

# Analysis of Small Business Tax Cut Act

**By Gary Robbins  
Fiscal Associates, Inc.  
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## **Executive Summary**

On March 21, House Leader Eric Cantor unveiled the Small Business Tax Cut Act which would reduce taxes on small businesses. This report examines the plan to determine its likely cost and impact.

We find that:

\* Sun-setting income tax cuts, expiring temporary payroll tax cuts and spending measures, along with the impending sequester at the end of 2012 could send the economy into tailspin. In addition, President Obama proposes to raise taxes on millions of small businesses and working families and to enact a new minimum tax, the Buffett Rule.

\* The Cantor plan would lower tax rates on millions of small businesses, from mom and pop stores to small manufacturing and service companies, allowing them to invest, expand, and hire workers.

\* Official static revenue estimates predict a \$47 billion reduction in federal taxes paid by small business but ignore the beneficial effects of the plan.

\* The Small Business Tax Cut Act would lead to a reduction in prices for the products and services sold by these businesses, helping families and increasing demand and sales.

\* Over time the plan would yield \$112 billion more in GDP, create 194,000 jobs, and lead to a 2.24% increase in business capital. Our cost benefit analysis shows that this increased economic activity and growth would offset much of the government revenue loss.

\* Once fully implemented, over time the 20% small business tax cut will create more than an average of 100,000 jobs per year.

\* One third of the firms directly benefiting from the Act are owned by women and one fifth are minority owned.

\* The Cantor Small Business Tax Cut Act would help middle class workers even more than small business owners. Workers would receive more than two-thirds of the added private sector benefits.

\* The plan would return to middle-class private citizens \$4.30 for every \$1.00 of actual government revenue loss.

\* Given the current shallow economic recovery, the Small Business Tax Cut Act is definitely a step in the right direction.

## **Analysis of Small Business Tax Cut Act**

On March 21, House Leader Eric Cantor unveiled the Small Business Tax Cut Act which would reduce taxes on small businesses so that they could expand and create jobs. The Cantor Plan would give millions of unincorporated businesses with fewer than 500 employees — one federal definition of a small business — the ability to exclude 20 percent of their income from taxation. These small businesses would range from the mom and pop corner deli to local manufacturers and tech startups. The reduction would be accomplished by amending Internal Revenue Code Section 199 (Domestic Production Activities Deduction) to specifically allow a small business to subtract 20 percent of taxable income from its tax base.

This report examines the Small Business Tax Cut Act to determine its likely cost and impact on growth. We first estimate the static cost of the proposal in a manner consistent with the methods used by the official revenue estimators. We then examine the likely economic effects. Last, we provide dynamic estimates of the revenue cost, benefits flowing to business owners and workers, and the impact on government bottom lines. We first look at the impact of a permanent version of the Act as well as limiting the term to one, three, five, and seven years.

Under current law, tax cuts enacted in 2001 and 2003 will sunset at the end of the year. This will result in much higher marginal tax rates for unincorporated and corporate business. Several temporary spending measures also will end along with imposition of new spending cuts provided as part of passing the debt limit in the fall of 2011. Finally, the temporary payroll rate cut and 50% bonus expensing will expire as well.

These changes will produce a large economic drag beginning in January 2013. Without new legislation the impact on the economy of these scheduled changes could be quite large. Ezra Klein of the Washington Post reports that allowing the changes to occur “would increase unemployment by 1.1 percent in 2013.” To date, President Obama has proposed to extend the 2001/2003 tax cuts for taxpayers below \$250,000 in adjusted gross income (AGI). The President has also proposed the “Buffett Rule,” which would change current policy by establishing a minimum tax rate for certain taxpayers regardless of whether their income is derived from long-term capital gains, dividends, wages or salary. The Republican leadership has countered with a proposal to ensure that no American faces a tax increase in January.

To put the Small Business Tax Cut in context, we have looked at the impact of the scheduled tax increases. This analysis allows us to estimate the potential drop in output that would begin to take place in 2013 as taxes are increased.

We use an econometric model to provide the dynamic analysis. This provides a consistent framework to analyze the impact of the tax change on business expenses, output, and payments to capital and labor. A reduction in business taxes will reduce the cost of producing output and will allow businesses to expand their sales (and market share) by reducing the prices they charge for their products. Lower prices will lead to greater sales volume, and higher sales will lead to an increase in employment. The increase in output and sales will lead to higher tax revenues that will partially offset the revenue cost to government.

