



Written Testimony to the U.S. House of  
Representatives, Small Business Committee, on  
“Reforming the Tax Code to Assist Small  
Businesses”

John S. Irons\*

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Thank you Mr. Chairman, I would like to thank you and Ranking Member Velazquez for inviting me to testify before this committee.

My name is John Irons. I am a Ph.D. economist by training, and I am currently the director of tax and budget policy at the Center for American Progress, a nonprofit think-tank here in Washington, DC.

As an economist, I am continuously amazed at the resiliency of the U.S. economy, and at the creativity of our nation’s small business owners. While the title of this hearing is “Reforming the Tax Code to Assist Small Businesses,” I feel that it is important to recognize up front that the small business community does quite well on its own, and the goal of tax policy in many ways should be to get out of the way of private activity, while still raising adequate revenue for vital domestic and international priorities.

When talking about the overall tax code, analysts often think about following three basic principles of simplicity, fairness, and economic growth.

The Center for American Progress has developed a broad reform package based upon these principles. A copy of that proposal is included in my written testimony.

The American Progress tax proposal calls for a variety of changes to the tax code, and includes the elimination of the employee side of the Social Security payroll tax and an elimination of the AMT.

However, we do not simply cut these revenue streams without making other adjustments. Rather, we shift the tax share onto a restructured income tax that is more progressive than our current tax structure. And we tax all sources of income for very high earners according to the same, progressive rate schedule. In total, we are able to increase revenues by about \$500 billion over 10 years compared with current policy. And we are able to reduce taxes for about 70 percent of the population. Those at the high end of the income distribution—those that have benefited the most from recent tax cuts—would likely see an increase in their tax share.

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\*Director of Tax and Budget Policy, Center for American Progress

A reduction in the employee side of the payroll tax would mean an immediate reduction in the taxes for a large swath of low- and moderate-income small business people.

The principles that guide overall tax reform should also be followed when looking at taxation of small businesses, and my submitted written comments are organized along those three themes as well.

But first let me first frame some of my comments by considering the general makeup of small businesses in the U.S.

## 1 Who are Small Businesses?

I think it is important to keep in mind that most small businesses are indeed small. The median number of employees is fewer than 4, and 89 percent of firms employ less than 20 people.<sup>1</sup>

The average amount of receipts for firms with 1-4 employees is \$348,000. And the average per-employee payroll is just over \$27,000. Over 80 percent of partnerships have less than \$1 million in assets.<sup>2</sup>

While there is no consensus on how to officially define a “small business,” those with small business income are spread throughout the income distribution. Recent estimates of IRS data from the Tax Policy Center show that in 2004, only 1.3 percent of those that reported small business income on their tax returns were in the top marginal income tax bracket. And of those with more than 50 percent of their income from business income, only 2 percent were in the top marginal income bracket.<sup>3</sup>

Nearly half of those with small business income are in the 10 and 15 percent tax brackets.

Therefore, any policy that simply reduces the top marginal brackets or that provides a windfall profit increase for larger companies is not a policy that helps most small businesses. And in our tight fiscal environment, any reduction at the top means potentially harmful adjustments elsewhere.

## 2 Small Businesses Taxes

Let me return to the three principles of simplicity, fairness and growth. A summary of the main points are as follows:

- First, the tax code needs to be simple and predictable. I think we all know the tax code needs to be simplified, yet the code has become more

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<sup>1</sup>Small Business Administration data based on Census Bureau survey, available at <http://www.sba.gov/advo/research/data.html>

<sup>2</sup>Joel Slemrod, “Small Business and the Tax System,” Mimeo prepared for the conference “The Crisis in Tax Administration,” University of Michigan, February, 2004. As Slemrod points out, the distribution of business income across business type-sole proprietorship versus Subchapter S for example-varies significantly with income.

<sup>3</sup>Estimates derived from W. Gale, “Small Business and Marginal Income Tax Rates,” Tax Notes, April 26, 2004, p.471.

complicated and less predictable over the last several years. In order for small businesses to make sound investment decisions, tax policy must also be stable so businesses can be confident in their business projections. To take one implication, the use of reconciliation in the budget process to enact tax policy should be avoided.

Some would argue that making the president's tax changes permanent would solve some of this uncertainty. But doing so would simply lock in a complicated policy and permanent deficits—I would argue that a reform of the tax code is indeed necessary, but it should be a reform that takes a very different direction than recent policy.

- Second, most small businesses are not at the top end of the income scale. Thus, any restructuring that cuts revenue from the top will either shift the tax share to the middle- and low-income business owners, or will increase the deficit, which can then harm small businesses through higher interest rates.

Many so-called fundamental reforms, such as replacing the income or corporate tax with a value added tax (VAT), a national retail sales tax, or a flat tax would not be good for most small businesses. Small business efficiency requires a fair, progressive rate structure, not a flat structure.

