American businesses, large and small. After all, there is no strict separation of large and small businesses in the tax code. Many businesses that report their profits on individual returns are medium and larger businesses.

New jobs are created by fast-growing businesses, whether small or large. A new job at a multinational computer chip maker is certainly as valuable as a new job at the corner restaurant, and probably more durable. Thus, while my remarks focus on tax policies for smaller businesses, large C corporations are also crucial to U.S. economic growth. Policymakers should consider reforms to reduce statutory tax rates on both corporate and noncorporate businesses.[1]

Responses to High Marginal Tax Rates

The Obama administration is proposed to raise the top two individual income tax rates from 33 and 35 percent to 36 and 39.6 percent, respectively, in 2011. That would likely harm investment, job creation, and growth. Higher marginal tax rates reduce incentives for productive activities, such as working and expanding businesses, and they increase incentives for unproductive activities, such as tax avoidance and evasion.

If income tax rates rise next year, we may not perceive large negative effects right away, but changes in marginal tax rates do affect behavior over the long term. Some high-income workers would decide to work fewer hours and retire a bit earlier. Some spouses in two-

earner families would decide to stay out of the workforce. Some angel investors would have less cash to invest in start-up ventures. And some small businesses would decide not to buy new equipment or hire new workers.

How large are the behavioral responses to marginal income tax rate changes? Many empirical studies have found that reported income is quite responsive to the top income tax rates. In a 2009 paper, for example, economists Emmanuel Saez, Joel Slemrod, and Seth Giertz noted that the share of income "received by the top 1 percent of income recipients started to increase precisely after 1981 when marginal tax rates started to decline. The timing of the jump in the share of top incomes from 1986 to 1988 corresponds exactly to the sharp drop in the weighted average marginal tax rates from 45 percent to 29 percent after the Tax Reform Act of 1986. [This] provides circumstantial but quite compelling evidence that high incomes are indeed responsive to marginal tax rates."[2]

A typical finding is that a tax rate increase that reduces the after-tax share on additional income by 10 percent results in shrinking reported income by about 4 percent.[3] For higher earners, empirical studies usually find substantially larger behavioral responses.[4] That's because higher-income taxpayers typically have more flexibility on their working decisions and they have greater shares of financial and business income, which are more responsive and mobile than labor income.

A side-effect of these behavioral responses is that governments raise less money than they expect from tax rate increases, particularly at the top end. If Congress raised the top income tax rate from 35 to 39.6 percent, the government would gain 4.6 percentage points on the money in the top bracket. But reported income would fall modestly, and that fall would offset a substantial portion of the revenue gain. In a recent paper, economist Robert Carroll summarized Treasury estimates that modeled changes in the top two income tax rates.[5] The results suggest that raising the top two rates would cause reported income of affected taxpayers to fall three percent, which would be enough to offset about 40 percent of the expected static revenue gain.

When considering raising tax rates at the top end, Congress needs to think carefully about who would be hit. Today's highest-earners are generally not passive inheritors of wealth, but are usually self-made and entrepreneurial.[6] Business ownership and current earnings are the main sources of wealth for the richest individuals, while inheritances account for less than one-fifth of the assets of the richest people and that share has been declining.[7] As economist Glenn Hubbard noted, "when you look at data, you see that people who are rich almost entirely are rich because of entrepreneurial risk taking,"[8]

Many with high incomes are angel investors, who help to fuel small business expansion. There are at least 300,000 angel investors in the United States, who are often wealthy individuals and have been entrepreneurs themselves.[9] They provide an important source of financing for fast-growing small businesses. If their taxes go up, they will have less money and fewer incentives to invest, while perhaps parking more of their funds in tax-free municipal bonds.

In sum, trying to raise revenue by increasing the top income tax rates is a perverse budget strategy. It would hit some of the most talented people in the economy. Since high earners generally have the largest behavioral responses to taxes, the deadweight losses (or costs of inefficiency) of such tax changes would be quite large.[10] And since deadweight losses rise more than proportionally as marginal tax rates rise, raising the top rates would be very counterproductive.[11]

Top Tax Rates and Small Businesses

The income tax system has a wide-ranging impact on businesses. It affects decisions on building factories, purchasing capital equipment, and hiring workers. Rather than trying to micromanage these decisions through the tax code, we should design a system with low statutory rates and neutral treatment to allow businesses to allocate resources efficiently.