**Table 1**  
**Impact of Permanent 20% Small Business Tax Rate Cut**  
(Amounts in \$billions unless otherwise noted)

	Baseline	Lower Small Business Tax Rates		
	2008	Level	Diff	%Diff
<b>Gross Domestic Product</b>	14,291.5	14,403.2	111.7	0.78%
<b>Private business capital stocks</b>	27,623.3	28,241.3	618.0	2.24%
<b>Wage rate (economy-wide average \$/hr.)</b>	\$33.47	\$33.69	\$0.22	0.66%
<b>Total hours worked (billions of hours)</b>	259.148	259.473	0.325	0.13%
<b>Current receipts</b>	4,051.6	4,046.9	-4.7	-0.12%
<b>Federal</b>	2,501.7	2,479.9	-21.8	-0.87%
<b>State &amp; local</b>	1,945.4	1,962.5	17.1	0.88%
<b>Net lending or net borrowing (-)</b>	-918.4	-936.1	-17.7	1.93%
<b>Federal</b>	-692.8	-718.4	-25.6	3.69%
<b>State &amp; local</b>	-225.6	-217.7	7.9	-3.48%

**Other Details:**

<b>Static Revenue Loss</b>	-47.5
<b>Federal Revenue Reflow</b>	25.7
<b>Federal Revenue Reflow as %</b>	54%
<b>State &amp; Local Revenue Reflow</b>	17.1
<b>Total Revenue Reflow</b>	42.8
<b>Total Revenue Reflow as %</b>	90%
<b>Change in Jobs (thousands)</b>	194

**Aftertax Distribution of Additional GDP (\$billions):**

<b>Workers</b>	52.6
<b>Capital Owners</b>	23.5
<b>Government</b>	18.1
<b>Depreciation</b>	17.5
<b>Total</b>	111.7

We estimate the impact of the Act in two parts. First we assume the tax change is permanent. We then limit the Act to four different periods.

### **Impact of Permanent Reduction in Small Business Tax Rates**

The Small Business Tax Cut Act would reduce taxable small business profits by 20 percent. Some small businesses already receive a 9 percent reduction under section 199 and the new reduction would be in place of the current reduction. We estimate that the new provision is equivalent to an additional 17.5 percent reduction in taxable profits resulting in a \$47 billion reduction in taxes paid by small business, money that can be used to invest in job creation. It would also reduce the effective marginal tax rate on noncorporate capital income by the same percentage.

Using this as the starting point we estimate that the lower tax rate would lead to nearly a 0.5 percent reduction in prices charged by producers for their products and an increase in the quantity demanded by customers. Table 1 shows the dynamic estimate of the impact of permanent adoption of the plan. Ultimately GDP would be \$112 billion higher with 194,000 new jobs created and 2.24% more business capital.

Higher incomes and the resulting increase in all taxes would reduce the out-year revenue loss. Federal revenue loss would ultimately be less than half of the static estimate; 54 percent would be offset by reflows from all sources of receipts. Including increases in state and local receipts, the reflows would offset 90 percent of the static estimate of the revenue loss due to the proposal.

While the initial cut was directed at owners of small business capital, the expansion would ultimately benefit workers by more than the initial small business capital income tax cut. Workers would end up with more than two-thirds of added private sector benefits. The extra \$24 billion going to capital owners would ultimately lead to over \$600 billion in new business investment that would otherwise not have been undertaken.

The cost of implementing Cantor's Small Business Tax Cut Act is often incorrectly taken as the foregone revenue, typically using an incorrect static revenue estimate. This is highly misleading as the ultimate revenue cost generally is much smaller. Further, even this cost ignores the added output and income received by the private sector. Private citizens would receive \$76.1 billion after taxes compared with an increase in total government borrowing of \$17.7 billion. In other words, the private sector would gain \$4.30 for every extra dollar not paid to government. Unless the return on another dollar of government spending is more than 4.3 times as efficient as what the private sector could do with that dollar, the Cantor Plan is preferable.

## Limiting the Term of the Small Business Tax Cut Act

It is widely accepted that temporary measures are less effective than permanent enactment. There are lags in the recognition by businesses, supply problems, implementation delays, and uncertainty as to what government policies would follow. Table 2 shows economic changes if Cantor's Small Business Tax Cut Act were in effect for one, three, five, or seven years. Each entry contains the results for the last year of the indicated period.