- Third, to be efficient and to have solid growth, incentives for investment in physical capital must also be balanced with incentives for investment in human capital. A tax code that already favors wealth and investment in capital goods ignores the fact that it is human capital that is often the most important component of modern businesses.

Also, expenditures in other areas are vital for small businesses, and raising adequate revenue to fund our national priorities is essential. For example, the budget for the U.S. Small Business Administration has been cut by nearly a third over the past several years.

### 3 Increasing Complexity in the Tax Code

The last several years have seen remarkable increases in tax complexity.

While there is no perfect measure of complexity, we can look at some simple statistics that might point to increasing complexity.

- There are now 61,000 pages of federal tax rules, including tax code, regulations, and IRS rulings, an increase of about 15,000 pages since 2001.<sup>4</sup>

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<sup>4</sup>The page count is from CCH Standard Federal Tax Reporter. For 2001, see Chris Edwards, "Simplifying Federal Taxes," CATO, October 2001, available at <http://www.cato.org/pubs/pas/pa416.pdf>. For current 2005 data, see written statement of Mark Everson, IRS commissioner to the House Committee on Government Reform, May 25, 2005.

- The IRS estimates the total amount of time to file the IRS 1040 and related forms, schedules and worksheets is 68 hours and 53 minutes, up 17 percent from 1995.<sup>5</sup> The number of pages in the 1040 instruction booklet has increased by 34 percent and is now 128 pages.
- H&R Block's revenue from tax preparation has increased by 219 percent since 1996, and is now over \$2.3 billion.

Also, much of the paperwork burden for small businesses is due to the provision of employee benefits such as pensions, health care, etc. The tax code must ensure that efforts to provide solid benefits are not penalized by excessive filing burdens.

I think virtually everyone agrees that the tax code for small businesses is too complicated.

I would like to focus on one particular aspect of the degree to which our tax code has been mangled: the uncertainty of tax policy over time. Businesses routinely must assess the value of investment projects, meaning they must compare future projected revenues with today's costs. To the extent that future policy is uncertain, it adds just another component to an already risky decision.

For example, for the very few businesses that must prepare for the estate tax, the current path of elimination and resurrection is bordering on the ridiculous. A better option would be to set the estate tax exemption to a reasonable \$2.5 million exemption level, as American Progress has proposed, and index that level to inflation.

Other examples include other provisions in the code that are set to expire, or that will need to be adjusted, including the AMT, certain depreciation rules, tax preferences for capital gains and dividends, not to mention the bulk of the 2001 and 2003 tax laws set to expire in 2010.

Some would argue that making the president's tax changes permanent would solve some of this uncertainty. But doing so would simply lock in a complicated policy and permanent deficits—I would argue that a reform of the tax code is indeed necessary, but it should be a reform that takes a very different direction from current policy.

The lesson we should take from recent tax policy is this: Congress should make permanent changes, unless the desire is explicitly a short-run economic boost—and in that case the provisions should be allowed to expire. And Congress should not use reconciliation in the budget process to make significant tax changes, since this virtually guarantees that policy will be continually revisited.

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<sup>5</sup>Schedule C has increased by 13 percent from 1990 to 2004 and is approaching 11 hours according to the IRS's analysis. The time to file schedule E increased by 7 percent and is now over 6 hours.

## 4 Fairness and Efficiency

As I've already mentioned, most small businesses are indeed small, and the tax rates faced by most small businesses are well below the top bracket.

Small business efficiency requires a fair, progressive rate structure, not a flat structure.

This means that the tax structure for small businesses must reflect the tax structure of a progressive tax code. When just getting started, businesses will have low levels of revenue and profits, and should face lower levels of taxation than larger companies, which can better afford higher tax rates. In addition, by their very size, larger corporations utilize more public resources—for example, they have more trucks on the road, use more of our ports, and rely more on the protections that our court system provides.

Lower tax rates on smaller businesses can also be justified by the fact that compliance costs (e.g. for regulations and taxes) are higher on a per-revenue, or per-employee basis for smaller businesses than for larger businesses.

Furthermore, small businesses must also pay the payroll tax for their employees as well as for themselves. Removing the employee side of the Social Security payroll tax would benefit not only small business employees, but would also improve the take-home pay of the owners themselves.

Tax reform requires making choices and setting priorities. In today's tight budget environment, tax cuts for those at the top of the income distribution necessarily mean shifting the tax share to middle-class taxpayers and most small businesses.

## 5 Economic Growth

A strong economy is essential to the health of small businesses and vice versa. And both require educated and skilled workers.

### 5.1 Human Capital

The tax code should not focus solely on what economists call physical capital—computers, trucks, machinery, etc.—but should also focus on building “human capital;” that is, education, on-the-job training, and advanced skill formation, thereby increasing the capabilities of employees to be better and more efficient at their jobs.

