United States Senate
Committee on Finance

Sen. Chuck Grassley · Iowa
Ranking Member

http://finance.senate.gov
Press_Office@finance-rep.senate.gov

Floor Speech of Sen. Chuck Grassley
McCain and Obama Tax Plans Effects on Small Business
Delivered Thursday, Sept. 11, 2008

Today I'd like to continue my discussions about one of the big choices facing the voters this fall. That choice is which of our colleagues, Senator McCain or Senator Obama, should we follow in terms of future tax policy. In recent weeks, I've talked about the history of party control and the likelihood of broad-based tax increases. I used the tax increase thermometer to point out the history. I've discussed the specific precedent of the 1992 campaign with its promise of a middle class tax cut and the 1993 world-record tax increase that hit taxpayers above $20,000. I've referred to a case of tax hike amnesia. I've discussed the fiscal impact of the McCain and Obama plans. I've talked about how the McCain and Obama plans would affect seniors and middle income families. Today, I'll focus on how the two plans will affect small business.

There's been a lot of controversy over the years about the effects of marginal rate increases on small business. It first arose back in 1993. At that time, President Clinton and the Congressional majority Democrats pushed through legislation that retroactively raised the top marginal income tax rate. The rate was 31%. Under the 1993 bill, two new higher rates went into effect, the 36% and 39.6% rates. One of the criticisms of the higher marginal rates was that these rates would harm small business.

In 2001, Chairman Baucus and I crafted a bipartisan package of marginal rate reductions. Part of that package brought down the top rate from 39.6% to 35%. Another part of the package lowered the 36% rate to 33%. Although the non-partisan Joint Committee on Taxation, in its distribution analysis, concluded that the legislation improved the progressivity of the tax code, the top marginal rate reductions were controversial. Many on the Left in the punditry decried the marginal rate reductions as tax cuts for the wealthy. Many in the press echoed those criticisms. They focused on the top rate reductions and defined the bipartisan broad-based tax relief as "the Bush tax cuts for the rich." These critics and the members who shared their view failed to examine the data on the whole bill.

The fact that the Democratic Presidential candidate is embracing most of the policy from the bipartisan deal should give these liberal critics pause. Senator Obama's campaign tax plan confirms what I said many times here over the last seven years. It confirms that the bill Chairman Baucus and I crafted was a bipartisan plan that would stand the test of time.

Since the top rates of 35% and 33% were the source of considerable opposition, there was a lot of debate about their merits. Aside from the general economic benefits of increased incentives for work and investment, Chairman Baucus and I focused on the benefits to small businesses. On Monday, August 20, 2001, Chairman Baucus and I released a statement on a Treasury Department analysis. I'd like to quote from part of that press release:

"{o}wners of sole proprietorships, partnerships, S corporations, and farms – will receive 80 percent of the tax relief associated with reducing the top income tax rates of 36 percent to 33 percent and 39.6 percent to 35 percent... Baucus and Grassley said most of the job growth over the past decade has come from small businesses.. Experts agree that lower taxes increase a business' cash flow, which helps with liquidity constraints during an economic slowdown and could increase the demand for investment and labor.."

I ask unanimous consent to place in the record a copy of the August 20, 2001, Baucus-Grassley press release. I also want to thank my friend, Chairman Baucus, and other members from the other side, for sticking with me on these marginal rate reductions over the years. With the strong impulse to raise marginal rates in the Democratic Caucus, I know those votes were not easy. I know small business folks in his state are grateful.

Today, over 7 years later, we find ourselves in the same debate. And the data and implications of it are still very important in debating the merits of the stated top rates of 35% and 33%. Senator McCain's position is that we should not raise those rates, especially in a time when the economy has slowed. Senator Obama insists that we raise those top rates. This is a sharp difference between the two potential Presidents on tax policy. As Ranking Republican on the tax writing Finance Committee, it is my duty to clarify this important debate. Our constituents have a right to be informed, in an intellectually honest manner, on this important question.

So, let's take a look at this small business issue. The first question we need to consider is what is a small business? The second question would be what role do these small businesses play in our economy? After that, we need to get a handle on which small businesses are affected by the higher rates Senator Obama has proposed. Finally, we need to get a sense of how the small businesses are affected in the short-term and long-term.

