Health Care Reform and Small Business

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Summary

An issue in the development of the new health care reform plan is the effect on small business. One concern is the effect of a "pay or play" mandate to require firms to provide health insurance for their employees or pay a penalty. Current proposals include mandates, but have exemptions for small businesses, and also propose to provide subsidies for purchasing insurance. Economic theory suggests that health insurance costs (and any penalties) should be passed on to labor income, but that may be more difficult for employers of lower-wage workers. Furthermore, average wages are generally smaller for small firms (except for the smallest). A second concern is the potential effect of the surcharge on high-income individuals, which has been proposed as a funding mechanism in the House proposal, and its effects on owners of small businesses.

The House proposals, in versions of H.R. 3200, and the proposal approved by the Senate Health, Education, Labor and Pensions (HELP) Committee would exempt small businesses from the mandate; as a result, very few smaller businesses would be affected. Depending on the proposal, the plans would exempt between 80% and 90% of firms, but the House plan would exempt fewer firms when enacted because the exemption is not indexed. The share of firms that would not be affected either because they are exempt or because they already offer insurance would be larger, as much as 97%. About 22% of employees work for firms that were estimated to be affected. The Senate Finance Committee is currently discussing a plan, although the chairman's mark proposes to exempt firms with 50 or fewer employees from penalties, exempting almost all firms.

The penalties in the Senate HELP proposal are per-employee flat dollar amounts and are relatively small compared with the cost of health insurance. Their phase-in provisions reduce the impact on smaller firms subject to the mandate. The penalties also appear smaller than those in the House proposals, which are calculated as a percentage of payroll. The proposals also provide credits to subsidize small employers' contributions to insurance for lower-income employees. They would be as much as 50% of the cost in the House plans for some small businesses, but are somewhat smaller in the Senate plan. The subsidies in the House bills are provided through the tax system and would not benefit firms with no income tax liability (including nonprofits).

Because most small businesses are subject to the individual income tax , high-income business owners could be affected by the proposed surcharge that would be imposed (for couples) at 1% on income of $350,000 to $500,000, 1.5% on income of $500,000 to $1 million, and 5.4% on incomes over $1 million. The surcharge affects 1.2% of taxpayers and 0.2% at the highest (5.4%) surtax level. About 4% of businesses are affected.

Concerns have been raised that the surcharge on adjusted gross income would have adverse effects on small business and, in turn, on job creation. The top 1% of taxpayers receive more than half of the income of unincorporated business, but some income is passive (reflecting investment rather than operating a business). Some is active income received by professional services (e.g., doctors, attorneys, financial advisors). These activities may be less related to job creation, often associated with new entrepreneurial firms. The job creation justification is problematic on several grounds. It would be possible to exclude certain types of business income from the surcharge at a small cost if passive income and certain income (e.g., finance, insurance, real estate, professional services) were not eligible for the exclusion.

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Introduction

One issue that has been of interest in the development of the new health care reform plan is the effect on small business. An important feature of the plans is a “pay or play” mandate to require firms to provide health insurance for their employees or pay a penalty. Given the structure of individual market reforms, the comprehensiveness of a mandate for individuals is important to the success of the reform of health insurance markets. Employer mandates are also included in the proposals. There is a concern that mandates will be damaging to small businesses.

The legislation being considered in both the House and Senate includes exemptions for small businesses, and credits to assist in providing health insurance, but these provisions differ.[1] These provisions have consequences both for small businesses and for the reforms of the individual health insurance market. Another issue that has received attention is the effect of using a surtax on high-income individuals as a financing option.

This report first provides a brief discussion of the need for mandates in comprehensive health care reform and why employer mandates might be useful. It also describes the provisions in the various proposals. The second section discusses the potential impact of employer mandates and credits on small business. The final section discusses the effect of the high-income surtax.

The Rationale for Employer Mandates in Health Care Reform

The health insurance and health care markets have some fundamental flaws that economists frequently refer to as “market failures,” and many of the provisions in the legislative proposals are aimed at addressing these flaws and market failures.[2] One of these problems is “adverse selection.” If individuals know more about their health status than insurance firms, then insurance costs will be too high relative to benefits for healthy individuals, who will tend not to purchase health insurance. Their lack of participation causes the price of insurance to rise further, as those now in the insurance pool are less healthy. The end result is that many individuals will not have health insurance, exposing them to risk in the case of ill health and possibly imposing a burden on society if their illnesses become serious enough to deplete their wealth and require public assistance. In addition, even if both parties are informed about health status, people who have preexisting conditions or other characteristics that make use of health care more likely (such as old age) may not have, or be able to afford, health insurance (assuming that premiums are permitted to reflect such characteristics).