More than half of all business income in the United States is reported on individual returns, not corporate returns.[12] This income is reported by proprietorships, partnerships, LLCs, and S corporations. If the top two individual income tax rates are increased, it would hit a substantial amount of this business income.

It is true that only a small share of the total number of tax returns with business income would be hit by raising the top two tax rates. That's because many tax returns have small amounts of business income and many self-employed persons have modest incomes.

Breaking down the data, Robert Carroll looked at just those individual tax filers who derived more than 50 percent of their income from a business.[13] Carroll found that one-quarter of these taxpayers—who number about 600,000—were in the top two tax rate brackets, and thus would be hit by the proposed tax increases.

A Joint Committee on Taxation analysis looked at the share of business income on individual returns that is in the top two tax rate brackets.[14] The JCT found that about 25 million individual tax returns will report about $1 trillion of net positive business income in 2011. Of that total, $437 billion, or 44 percent, will be taxed in the top two income tax brackets and thus will face the proposed tax increase.

Finally, a microsimulation analysis by analysts at the Tax Foundation looked at the share of the proposed tax increase that would fall on business income versus other sorts of income.[15] They found that the tax rate increase would raise about $90 billion in 2011, measured on a static basis. Of that total, about $36 billion, or 40 percent, would be from tax increases on business income.

In sum, various estimates show that while only a small share of tax returns will be hit by raising the top income tax rates, those that will be hit represent a large share of all business income on individual returns. Further, business income represents a large share of all the income that will be hit by the proposed tax rate increases.

How will higher tax rates affect entrepreneurship and small business growth? Economists Glenn Hubbard and William Gentry looked at how tax rates affect the initial risky decision to become an entrepreneur, and they found "large" effects.[16] Higher marginal tax rates discourage entry into self-employment and business ownership. They found, for example, that the 1993 increase in the top tax rate to 39.6 percent "reduced the probability of entry into self-employment for upper middle income households by as much as 20 percent." Hubbard concluded that today's income tax code gives the message, "if you take a risk and you're successful, we tax you at a high rate; if you take a risk and you fail, we don't share that loss with you."[17]

A study by Donald Bruce and Tami Gurley for the Small Business Administration similarly found that marginal tax rates affect levels of entrepreneurship.[18] Using a detailed empirical model, the authors found that "A reduction in the marginal tax rate on entrepreneurial income of one percentage point would increase the probability of entry into entrepreneurial activity by 1.42 percentage points for single filers and 2.0 percentage points for married filers."[19]

Once a small business is up and running, empirical tax research by economists Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey Rosen found that higher individual income tax rates negatively affect hiring, investment, and expansion. One of their studies found that changing the "tax price" (one minus the marginal tax rate) faced by small businesses by 10 percent changed the likelihood of hiring workers by about 12 percent.[20] Thus, raising the top income tax rate from 35 to 39.6 percent would reduce the likelihood of hiring by affected businesses by more than 8 percent.

Another one of their studies found that changing the tax price faced by small businesses by 10 percent caused business revenues to change by about 8 percent.[21] That is, raising marginal income tax rates reduces business growth. Finally, one of their studies found that a 5 percentage point increase in marginal tax rates would cause a 10-percent reduction in small business capital expenditures.[22]

The authors noted that tax rate changes affect businesses by altering the return to marginal investments and changing the cash flow available to fuel expansion.[23] In other words, higher tax rates reduce both the incentive and the funding for activities such as investment and hiring.