Let's go to the first question. What is a small business? It's not a precise answer. In one way, some on the other side have said the only small businesses that matter are those with owners who earn less than $200,000 to $250,000. To those folks, the local hardware store, if one of the owners or the sole owner earns over $250,000, no matter how many folks it employs, is the same as Home Depot or Lowe's. Those of us from the heartland know that the definition of small business is not limited to those whose owners make $250,000 or under. For us, it depends on whether the business is locally-based. It depends on whether the business finances its growth from its own earnings. Conversely, to folks from small towns, like myself, big business is generally the companies that finance themselves through the stock market.

The reason the distinction is important for public policy issues, like the level of taxation, is that we value local or regionally based businesses. The folks that own those businesses are drawn from the community. They attend the Rotary meetings. They support the local Little League. Small business, as I see it, is a stabilizing yet dynamic social force.

So, when we talk about small business, we should not use any artificially low level of income. We should use a common sense definition of small business. There's too much at stake to demagogue the definition.

It seems that a good place to go for a definition of small business would be the Small Business Administration ("SBA"). For most Federal policy, as a rule of thumb, the SBA would tell you that a small business is a privately-held business with 500 or fewer employees. When we are considering tax policy, and specifically the tax rates applicable to business, we really have two categories. The first category is regular corporations. Virtually all big businesses, that is, publicly-traded companies, are taxed under the regular corporate rate schedule.

There are several tax code rules dealing with small business. In general, the tax code treats those businesses that go to the capital markets differently than those businesses that are financed by their owners. There are special rules for depreciation. There are special pension rules. Most important, however, are the rules that allow small business to avoid the double taxation that applies to corporate earnings. Owners of certain kinds of small business corporations, known as "S" corporations, can elect to be taxed like proprietorships or partnerships. That is, these corporate shareholders include the business income on their individual returns. In general, an S corporation can have no more than 100 shareholders. In the case of families or pension plan owners, the number of shareholders can be larger.

So, with respect to the first question, I think we're on pretty solid ground in identifying small businesses as privately-held businesses with 500 or fewer employees. You won't find much controversy over this definition.

Let's turn to the second question. That question is what is the economic impact of small business? No one disputes the fact that small business creates most of the jobs in America. According to the Small Business Administration's Office of Advocacy, small business has generated 60% to 80% of the net new jobs annually over the last decade. Let me repeat that. Over the last decade, small business has generated 60% to 80% of the new jobs.

Where are tomorrow's jobs going to come from? The answer is the lion's share of future jobs are going to come from small business employers. I recommend that my colleagues consult the Small Business Administration's Office of Advocacy's Frequently Asked Questions, available on the internet at "www.sba.gov/advo".

We shouldn't be surprised that small business creates the lion's share of new jobs. A lot of America's economic might, know-how, and dynamism resides in small business. According to the latest Treasury data, flow-through small businesses account for 93% of all businesses, 36% of business receipts, 34% of wages paid, and 50% of all business income. I have a chart that shows the growth of these flow-through small businesses since 1980.

While I've focused on the flow-throughs, keep in mind that many other small businesses would be affected by the top marginal rates. Let's focus on the small business data. The non-flow-through small businesses are what are called “C” corporations. These entities are taxed like conventional corporations, but are not big publicly-traded businesses. So, the owners are paid through salary and dividends. These small businesses account for 10% of receipts.

In terms of business receipts, then the combination of flow-throughs and regular corporations account for 46%. That’s almost half of the nation’s private sector income. These regular small business entities account for 13% of wages paid. When combined with flow-throughs, the small business sector accounts for 47% of wages paid. That’s almost half of the wages paid in private sector jobs. In terms of net income, these regular small business entities account for 2% of net business income. When combined with flow-throughs, the small business sector accounts for 52% of net business income. So, that’s over half of the net business income in our nation.

We may use the adjective “small” to describe this part of the business sector of our nation, but the economic impact of these businesses is not small. Like the answer to the definition of small business, I don’t think many on the other side would quarrel with the notion that small business is a key part of our economy.

We’ve answered the first two questions, the definition of small business and its economic impact. Now, we need to ask the third question. That question is: how are small businesses taxed?

First off, the small business owner pays the tax. And the individual tax rate, at the owner’s level, is the rate paid by small business. These businesses are described as flow-throughs because the business income and tax burden flows through to the business owner. I have a chart here that shows how a small business owner is taxed. The chart shows the business entity. It could be a partnership. It could be an “S” corporation. It could be a proprietorship. The business gets it’s cash from four sources. The first is its sales. The second is debt. As a practical matter, a business will be able to access credit only if its owners are willing to guarantee the debt. The third source is the owners investment. The fourth is retained after-tax profit. I want to emphasize the phrase “after-tax.” These are the sources of cash for a business.