The problem of adverse selection and excessive cost has been addressed among the elderly by Medicare and is significantly reduced among the working population by employer health insurance. Some states also limit variations in premium costs. Employer health insurance also provides a pooling mechanism that is unrelated to health factors and thus addresses both the

[1] For a discussion of these proposals as well as other legislative proposals, see CRS Report R40581, *Health Reform and the 111th Congress*, by Hinda Chaikind.

[2] These “market failures” are discussed in CRS Report RL33759, *Health Care and Markets*, by D. Andrew Austin and in CRS Report RL32237, *Health Insurance: A Primer*, by Bernadette Fernandez.

adverse selection problem and the problem of being priced out of the market for those with ill health.[3] It also tends to reduce administrative costs compared with such costs when individuals purchase coverage on their own. These pooling and administrative advantages are lessened for businesses with few employees.

Employer-provided health care benefits should, according to economic theory, offset wages so that employees as a group are still incurring the cost of insurance, but do not face the difficulties they would with non-group private insurance purchase. Employers with small pools of individuals may experience some of the same types of problems as individuals. If there is one employee who has (or whose family has) a serious health problem, that problem can drive up the cost for the group. Aside from the problem of too small a pool for small employers, to the extent that small businesses employ lower wage or younger workers, the trade-off of cash wages for health care becomes more difficult, and cannot occur in the case of workers at or close to the minimum wage. As indicated above, the administrative costs per employee are larger in small firms; one study estimates these costs are 18% higher for small businesses.[4] The offering of health care plans is more common in large businesses than small ones, and the participation of workers is generally larger as well.

Two crucial elements are necessary to address the problems relating to adverse selection and lack of affordability, especially for those with preexisting conditions: some form of community pooling so that individuals with health problems (including age) would not have to pay a substantially different price, and a provision to require most individuals to have health insurance. Since health insurance through employers has worked reasonably well and more than 60% of workers are already covered by their employers, a proposal that imposes such mandates on firms might be considered desirable as well.

Small businesses are subject to exemptions from mandates in both the House and Senate proposals. Proposals include credits for certain smaller businesses that have a high-cost employee group and can benefit from the ability to purchase insurance through a program that limits the variation in premiums. House and Senate plans continue to permit existing private individual insurance outside of the community-rated pools. That means that low-cost individuals (the young and healthy) who are not covered by employer plans would wish to retain their plans, thereby raising the costs for those in the community pools. However, the community pools are the only pools that provide subsidies, so they are more likely to attract lower-income individuals, even if they are young and healthy and current participation in the individual market is low.

Senate Proposals Relating to Small Business

Senate health care proposals are being considered in two committees of primary jurisdiction: the Senate Health, Education, Labor and Pensions (HELP) Committee and the Senate Finance Committee. Only the former has agreed upon a proposal; the Finance Committee is still considering legislation. In the Senate HELP Committee proposal, businesses with 25 or fewer workers are exempt from a $750 fine per qualifying worker ($375 for part-time workers) if the

[3] Employer health insurance also benefits from the exclusion of premium contributions by employers from wage income, which benefits any taxpayers with income tax liability. Insurance benefits are also excluded from the payroll tax although there are future benefits that partially offset the cost of the payroll tax.

[4] Executive Office the President, Council of Economic Advisers, *The Economic Effects of Health Care Reform on Small Businesses and Their Employees*, July 25, 2009.

firm does not pay at least 60% of employees' premiums.[5] Firms with 25 or fewer workers are exempt from the penalty.[6]

In addition, businesses with 50 or fewer workers whose average wage is less than $50,000 would receive assistance in the form of credits if they provide at least 60% of health insurance costs. These credits, for each employee plan, are $1,000 for self-only plans, $1,500 for two adults or an adult and child plan, and $2,000 for a family plan. There would be an increase of $100, $300, and $400, respectively, for each payment of 10% of the cost, in excess of the 60%, by the employer. The payments would be allowed in full for firms with 10 or fewer employees, and reduced to 80% of these amounts for those with 11 to 20 employees, 50% for 21 to 30, 40% for 31 to 40, and 20% for 41 to 50. Self-employed individuals would be eligible as well. The credits will be indexed to wage inflation, but allowed for no more than three consecutive years. (Note that there are delays in the effective dates). Small businesses will also be able to purchase insurance through gateway plans, which disallow variations in premiums based on health status, and limit the premium variation based on age. The credits are applicable to these plans.