Already, we provide substantial preferences for income from accumulated wealth through preferences for capital gains and dividends and the expensing (or accelerated depreciation) of physical assets.

We need to create a tax code that balances incentives for investment in physical capital with investment in human capital.

## 5.2 Revenue Adequacy

Businesses also rely on a range of public services that are supported by tax dollars. Businesses obviously benefit from roads and ports, but they also benefit from a solid educational system and a clean environment. A small Internet design firm cannot survive without educated designers and computer experts, and a fisher cannot make a living from a polluted river.

Tax reform must ensure that there are adequate resources overall to ensure an economic environment that is conducive to a strong small business sector and solid economic growth. And that requires raising adequate revenue to fund national priorities to ensure a vibrant economy.

To take another example of how tax and budget policy can harm the small business community: the Small Business Administration's budget has been cut by a third over the past 5 years from \$900 million in 2000 to \$610 million in 2005.

## 5.3 New Business Creation

Finally, we need to not only unleash the creativity and work ethic of our nation's business owners, but also respect the work of all Americans, including those who may not have the means to start their own companies.

In fact, part of growing the small business community is about making sure that as many people as possible have an opportunity to start their own businesses.

# 6 On Fundamental Reform Proposals

A number of fundamental reform ideas have been floated in recent years. The flat tax, a value added tax (VAT), and the national retail sales tax are all examples of policies that have emerged as replacements for the current income and/or corporate tax code.

First, evaluation of fundamental reform must be done in light of the current budget situation. The low rates one often sees in VAT, flat tax, or national sales tax proposals are often unrealistically low-and would simply put an inexcusable drain on already scarce national resources.

Second, one must look at the macroeconomic effects of these proposals. It is claimed that by reducing the top marginal tax rate and exempting capital income from taxation, one is promoting economic growth. Yet, most, if not all of these benefits are eroded if these changes add to the federal deficit and raise interest rates in the long run.

Third, as cited above, since most small businesses are owned by those in lower tax brackets, cuts at the top do nothing for the bulk of small businesses. And the inevitable shift in the tax share towards low- and middle-income business owners can be harmful to those businesses most in need of resources with which to grow their business.

It is often falsely argued that these reforms (or less ambitious versions) are somehow needed for our economy to grow. To take one example, those who wish to repeal the estate tax argue that it is harmful to family farms and businesses and is thus bad for economic growth. However, there is little evidence that there would be a significant impact on the economy from estate tax repeal. Our economy thrived, for example, in the late 1990s despite having a lower estate tax exemption than today. And the nearly \$1 trillion that would be added to the debt over the first 10 years of repeal would certainly place a drag on the economy. I would suggest that the booming economy of the 1990s did more for small businesses than all of the tax changes over the past few years.<sup>6</sup>

By making other changes that reduce tax rates on higher-income taxpayers or larger businesses, we are necessarily shifting the tax share onto those with lower incomes or smaller businesses. Providing additional incentives to a few at the top thus means reducing productive incentives to the bulk of people in the middle.

Sometimes it seems that virtually any proposed tax cut, tax reform, tax deduction, or tax credit is claimed to be “good for small business.” The task of policymakers is, in many ways, to sort out these claims and apply a high standard: what is the best use of public resources.

If you gave me a check for \$10 billion today, I could create a bunch of jobs and add value to the economy, but while I would certainly encourage you to do so (and I can provide you with a direct deposit account number if you like), I would also suggest that there might be better ways to provide targeted incentives to both existing and not-yet-born small businesses.

To be most effective in stimulating growth, tax incentives need to reward new investments in innovation and technology in a targeted way, and not simply create a windfall for income derived from past investment decisions - which is what many of these policies will do.

Also, fundamental shifts in the code can also shift the burden of compliance. For example, under a VAT, the costs of complying with the tax code would be shifted onto businesses, including small businesses.

## 7 Conclusion

Overall, the goal of small business policy should be to set the right environment for growth. The American small business community is vibrant, resilient, and helps to make our country economically strong.

We need to resist the temptation to claim that the small business community needs a tax cut each year to survive. Massive budget deficits which can increase long-term interest rates do far more damage to small businesses and investments

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<sup>6</sup>A recent CBO study dramatically illustrated just how few small businesses are actually significantly impacted—with a 3.5 million exemption, just 200 estates would not have had sufficient liquid assets to pay the estate tax in 2000. The CBO report estimated the number of estates that would have been affected by the estate tax in 1999 and 2000 for various levels of exemptions.

than a few tax breaks here and there.

The goal of tax reform should be to simplify the code, while keeping a progressive rate structure and preserving the incentive to add value to the economy.

Thank you for the opportunity to present to this vital committee.