The business uses its cash to pay workers. It uses cash to pay other expenses like utilities, rent, and supplies. A business either makes a profit or suffers a loss. If it makes a profit, the profit is taxed at the owners’ level. It flows through to the owners. At that point, the Federal Government takes its share. The after-tax profit is available to the owners.

Currently, the top two Federal tax rates are 33% and 35%. Senator McCain wants to keep the rates there. Senator Obama wants to raise the statutory rates to 36% and 39.6%. Senator Obama also wants to restore the hidden marginal rate increases known as “PEP” and “Pease.” For small business-owning families, their real marginal rates would go up to 40% and 41% respectively. Senator Obama has also proposed to raise the Social Security tax on this same group of small business owners by 2% to 4%.

Recently, however, Senator Obama modified his tax plan to defer the Social Security tax increases. If we set aside this future Social Security tax increase, the taxes owed by small business owners would rise by as much as 21% and 17% respectively. I have a chart that shows the difference between the current law top rates, which Senator McCain would keep, and the increase in these rates proposed by Senator Obama.

Let's take a look at how small businesses that are organized as regular corporations would be affected. These businesses are not flow-through entities. Since the top two rates, as proposed by Senator Obama, would rise by 21% and 17% respectively, the salary income would be taxed at those higher rates.

For that same group of taxpayers, Senator Obama proposes to tax dividend income at 20% instead of the 15% rate that applies now. That is a 33% tax increase.
So, for these regular, non-flow-through small business owners, the amount of tax owed on their business income would rise at a range of 17% to 33%.

As with the answers to the questions of definition and economic impact of small business, I don't think folks on the other side would dispute what I've just said about how small businesses are taxed.

Now, we come to the fourth question. That question is: what is the relationship between the top two marginal rates and small business activity? Put another way, how much small business activity will be affected by the increased rates Senator Obama proposes?

Unlike the first three questions, the answers to this question have been controversial. Over the years, folks who are hostile to marginal rate reductions have pointed to one statistic. They've referred to the percentage of small business tax filers who fall into the two top rates. For instance, they cite a statistic from the Tax Policy Center that concludes that 1.9% of filers with business income pay the top two marginal rates. I ask unanimous consent to include in the record a copy of the relevant Tax Policy Center analysis, dated July 14, 2008. According to the Tax Policy Center analysis, that percentage is roughly three times the percentage of tax filers in the general population. They'll state the proportion of small business owners in the top two brackets is roughly similar to that of the general taxpaying population. The opponents of marginal rate relief will use this data to conclude that small business owners' tax profile is similar to the non-business taxpayer's profile. Since the tax profile is similar, the general re-distribution argument applies. Bottom-line is that opponents will argue that raising rates on small business owners makes the tax system more progressive.

For the opponents of marginal rate relief, the discussion ends there. It comes down to their view of tax fairness from their perspective. Although the statistics show small business owners are three times more likely to be in the top two brackets, that matters not a wit to the opponents. The rates must go up and the revenue must be spent on expanding government. For an example of this perspective, I recommend my colleagues consult the article "Big Misconceptions About Small Business and Taxes," from the Center on Budget Policy and Priorities dated August 29, 2008, available on the internet at www.cbpp.org

The political point of the opponents boils down pretty simply. This small group of filers is well off, so, other than them, who cares if their rates go up. That's good politics. When you're talking about 1-2 percent of the population versus the rest, and your theory is re-distribution, you're going to be making the easier political case. And that's where they leave it.

There is a huge assumption that makes this argument dangerous. The assumption is that since the number of filers is limited to roughly two percent, the business activity is likewise limited. The assumption is extremely dangerous economic policy. Why? Two reasons. One, the 2% understates the number of small businesses affected. Second, the assumption discounts any negative effect of removing resources from small businesses.

Let's go to the first dangerous assumption. Distribution tables are like any other estimate. Inside the Beltway, distribution tables are a fetish. Many on the left side of the political spectrum worship at the altar of distribution statistics. They treat it as the <u>only</u> measure of whether a tax policy proposal is good or bad tax policy. But distribution tables are an analytical tool meant to inform a tax policy debate. Distribution tables are a snapshot. Like any other snapshot, the analysis is limited.

Let's take a look at the oft-cited Tax Policy Center distribution table. The table references a total of roughly 35 million business tax units. That's a proxy for tax returns and households. About 30 percent of that total, roughly 8 million tax units, represent folks that pay no income tax for that year. The footnote to the tables states that all business income is defined as the sum of "gains or losses reported on Schedules C, E, and F." Those are where the flow-through income is reported on the owner's tax return.