House Proposals Relating to Small Business

The House bill, H.R. 3200, is being considered by three committees of primary jurisdiction, and has been referred to five committees. The three committees of primary jurisdiction are Energy and Commerce, Ways and Means, and Education and Labor. The proposal mandates firms to provide 65% of the cost of family health insurance (72.5% for single coverage), with exemptions for small firms. The most recently released House proposal, approved in the Energy and Commerce Committee, apparently intends to exempt employers with a payroll under $500,000 from the mandate. An earlier version of the bill considered by the committee and the versions considered by the other two committees would exempt employers with a payroll under $250,000. **Table 1** shows the penalties for firms that do not offer insurance based on the $500,000 level.

Table 1 also shows the subsidy rate in 2013 for aiding low-wage employees in small businesses, in the form of a general business credit allowed through the income tax. The credit is not available to employers without income tax liability, and the full credit may not be available to employers with small liabilities. The credit is based on the employer's payment toward insurance coverage. The credit is not allowed to firms for employees with compensation over $80,000, but all dollar amounts are indexed for inflation. Small businesses can purchase insurance through the exchange, which disallows variations in premiums based on health status.

[5] "In Historic Vote, HELP Committee Approves The Affordable Health Choices Act," press release, July 15, 2009, http://help.senate.gov/Maj_press/2009_07_15_b.pdf. See also http://help.senate.gov/BAI09A84_xml.pdf.

[6] The original press release indicated that the first 25 workers were exempt, but the additional mark indicated that firms with 25 or fewer employees would be exempt. See discussion under penalties for the differences between these approaches. Additional mark is posted at http://help.senate.gov/BAI09F54_xml.pdf.

Table 1. Provisions of H.R. 3200 in 2013, House Energy and Commerce Committee

Employer Penalty or Credit	Provision
Pay or Play Penalty Payroll Level	Percentage of Payroll
Less than $500,000	0%
$500,000 to $585,000	2%
$585,000 to $670,000	4%
$670,000 to $750,000	6%
Over $750,000	8%
Subsidy for Low Wage Employees	Rate and Phase Out
Less than 10 Employees	50% for Employer Contribution, for Compensation Less than $20,000
Compensation Phase Out	Between $20,000 and $40,000
Firm Size Phase Out	Between 10 and 25 Employees

Source: H.R. 3200 as approved by the House Energy and Commerce Committee, July 31, 2009.

Potential Impact of Special Provisions on Small Business

Small businesses would be affected by the mandate and the exemptions from the mandate, by the penalties under the pay or play rules, by credits for purchase of insurance, and by the community rating aspects of the proposal.

The Mandate and Exemptions

The number of small businesses potentially affected by the mandate for health insurance depends both on the distribution of firms and the number that already offer insurance.

Small businesses are quite concentrated as micro-businesses with very few employees. As shown in **Table 2**, 61% of firms in the United States have four or fewer employees and almost 80% have less than 10 employees.

The Senate HELP and House proposals differ on what characteristics determine the exemption: the Senate proposal is based on number of employees and the House proposal is based on size of payroll. In general, the Senate HELP proposal is likely to be more generous because 25 employees would exceed a $500,000 payroll at $20,000 per employee, a lower-than-average wage.

For the Senate proposal, all of the first three classes in **Table 2**, which amount to 89.3% of all businesses, as well as a part of the fourth class would be exempt from the mandate. Thus, over 90% of firms would be excluded from any mandate. The first three classes account for 18% of employees in the United States; thus, approximately one-fifth of employees would not be covered by the mandate.

Table 2. Characteristics of Firms in the United States, 2006

Number of Employees in Firm	Percentage of Firms	Average Payroll ($)	Percentage of Work Force
0-4	60.9	62,596	5.0
5-9	17.6	201,866	5.8
10-19	10.7	436,866	7.2
20-99	8.9	1,384,522	18.0
100-499	1.5	7,297,315	14.6
500 and Over	0.3	147,398,418	49.5

Source: U.S. Census, Statistics of U.S. Businesses, http://www.census.gov/econ/susb/.

