CENTER ON BUDGET AND POLICY PRIORITIES

820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080 Fax: 202-408-1080 center@cbpp.org www.cbpp.org

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PROPOSED SENATE TAX CUTS FOR SMALL BUSINESSES AND FARMERS NOT A TOP PRIORITY, GIVEN BUDGET OUTLOOK AND OTHER PRESSURES

By Joel Friedman

Recent projections by the Congressional Budget Office paint a gloomy fiscal picture. Compared to January 2001, when it was estimating a ten-year surplus of $5.6 trillion, CBO now finds that nearly this entire surplus has disappeared. These estimates not only indicate the scarcity of resources available to address a range of pending policy proposals, but highlight the need for the Administration and Congress to set priorities among competing proposals — particularly in the waning days of a congressional session prior to a competitive election. The Administration has claimed to embrace fiscal restraint by focusing on the spending side of the budget. At a recent campaign event in Iowa, for instance, the President declared that "[w]ithout some kind of constraint on the appropriations process in Washington…somebody is liable to go hog wild."[1] Yet where some in Congress seem more inclined to go "hog wild" is in the area of tax cuts.

The House of Representatives has to date passed numerous tax cuts — from making permanent the provisions of last year's tax-cut package that expire in 2010 to providing energy-related tax breaks and incentives for charitable giving — that total some $455 billion between 2003 and 2012.[2] Moreover, the House appears to have even more proposals waiting in the wings. The Senate has, so far, been more restrained in passing tax cuts. But the Senate Finance Committee is scheduled to consider today a new package of tax cuts, most of which are intended to benefit small businesses, farmers, and rural communities. (Note: This scheduled meeting was subsequently postponed.)

Revenues From Curtailing Tax Shelters Should Be Reserved For Deficit Reduction Or High-Priority Policies

The Senate Finance Committee package, which would reduce revenues by $16.1 billion between 2003 and 2012 according to the Joint Committee on Taxation, is far more modest than costly House-passed tax-cut bills. Further, the Finance Committee offsets the cost of its tax cuts primarily by taking the positive step of curtailing tax shelters and ending the tax benefits that some corporations have reaped by reincorporating overseas. Underlying the Senate Finance Committee package, however, is the rationale that savings secured by reducing tax avoidance — and averting revenue losses that Congress never intended — ought to be applied to new tax cuts. This approach is highly questionable. Furthermore, there is no guarantee that Finance's deficit-neutral approach will hold once the package moves out of Committee.

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[1] Elizabeth Bumiller, "Amid Talk of War Spending, Bush Urges Fiscal Restraint," *The New York Times*, September 16, 2002.

[2] Joel Friedman and Andrew Lee, "The House to Consider More Tax Cuts, Even Though Tax Cuts It Has Already Passed Exceed Budget Resolution Totals," Center on Budget and Policy Priorities, September 12, 2002.

There is no requirement that revenues raised by closing tax loopholes must be redirected to new tax breaks. Given the worsening of the fiscal situation, serious consideration should be given to using these funds — or at least a substantial portion of them — to reduce the deficit. If these funds are to be used for policy initiatives rather than to reduce the deficit, the policies in question should be of high priority. It is hard to argue that the tax cuts in the Finance package — which represents a grab bag of disparate proposals, many of which have been around for some time — meet the test of being a top priority, particularly given that small businesses and farmers have already benefited significantly from other legislation enacted over the past year or so.

- Nearly half of the cost of the Finance package is allocated for tax breaks to encourage small business investment. Yet the "stimulus" bill enacted earlier this year already includes the so-called bonus depreciation provision that was intended to boost investment by allowing businesses — including small businesses — to write off 30 percent of the cost of new investments in the first year. Bonus deprecation is estimated to provide $97 billion in tax reductions over the next three years.

- Further, because small businesses typically pay income taxes through the owner's individual income tax return rather than paying corporate income tax rates, many of these businesses benefited from the reductions in the individual rates that were part of last year's tax-cut package.

- Similarly, the Finance measure includes tax breaks for farmers and rural communities. Some of these groups were beneficiaries of the farm bill enacted earlier this year, at a cost of $87 billion through 2012. (The Senate also recently passed an additional $6 billion of emergency assistance for drought-stricken farmers.)