When you look at small business gains and losses, it is quite revealing. Small businesses are at the cutting edge of our capitalist system. With capitalism comes the volatility of the business cycle. Small businesses are more susceptible to the good and bad years that come with business cycles. One year a small business may do well. The next year might be a loss year.

As evidence of this volatility, I'd like to refer to SBA data on small business survival rates. You'll find this on the frequently asked questions document I referred to earlier. According to SBA, two-thirds of small businesses survive for at least 2 years. Forty-four percent of small businesses survive for at least 4 years. What this means is that, over time, many small businesses rise and fall.

By the way, mobility within income brackets is something that occurs to a great degree in the U.S. Think about it. How many people in their mid-twenties stay in the same tax bracket all the way through retirement? The mobility of income of small business is a subset of the overall income mobility in the U.S. population.

Treasury data clarifies the TPC snapshot. I have another chart. This chart shows that, when gain and loss is considered, the snapshot changes dramatically. For all flow-through taxpayers, 8 percent fall in the top two brackets. For taxpayers with active, positive flow-through income, the percentage is roughly the same, about 7%. For taxpayers with flow-through income that is greater than half their wage income, the percentage is the highest, 9%.

So, keep in mind, we're dealing with a moving target when we talk about the 2% figure. Some businesses will produce losses for their owners one year and income in another year. So, the business owners caught in the snapshot may not be the same business owners in another snapshot.

The second assumption about the 2% filer argument is even more dangerous. That assumption is that, since a small percentage of tax filers are affected, the impact on small business activity is trivial.

How will the higher marginal rates remove resources from small business you might ask? It's fairly simple. Let's go back to the chart that shows how a small business works. If the amount paid in taxes increase by 17% to 33%, the tax take of the business rises as well. It comes out here. Let's go through an example. I'm going to use another chart. This taxpayer files jointly, owns a small business, and earns $500,000 of business income. For purposes of this example, we'll assume all of this taxpayer's income comes from the small business. As an aside, this assumption favors the opponents of marginal rate relief. Why? Because most small business owners have income from other members of the household and income from other sources. In that more likely scenario, the marginal rate hikes would bite harder because more business income is pushed up into the higher brackets.

Under this example, the small business owner pays $146,700 under current law. Senator McCain's plan leaves this level of taxation in effect.

Under Senator Obama's proposal, the small business owner's taxes would go up by about $20,000. That's a tax increase on this small business owner of roughly 13%.

The tax increase would present the small business owner with a $20,000 current problem. The small business owner's current problem is how does he or she alter his or her business to make up for the $20,000 he or she has lost to Senator Obama's higher tax rates? Can he or she grow enough sales to pay the extra tax? Maybe. Maybe not. Can he or she not replace a $20,000 machine? Maybe. Maybe not. Can he or she cutback on payroll? Maybe. Maybe not.

How about the future? Any good business person has to project how their investment is working. Any investment's value is predicated on how much income the investment is likely to produce in the future. If income is projected to go down, then the value of the investment declines.

Higher taxes negatively affect the net income from an investment. Small business owners have choices about where to put their capital. If taxes press down on the projected net income, then the value of the small business investment declines. Everything else being equal, a small business owner is less likely to leave the after-tax profit in the business. Likewise, a small business owner is less likely to make future investments in the business.

My point is the tax increase Senator Obama is proposing has a very real cost to the small business owners. Who are the businesses Senator Obama is proposing to hit with this tax increase? That is, which businesses are owned by taxpayers making over $250,000? How many employees do they have?

I have another chart. It is based on data from the National Federation of Independent Business ("NFIB"). It is a national small business organization. NFIB has 350,000 dues-paying members. They take surveys of their members and other small business folks. I have the latest survey that deals with finance questions from 2007. This chart contains the results of question #12. Take a look at the chart. The question identifies groups of small business owners by household income with the size of their firm by number of employees. Household income includes income from other adult members of the household. If you take a look at the responses, you can compare firm size with income level of the owners. Here we have $250,000 and above. Those are the folks that are targeted for a tax increase that would raise the amount owed to the government between 17% and 33%. The survey indicates that 6.4% of the business owners of firms with 1 to 9 employees would be hit by Senator Obama's tax increase.