For the House proposal with a $500,000 wage level, the exemption can only be approximate, because there would be variations in payroll.[7] However, based on the average payroll per firm reported in **Table 1**, it appears that the first two classes and probably at least three-quarters of the third would likely be excluded under a $500,000 exemption, accounting for 86%-87% of firms. This number is consistent with news reports that indicate the $500,000 amount would exempt 86% of firms.[8] About 16% of employees would be exempt. Under the earlier version with the $250,000 exemption, most of the first two classes (about 78% of firms) would be excluded. About 10% of employees would be excluded.[9]

However, without adjustments for inflation and real income growth, the share of firms excluded with a dollar limit would be smaller on enactment and decline over time. For example, with a 4% annual nominal growth rate, by 2013, when the program takes effect, the $500,000 value would be equivalent to $380,000, with closer to a quarter of the third category excluded, and with the overall share of workers excluded closer to 81%-82%.

There are advantages and disadvantages to the alternative exemption approaches, which could be based on number of employees or size of payroll. An exemption based on number of employees is not likely to reduce the share of businesses exempt over time, although a dollar exemption indexed to wage growth would also keep the share relatively stable over time. The exemption based on payroll is relatively more beneficial to small firms with lower-wage employees, where the personal assumption of the cost may be more difficult.

The share of firms that would not be affected because they are either exempt from the mandate or are already providing health insurance would be larger than the share exempt from the mandate alone. **Table 3** shows estimates of the share of employees in firms with health insurance

[7] The percentages in this paragraph were estimated assuming the average wage is the midpoint of the distribution, which provides only an approximation.

[8] See, for example, Heather Rothman, et al. *Tax Changes Expected as Part of House Deal on Health Care Reform,* Bureau of National Affairs, July 30, 2009, http://www.bnasoftware.com/News_Articles/News/Tax_Changes_Expected_as_Part_of_ House _Deal_ on_Health_Care_Reform.asp.

[9] The Executive Office the President, Council of Economic Advisers, *The Economic Effects of Health Care Reform on Small Businesses and Their Employees,* July 25, 2009, cited above, reports that 77% of businesses would be excluded with a less than $250,000 payroll benchmark criterion mandate and that 87% would be excluded with a less than $500,000 payroll. These numbers sort by establishment size rather than firm size. The Medical Expenditure Panel Survey also provides data by establishment. See http://www.meps.ahrq.gov/mepsweb/data_stats/summ_tables/insr/national/series_1/2008/tia1.pdf.

coverage, although the data are for 2002, the most recently available. **Table 3** also shows the percentage of employees actually covered (employees may decline coverage because they do not wish to pay their own share of the costs or because they are covered under another family member's insurance). It also shows the average cost of coverage per covered employee for a family plan. These costs are similar and do not show a specific trend (the cost is larger for very small firms because employers pay about 80% of the cost; in other firm sizes average shares are between 65% and 75%).

Table 3. Health Coverage by Employer Size, 2008

Number of Employees in Firm	Percentage of Employees in Firms Offering Coverage	Percentage of Employees Eligible	Percentage of Employees Covered	Cost Per Employee Covered ($) Family Plan
Under 10	45.0	37.8	29.8	9,310
10-24	69.5	54.4	40.4	8,195
25-99	85.3	64.9	48.0	7,447
100-999	95.9	72.3	57.7	8,602
1000 and Over	99.0	79.4	63.1	9,370
All	87.7	68.4	53.9	8,904

Source: Medical Expenditure Panel Survey, http://www.meps.ahrq.gov/mepsweb/SBAHQ03M0562, http://www.sba.gov/advo/research/rs262tot.pdf.

For the Senate proposal, data in **Table 3** are used to estimate that roughly another 7% of firms may be firms that are not eligible for the exemption, but already are providing coverage.[10] Thus about 97% of firms would not be required to offer coverage that they had not already offered.[11] This leaves only 3% of firms, mostly those with between 25 and 100 employees, who would be required to offer insurance or pay a penalty. For the House proposal with a $500,000 limit, another 8.6% of firms are not eligible for the exception but are already providing health insurance; thus over 95% of firms would not be required to offer coverage that they have not already offered, leaving 4% to 5% of firms affected.

Effect of Penalties

If firms subject to a mandate do not offer insurance, they are subject to a penalty. In the Senate proposal, which is likely to be somewhat less burdensome for firms, the penalty is $750 for each full-time employee and $375 for each part-time employee. It does not apply to firms with 25 or fewer employees.

[10] The 7% is based on 8.9% times 0.642 plus 1.5% times 0.723 plus 0.3% times 0.794. Note, however, that this is a rough estimate because the data reflect the percentage of employees and not the percentage of firms. In general, because of the rising coverage, the share of employees would be larger than the share of firms. However, if the average for the next lower category were used instead, which would likely be an understatement, the share would be 6%.