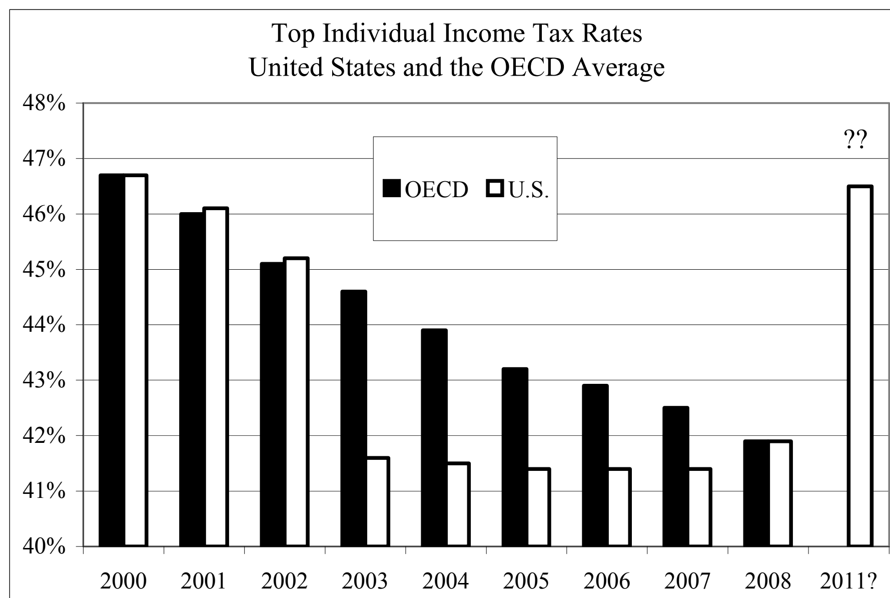
International Perspective

The bipartisan Tax Reform Act of 1986 reduced individual income tax rates to a simple structure of 15 and 28 percent. But then tax rates were increased during the 1990s, which the rate cuts of recent years have only partly reversed. President Obama's proposed top individual rate of 39.6 percent is 41-percent higher than the 28-percent rate achieved in the late 1980s. (The top effective top rate next year will be even higher if Congress reinstates a phase-out of personal exemptions and a limitation on itemized deductions).

Some people think that raising the top income tax rate to 40 percent is no big deal because the top rate was even higher during the mid-20th century. But the world economy has dramatically changed since then. In recent decades, nations have floated their exchange rates and opened their borders to capital flows, with the result that cross-border investment has exploded. There is also rising international mobility of highly skilled workers in industries such as technology and finance. Thus, in addition to the domestic reasons to reduce marginal tax rates, the competitive pressures of globalization have convinced most nations to cut their top income tax rates.

The average top personal income tax rate in the 30 nations of the Organization for Economic Cooperation and Development fell from 68 percent in 1980 to 42 percent in 2008.[24] Federal tax rate cuts in 1981 and 1986 established the United States as a tax reform leader, but many other countries had caught up to us with their own rate cuts by 2000.

The chart shows that the top U.S. income tax rate was the same as the average top rate in the OECD in 2000 at just under 47 percent.[25] This data includes both federal and state-level taxes. Tax rate cuts reduced the U.S. rate to 42 percent by 2008, but other countries have been cutting as well, such that the OECD average rate also fell to about 42 percent.



Source: OECD Tax Database, Table 1.7. Includes subnational taxes.

If the top federal rate is increased by about 5 percentage points next year, the top U.S. rate with state taxes would be more than 46 percent. The United States would jump into the ranks of nations with high individual income tax rates, and we've already got the second-highest corporate tax rate in the OECD.[26] Our nation—which has been a bastion of market capitalism and individual achievement—has a tax code that is becoming more unfriendly to businesses and high-earners than the tax codes of many other nations.

Consider just one possible effect of increased individual tax rates—damaging the nation's historical role as a magnet for smart and productive people. High-skill immigrants have flocked to places like Silicon Valley because they could start businesses in a more free-market environment than other locations around the world. One 1999 study found that 24 percent of Silicon Valley firms were founded by Chinese and Indian immigrants.[27] Similarly, a 2007 study found that one-quarter of U.S. technology companies launched in the past decade had an immigrant founder.[28]

Taxes are only one factor that influences where highly skilled entrepreneurs decide to start businesses. But as other nations have improved their economic polices, America may lose one of its long-standing advantages in attracting the elite of the world's knowledge workers.

Conclusions

The Obama administration has proposed a number of narrow tax breaks for business hiring and investment, including a capital gains provision for small-business stock and a $5,000 tax credit for small business hiring. Those provisions would complicate the tax code and would be far inferior to broad-based tax rate reduction.

Rather than raising income tax rates next year, policymakers should consider ways to reduce them. The Tax Reform Act of 1986 eliminating deductions and credits while cutting statutory rates in a revenue-neutral fashion. Today, we have a number of large tax breaks—such as the mortgage interest deduction and the state and local tax deduction—that are tilted toward high-earners, and which we could repeal and use the revenues to cut the top tax rates. Such reforms would enhance economic growth because there is a large amount of business activity in those top rate brackets, as noted.

Even better, Congress should consider a simplified two-rate individual tax structure of 10 and 25 percent. Such a structure has been proposed by Rep. Paul Ryan (R-WI) and also discussed in the recent National Academy of Sciences study, *Choosing the Nation's Fiscal Future*.[29] The NAS plan has individual tax rates of 10 and 25 percent combined with a 25-percent corporate tax in a revenue-neutral package. These lower rates would improve marginal incentives for American businesses of all sizes and in all industries.