Move a step over and we find that about 21% of the owners of firms with 10-19 employees would be hit by the tax increase. Move one step to the right and we find 40% of small business owners of firms with 20-249 employees would be hit by the tax increase. Let me repeat that. Forty percent of the owners of small business firms would be hit by the marginal rate increases of 17% to 33%.

Now, there seems to be armies of hard-working tax analysts in this town that work for think tanks on the left side of the political spectrum. If you look at the analyses of the tax data, the armies of the Left clearly are far more numerous than the armies of the right or middle. I give them credit for their hard work and dedication. I'm sure they'll be poring over this data. Since the re-distribution dogma is what floats their boats, they will probably take a hostile attitude towards the data I'm citing. Anticipating the attack of the green-eye shaded armies of the left, I think we can trust the survey statistic.

NFIB has been conducting these surveys for years. I can't think of any reason why respondents to the NFIB survey would inflate or deflate their income statistics. So, I think this 40% snapshot is a solid figure.

The data above relate to taxpayers at $250,000 and above. Since Senator Obama's advisors have said his current proposal would raise taxes on single taxpayers above $200,000, on a rough basis, it's fair to look at those small business owners as well. If you do that calculation, then, on a combined basis, Senator Obama's proposed tax increase would hit even more small business owners. Let's go back to NFIB question #12. For small businesses that employ 1-9 workers, 12% would be hit by Senator Obama's higher taxes. For small businesses with 10-19 workers, about 27% would be hit by Senator Obama's higher taxes. For small businesses with 20-249 workers, 50%, half of those small businesses, would be hit by Senator Obama's tax plan.

Here's the scariest part. As the chart shows, the percentage of small business owners hit by Senator Obama's higher taxes goes up as the number of employees goes up. So, it's fair to say these figures probably understate the impact of the higher marginal rates on the remaining small businesses, those between 250 and 500 employees. Moreover, like the distribution tables, the survey is a snapshot. With small businesses alternately running gains and losses, over time, the higher rates will hit a larger number of small business owners.

With the conservative nature of this data in mind, let's take another look at the economic profile of the small businesses Senator Obama has targeted with a tax increase. Every year, the SBA prepares a report to the President on the small business economy. The last report we have was submitted to President Bush in December 2007. It covers data for 2006. For 2006, the entire private sector workforce growth occurred in small businesses with 500 or fewer employees. For 2006, over half of America's private sector employees worked in these firms. For 2006, these small businesses accounted for over half of the nation's private sector gross domestic product. Drill down deeper into the data and you will be worried even more. Two-thirds of that small business payroll came from firms that employ between 20-500 workers. If we go back to the NFIB question, we'll find that the owners of these small businesses are the ones most targeted by Senator Obama's tax increase proposal.

Finally, Mr. President, don't take my word for it. Listen to what small business folks have said about the importance of lower marginal rates. Take a look at this chart. The chart is a copy of a letter, dated March 14, 2003, from the three principal small business grass-roots organizations.

The first organization is the National Federation of Independent Business or NFIB, The second organization is the Small Business Legislative Council. The third organization is the Small Business Survival Committee. I'd like to read the second paragraph of the letter. It sums up the reality of the effects of marginal tax rates on small business. I quote:

"Approximately 85 percent of small businesses file their tax returns as individuals. An increase in tax refunds means small firms will have more resources and more capital to put back into growing their businesses. A series of studies by four top economists examined the effect of tax rate cuts on sole proprietors. Their results indicate that a 5 percent point cut in rates would increase capital investment by about 10 percent. And, they found that dropping the top tax rate from 39.6 percent to 33.2 percent would increase hiring by 12.1 percent."

What these small business groups said was their tax policy priorities included a reduction in the top marginal rate. It's right there in the letter.

Now, let's think about this. As the small business folks say in their letter, there's a link between tax relief, economic growth and jobs. We've seen the evidence of that linkage in years past. Tax relief kicked in, the economy started growing, and jobs started coming back.

Why would we want to go in reverse gear? Senator McCain and Senator Obama agree on the policy objective of growing jobs. Why would you aim a 17%-33% marginal tax rate increase at the businesses that grew all the jobs in the most recently-studied year? Senator McCain's plan recognizes this job-loss risk. Senator Obama plan goes in the opposite direction. Let me conclude with a challenge to the proponents of raising marginal rates on small business. When I say critics I'm referring to politicians, pundits, and some in the media. I think the data I've presented speaks for itself. If you disagree with the analysis, but hold the position that higher marginal rates won't affect small business, would you agree to exclude small business from the 17% to 33% marginal rate increases you're supporting? I await your answers.

-30-