Because of the normal lags described earlier, shorter periods provide less growth. Limiting the change to three years, for example, produces only half the positive economic impact of a permanent change. The five-year change would yield more than 85 percent of the change in GDP from permanent adoption, and the seven-year change would yield more than 95 percent.

**Table 2**  
**Impact of Temporary 20% Small Business Tax Rate Cut**  
 (Amounts in \$billions unless otherwise noted)

	1-Year	3-Year	5-Year	7-Year
<b>Gross Domestic Product</b>	21.1	58.8	96.2	108.3
<b>Private business capital stocks</b>	116.2	324.6	532.4	599.7
<b>Wage rate (economy-wide average \$/hr.)</b>	\$0.04	\$0.12	\$0.19	\$0.21
<b>Total hours worked (billions of hours)</b>	0.066	0.172	0.278	0.314
<b>Current receipts</b>	-39.4	-25.0	-10.6	-5.9
<b>Federal</b>	-42.6	-33.9	-25.4	-22.5
<b>State &amp; local</b>	3.2	9.0	14.7	16.6
<b>Net lending or net borrowing (-)</b>	-41.9	-31.8	-21.9	-18.5
<b>Federal</b>	-43.4	-35.9	-28.6	-26.2
<b>State &amp; local</b>	1.5	4.1	6.8	7.6
<b>Other Details:</b>				
<b>Static Revenue Loss</b>	-47.5	-47.5	-47.5	-47.5
<b>Federal Revenue Reflow</b>	4.9	13.6	22.2	25.0
<b>Federal Revenue Reflow as %</b>	10%	29%	47%	53%
<b>State &amp; Local Revenue Reflow</b>	3.2	9.0	14.7	16.6
<b>Total Revenue Reflow</b>	8.1	22.6	36.9	41.6
<b>Total Revenue Reflow as %</b>	17%	47%	78%	88%
<b>Change in Jobs (thousands)</b>	39	103	167	188

Even the shortest period, however, would mean the creation of 40 thousand new jobs and offset 10 percent of the static revenue estimate.

## **Putting the Act in Economic Context**

January 2013 will usher in a vastly different tax regime. The 2001/2003 tax cuts will sunset. The last of the temporary tax measures – payroll tax cuts and 50% bonus expensing – will expire. And, spending cuts contained in the debt ceiling negotiation sequester will begin. These three changes will seriously hamper the economy and have a direct impact on the livelihood of millions of families and businesses, small and large. Businesses will find that they have too much capital earning a lower rate of return than what could be had elsewhere in the world. The capital adjustment process will result in substantially less investment and less output. Lower output will result in new round of employee layoffs, and so forth.

Both parties have proposed alternatives to the spending cuts and tax increases. Republicans have proposed extending tax rates at current levels followed by a complete reform. President Obama offers to retain the current rates for married taxpayers with incomes less than \$250,000 (\$200,000 for others). Neither has addressed the expiration of the payroll cuts or bonus expensing. We estimate that these two provisions cost almost 4 times as much as Cantor's Small Business Tax Cut Act and would have about 2.5 times the economic impact. In other words, under current law the Act would offset less than half the economic damage from losing these two temporary measures.

Even this is inconsequential compared to the economic damage of allowing the 2001/2003 tax cuts to expire. While the Obama alternative would somewhat mitigate the impact, the economic effects will still be more than six times as large as those from the Small Business Tax Cut Act.

Table 3 shows the economic impact of the Obama alternative. The most striking feature is the decrease in business capital stocks which leads the economy down to a much lower level. The static revenue estimate is that \$178 billion per year would be raised. Taking economic effects in account, however, only 10 percent of this amount would ultimately be raised. Including the loss in state and local receipts would wipe out even that and more. The end result would be a mere \$41.3 billion reduction in the federal government deficit and only \$1.5 billion for all governments.

This \$1.5 billion in deficit reduction would come at a private sector cost of \$452.6 billion. Of course, the deficit as a percent of GDP would actually be higher because GDP will have fallen by far more than the deficit. Even ignoring the loss in state and local government receipts, the private sector will have to give up \$10.96 for every dollar of federal deficit reduction. This is a very expensive way to try to lower the deficit.