In contrast, Congress has yet to make progress on a number of pressing policy concerns — from near-term issues such as establishing a prescription drug benefit for seniors, reauthorizing welfare reform, and providing adequate education funding to longer-term issues such as restoring solvency to the Social Security and Medicare trust funds and reducing the ranks of those who lack health insurance. Progress on these issues has been frustrated, in part, by the shortage of resources. Indeed, as the President's statement above indicates, the current impasse over the fiscal 2003 appropriations reflects differing views as to what is affordable in the current fiscal environment. Even the so-called "higher" $768 billion appropriations level that the Senate is seeking constitutes a real reduction in nondefense discretionary programs outside homeland security — that is, a reduction below the fiscal year 2002 level, adjusted for inflation. Moreover, beyond appropriations, other important proposals also require congressional attention before the end of the fiscal year, including providing fiscal relief to states, preventing the expiration of extended unemployment benefits while unemployment remains high, shoring up the financing of the Children's Health Insurance Program to avoid cutbacks in the number of children insured, and extending the TANF block grant.

Finally, the Finance tax-cut package not only appears to be lower priority than other pending proposals, but it also represents an approach to addressing policy issues that raises a number of concerns. The package contains more than 40 separate tax cuts and thus would add to the complexity of the tax code, both for taxpayers and the Internal Revenue Service. Further, it is unclear whether some of these, often small, tax cuts would produce the desired policy outcome; rather than creating an effective incentive to change behavior, some of these tax cuts may simply reward a few taxpayers for actions they would have taken anyway. As economist Douglas Holtz-Eakin, currently Chief Economist for the President's Council of Economic Advisers, wrote several years ago, "it is difficult to construct a case in favor of systematically favoring small businesses. Moreover, to the extent that one wishes to do so, the tax code does not appear to be a tool particularly well suited to the task."[3]

Even if some of the proposals in the Senate Finance Committee package reflect reasonable policies, the issue is whether they are appropriate at this time. Given the range of other pressing concerns, and congressional actions to date that benefit small businesses and farmers, it is difficult to make a convincing case that the Finance package of tax cuts is a top priority that should have first claim on the new resources made available by the package.

Worsening Budget Outlook

In January 2001, the Congressional Budget Office projected a surplus of $5.6 trillion from 2002 to 2011. In the latest CBO forecast, the ten-year surplus has declined by $5.3 trillion, or 94 percent, to $336 billion. Furthermore, most of this projected surplus is based on the unrealistic assumption that last year's tax cut will completely expire at the end of 2010.

Revenue losses are the overwhelming factor behind the disappearance of the actual and projected surpluses. Revenue losses — from last year's tax cut, from the "stimulus" bill, and from economic and technical reestimates — account for 82 percent of the $5.3 trillion deterioration in the surplus. Increased costs of defense, homeland security, and international programs account for 16 percent of the deterioration. Domestic spending increases outside of homeland security account for two percent of the deterioration.[4]

Finally, even the projected $336 billion surplus is likely to prove illusory as it is based on current law baselines and omits a number of virtually inevitable costs. Additional costs likely to be incurred — including extending the tax cut, Alternative Minimum Tax relief, the President's defense and homeland security increases, and a prescription drug benefit — amount to approximately $1.5 trillion to $2 trillion over ten years.

Tax Breaks for Small Businesses and Farmers

Despite the interest that policymakers often show in the nation's small businesses, there is no standard definition of a small business. Rather, businesses may be classified as small based on the number of their employees, their level of income, or the amount of their assets. In addition, businesses are formed under various legal structures. The vast majority of businesses that meet some definition of small are sole proprietorships, a legal form that does not distinguish between

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[3] Douglas Holtz-Eakin, "Should Small Businesses Be Tax Favored?," *National Tax Journal*, Vol. 48, No. 3, September 1995.

[4] All figures in this paragraph include both the direct reason the surplus shrank and the resulting increase in interest payments generated by lower surpluses and higher debt than initially projected. For more details on the current budget outlook, see Richard Kogan and Robert Greenstein, "The New Congressional Budget Office Forecast and the Remarkable Deterioration of the Budget Surplus" and "An Examination of Recent Budget and Economic Projections by the Congressional Budget Office," Center on Budget and Policy Priorities, September 3, 2002.

the business and its owner for tax purposes. As a result, the income earned by these businesses is included in the individual income tax returns of their owners. Other legal forms, such as S corporations and partnerships, also pass all business income through to the shareholders or partners — some of whom are passive investors rather than active participants in the business — so that it is taxed as part of their individual returns. Only businesses formed as C corporations file a corporate income tax return and thus are subject to corporate rather than individual rates. More than the other categories, however, C corporations are dominated by businesses that are considered large, based on their level of receipts and assets.