Thank you for holding these important hearings. I look forward to working with the committee on these issues.

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[1] For more on tax reform, see Chris Edwards and Daniel Mitchell, *Global Tax Revolution* (Washington: Cato Institute, 2008).
[2] Emmanuel Saez, Joel Slemrod, and Seth Giertz, "The Elasticity of Taxable Income With Respect to Marginal Tax Rates: A Critical Review," May 20, 2009.
[3] Jon Gruber and Emmanuel Saez, "The Elasticity of Taxable Income: Evidence and Implications," National Bureau of Economic Research Working Paper 7512, January 2000. See also Robert Carroll, "The Economic Cost of High Tax Rates," Tax Foundation, July 2009.
[4] Jon Gruber and Emmanuel Saez, "The Elasticity of Taxable Income: Evidence and Implications," National Bureau of Economic Research Working Paper 7512, January 2000.
[5] Robert Carroll, "The 2001 and 2003 Tax Relief: The Benefit of Lower Tax Rates," Tax Foundation, August 2008.
[6] See, for example, the *Forbes* list of the wealthiest Americans. Matthew Miller and Duncan Greenberg, "The Richest People in America," *Forbes*, September 30, 2009.
[7] Merrill Lynch and Capgemini, "World Wealth Report," June 2006, p. 19.
[8] Interview with R. Glenn Hubbard, Columbia Business School, June 15, 2005. Available at www4.gsb.columbia.edu/ideasatwork.
[9] Scott Shane, "The Importance of Angel Investing in Financing the Growth of Entrepreneurial Ventures," Small Business Administration, September 2008.
[10] For a discussion of tax rates and deadweight losses, see Martin Feldstein, "The Effect of Taxes on Efficiency and Growth," *Tax Notes*, May 8, 2006.
[11] As a marginal tax rate rises, the deadweight loss rises by the square of the increased tax wedge between pre- and post-tax income.
[12] Peter Merrill, "The Corporate Tax Conundrum," *Tax Notes*, October 8, 2007.
[13] Robert Carroll, "The Economic Cost of High Tax Rates," Tax Foundation, July 2009. I am referring to income from flow-through businesses, not income from C corporations.
[14] Joint Committee on Taxation, Memorandum to Mark Prater from Edward Kleinbard, April 8, 2009.
[15] Email from Gerald Prante, Tax Foundation, February 18, 2010.
[16] William M. Gentry and R. Glenn Hubbard, "Success Taxes, Entrepreneurial Entry, and Innovation, National Bureau of Economic Research, Working Paper 10551, June 2004, p. 2.
[17] Interview with R. Glenn Hubbard, Columbia Business School, June 15, 2005. Available at www4.gsb.columbia.edu/ideasatwork.
[18] Donald Bruce and Tami Gurley, "Taxes and Entrepreneurial Activity: An Empirical Investigation Using Longitudinal Tax Return Data," Small Business Administration, March 2005.
[19] Donald Bruce and Tami Gurley, "Taxes and Entrepreneurial Activity: An Empirical Investigation Using Longitudinal Tax Return Data," Small Business Administration, March 2005.
[20] Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey Rosen, "Income Taxes and Entrepreneurs' Use of Labor," NBER Working Paper 6578, May 1998.
[21] Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey Rosen, "Personal Income Taxes and the Growth of Small Firms," NBER Working Paper 7980, October 2000.

[22] Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey Rosen, Entrepreneurs, Income Taxes, and Investment," NBER Working Paper 6374, January 1998.
[23] Cash flow is important because external finance may not always be available to entrepreneurs, or may be more costly than internal funds.
[24] Chris Edwards and Daniel Mitchell, *Global Tax Revolution* (Washington: Cato Institute, 2008).
[25] See www.oecd.org/ctp/taxdatabase.
[26] KPMG, "Corporate and Indirect Tax Rate Survey," 2009.
[27] Anna Lee Saxenian, "Silicon Valley's Skilled Immigrants: Generating Jobs and Wealth for California," Research Brief, Public Policy Institute of California, June 1999.
[28] Vivek Wadhwa, et al., "America's New Immigrant Entrepreneurs," Master of Engineering Management Program, Duke University, January 4, 2007.
[29] National Academy of Sciences, *Choosing the Nation's Fiscal Future* (Washington: National Academies Press, 2010), www.ourfiscalfuture.org. See also Chris Edwards, "National Academy Fiscal Future Report," Cato Institute, January 2010.