Allowing the 2001/2003 cuts to sunset without any offset would be almost twice as expensive the Obama alternative in terms of a lower capital stock and GDP. The efficiency would be somewhat higher but the end result would be much the same – the deficit and spending as a percent of GDP would still be higher because of reduced economic activity.

**Table 3**  
**Impact of Obama Tax Plan**  
(Amounts in \$billions unless otherwise noted)

	Baseline	Lower Small Business Tax Rates		
	2008	Level	Dif	%Dif
<b>Gross Domestic Product</b>	14,441.4	13,745.9	-695.6	-4.82%
<b>Private business capital stocks</b>	27,607.6	24,166.6	-3,441.0	-12.46%
<b>Wage rate (economy-wide average \$/hr.)</b>	\$33.37	\$32.06	-\$1.31	-3.94%
<b>Total hours worked (billions of hours)</b>	259.146	256.725	-2.420	-0.93%
<b>Current receipts</b>	4,057.6	3,980.8	-76.7	-1.89%
<b>Federal</b>	2,474.4	2,492.8	18.3	0.74%
<b>State &amp; local</b>	1,974.8	1,879.7	-95.1	-4.81%
<b>Net lending or net borrowing (-)</b>	-914.5	-913.0	1.5	-0.17%
<b>Federal</b>	-721.8	-680.5	41.3	-5.72%
<b>State &amp; local</b>	-192.7	-232.5	-39.8	20.63%

**Other Measures:**

<b>Static Revenue Loss</b>	178.2
<b>Federal Revenue Reflow</b>	-159.9
<b>Federal Revenue Reflow as %</b>	90%
<b>State &amp; Local Revenue Reflow</b>	-95.1
<b>Total Revenue Reflow</b>	-255.0
<b>Total Revenue Reflow as %</b>	143%
<b>Change in Jobs (thousands)</b>	-1,354

**Aftertax Distribution of Additional GDP:**

<b>Workers</b>	-322.0
<b>Capital Owners</b>	-130.6
<b>Government</b>	-182.9
<b>Depreciation</b>	-60.1
<b>Total</b>	-695.6

**The Pull of the Vortex**

The impending increase in tax rates at the start of 2013 will have a number of effects this year. Business planners will have to juggle the possible scenarios to arrive at an expectation of rates over the period of pending projects. It seems unlikely that planners will conclude that tax rates facing future projects will be as low as the current rates. Each week the expected rates that would apply to a project will increase as a low-rate week is replaced with a higher-rate week.

There will be an incentive to move income from the higher tax period into the current lower tax period which robs future income without increasing overall growth. Investment this year will be pulled in different directions by the higher bonus expensing versus a higher value of each dollar of cost recovery due to higher tax rates. Ultimately, investment will go down to offset higher future rates.

The vortex of the expected rate increase will influence 2012 GDP, and the closer we move toward 2013 the stronger the influence will be. We will likely see a slowing of orders for capital goods and hiring as businesses begin to adjust to the expected higher rates. Income, on the other hand, will tend to remain on track as businesses and individuals move future income from the higher taxed future to the present. Just like a vortex, the appearance of normal operation will continue to the lip of the vortex where the drop off will be magnified by the timing adjustments.

It may be tempting to forego temporary policies to boost the economy in the face of changes that are an order of magnitude larger and in the opposite direction. While it is true that the relatively small size of the Small Business Tax Cut Act will ultimately be overshadowed by future rate changes, it is still of value. It will help the economy as long as it is in effect and in the correct direction. The stronger small business is, the more likely families and the overall economy are to weather the pending changes.

## **Conclusion**

The implication of this analysis is that it worthwhile to provide support for small business through Leader Cantor's Small Business Tax Cut Act. It will be very difficult to close the deficit through higher taxes on the rich or even raising taxes on everyone. Given the shallow recovery, we need to restore the business sector in the short run and examine how we can make the tax system more efficient in the long run. The Small Business Tax Cut Act is a step in the right direction and should be longer rather than shorter in duration. The current political cycle probably inhibits hope for a quick solution to the peril that looms less than nine months out but now is the time to begin planning.

Last, the analysis shows that higher taxes come at a very substantial cost to the private sector. Policymakers should incorporate this cost into spending decisions. Will another dollar of government spending yield three, four, or even 10 times as much as if that dollar remained in the hands of private citizens? If not, should government spend the money?

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