In a review of small businesses and their tax treatment, the Congressional Research Service reached two conclusions. First, the study concluded that, as a result of the tax benefits directed at small businesses under current law, "the tax burden on small firms is substantially lower than the tax burden on large firms. Second, it found that small business owners have income and wealth that "tend to be well above average for U.S. households."[5]

Moreover, the CRS analysis, which was issued last year, did not take into account the individual rate reductions included in last year's tax-cut package. These rate cuts further reduce tax burdens on small firms relative to large firms, because virtually all small firms pay income tax based on individual income tax rates rather than the corporate rates. Given this already favorable tax status accorded to small businesses and the generally higher income and wealth status of small business owners, the question is whether further tax relief for small businesses should be viewed as a top national policy priority in the current fiscal environment.

Small Business Investment Incentives

The largest tax break in the Senate Finance Committee package would increase the amount of new investment that a small business can write-off (or "expense"). In 2002, businesses can expense the first $24,000 of an investment, with the deduction reduced by the amount by which the cost of the new investment exceeds $200,000. Beginning in 2003 and years thereafter, the total that can be expensed rises slightly to $25,000. The Finance Committee proposes to increase the amount that may be deducted to $30,000 in 2003, with that amount and the $200,000 limit indexed to inflation after 2006. The Joint Tax Committee estimates this provision would cost $6 billion between 2003 and 2012.

This proposal to encourage investment by small businesses would come on top of a similar provision enacted as part of the "stimulus" package earlier this year. Under that provision, businesses — both large and small — can write off 30 percent of the value of new investments in the first year. Small businesses can combine this "bonus depreciation" with the favorable treatment they already receive under current law. In 2003, for instance, a small business can expense the first $25,000 of an investment under $200,000 and then expense 30 percent of the remaining cost before applying the regular depreciation schedule.

The bonus depreciation provision in the stimulus bill remains in effect through 2004. It thus is hard to argue that more generous expensing for small businesses is an urgent priority in need of immediate attention. In fact, another proposal in the Finance package that seeks to encourage business investment in certain leased property would not take effect until *after* the

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[5] Gary Guenther, "Small Business Tax Relief: Selected Economic Policy Issues for the 107th Congress," Congressional Research Service, July 18, 2001.

bonus depreciation expires in 2004, highlighting the lack of urgency. In contrast, in the closing days of the session, other pending proposals require congressional action and the allocation of resources before the end of the fiscal year.

Benefits for Farmers and Rural Communities

Just as small businesses will benefit from congressional action this session, farmers also will benefit from the enactment of the farm bill, which the Congressional Budget Office estimates will cost $87 billion through 2012. Although not all of the funds that legislation provides will go directly to farmers and some of the funds will go for environmental and nutrition programs, farmers and rural communities are the primary beneficiaries of the measure. Further, the Senate voted last week to provide another $6 billion of emergency aid to assist farmers hurt by the drought. Given congressional action to date, the need for a new package of tax cuts designed to benefit farmers and rural communities appears to be neither compelling nor a higher priority than other matters pending before Congress, including the need for long-term deficit reduction.

Other Concerns

Finally, the Finance package not only reflects comparatively low-priority policy proposals, but it also represents an approach to addressing policy issues that raises a number of concerns. For instance, many of the more than 40 separate tax cuts in the package would add to the complexity of the tax code, both for taxpayers and the Internal Revenue Service. Some of these tax breaks have very low costs (for instance, $1 million a year), implying that they are targeted on a small number of taxpayers. Such narrow targeting not only adds to complexity but raises the issue of whether the proposed tax cuts will be effective at achieving their intended policy goals. Some of these tax breaks may do little to change behavior in the desired ways and, as a consequence, their cost may simply reflect rewarding taxpayers for actions they would have taken even in the absence of the tax incentives. On the other hand, some of these tax breaks may prompt some businesses to change their behavior solely to take advantage of the tax benefits involved, a result that would ultimately weaken the economy as businesses allocate resources for tax reasons rather than for sound business reasons. Overall, using the tax code in the manner proposed by the Finance Committee may not always represent the most effective way to address a particular policy issue.

Conclusion

The Senate Finance Committee is scheduled to consider a $16 billion package of tax cuts, which it intends to pay for primarily by raising revenue through curtailing tax shelters. Although taking action against tax shelters is a step in the right direction, using the revenues raised by curtailing these practices to finance a hodge-podge of tax breaks for small businesses, farmers, and rural communities is highly questionable at this time. This type of deficit-neutral approach might have been an acceptable strategy when the fiscal outlook was more positive than it is now. Recent estimates by the Congressional Budget Office show a marked worsening of the budget outlook, however, and highlight the need for caution and fiscal restraint. Under these circumstances, only policy proposals of the highest priority should be candidates for diverting away from deficit reduction the revenues that the Committee package would raise. Given that legislation has already been enacted this session that benefits small businesses and farmers, their claim on scarce resources — particularly given the grab-bag nature of the package — appears less compelling than either deficit reduction or other more pressing policy concerns.