[11] The total of 97% is the sum of the 90% not subject to the mandate and 7% subject to the mandate but already offering insurance.

The House Energy and Commerce proposal applies the penalty as a percentage of payroll, so the penalty would be less for firms whose employees earn less. **Table 4** shows the average wage by employer size. Note that the average wages for the very smallest firms are actually higher than those for mid-sized firms (but not for the very large firms). As noted in **Table 1**, the penalty as a percentage of income rises by payroll size and can be imposed at a 2%, 4%, 6%, or 8% rate. Given earnings of around $35,000 for the smallest non-exempt category, these amount to penalties per employee of $700 (2% of $35,000) for the smallest firm category of $500,000 to $585,000. For the larger percentages (4%, 6%, and 8%) the amounts would be $1,400, $2,100, and $2,800. The penalties in the House proposal appear, therefore, to be greater in most cases than those in the Senate proposal.

Table 4. Average Earnings Per Employee by Firm Size, 2006

Number of Employees in Firm	Average Earnings Per Employee ($)
0-4	38,547
5-9	30,707
10-19	32,524
20-99	35,200
100-499	37,680
500 and Over	44,612

Source: U.S. Census, Statistics of U.S. Businesses, http://www.census.gov/econ/susb.

In theory, penalties should help induce firms that fall under the mandate (i.e., are not exempted from penalties by size) and are not currently providing health insurance to do so. Although only about 3% of firms in the Senate proposal and about 4%-5% in the House proposal with a $500,000 exemption fall into this group, they are larger firms that employ a larger fraction of the work force. The share of employees falling into this category is about 22% of the workforce for the Senate plan and the House plan with the $500,000 exemption.

The penalties in the Senate bill are relatively small compared with the cost of insurance. According to the National Center for Health Care Reform, the premium in 2008 for a family of four was $12,700, with the individual paying $3,400, leaving the employer with a cost of $9,300.[12] The average cost for a single person was $4,700. Under the House bill the employer must pay at least 65%, or over $8,000, for a family of four (under the Senate bill the share is slightly smaller, 60%). These costs would be expected to be higher when the proposal is implemented. Note also that contributions employers make toward coverage would only be based on those who enroll.

Economic theory suggests the penalty should ultimately be passed through to lower wages and would not be a burden on small business owners. If firms cannot pass on the cost in lower wages, the higher cost of workers may lead firms to reduce output and the number of workers. (Individuals with lower incomes, however, should be able to receive subsidies in the community-rated pools, which will increase their welfare.) For the firm, paying a penalty may be more feasible than providing insurance, especially if their employees are lower income and the wage cannot be lowered below the minimum wage or the burden is too great.

[12] See http://www.nchc.org/facts/cost.shtml.

The exemption approach in the Senate proposes a flat penalty per employee for firms with more than 25 employees. The House proposal phases in the penalty amount by discrete firm size.

Any exemption based on size can create disincentives for adding employees. When there is a flat rule that imposes the full penalty at a specific level (often referred to as a cliff), an additional employee or dollar of payroll at that point will trigger a significant cost and discourage expansion. By phasing in the penalty as employee size or payroll rises, the cost will rise more smoothly and the disincentive at any specific point will be smaller.

For example, for the current Senate proposal, assuming full-time employees, the addition of the 26^{th} employee would cost $19,500 ($750 times 26) in penalties, and each employee after that one would trigger an additional cost of $750. In the initial Senate plan as reflected in the press release, by exempting the first 25 employees, the additional penalty cost of an employee after the first 25 employees is $750 per employee.

The House proposal has a phase-in, although it is not smoothly imposed and results in smaller cliffs. Without a phase-in, the first dollar in payroll after $500,000 would result in a penalty of $40,000.08 (0.08 times $500,001). With the discrete phase-in, the first dollar in payroll after $500,000 would trigger the 2% penalty on all payroll, $10,000.02 ($500,001 times 0.02). Every dollar after that point would trigger an additional 2 cents, until the firm reaches $586,000, when the increase in the penalty to 4% would be triggered. At that point the penalty would rise by $11,704 ($585,000 times 0.02 plus $0.04). Penalties of this general magnitude would be triggered at each discrete point when the percentage rises.

Another approach would be to phase in the penalty over some level of employees or income. For example, to phase in the House penalty smoothly between $500,000 and $1 million, the $500,000 exemption would be reduced for each dollar over $500,000. For a firm with a $600,000 payroll, the exemption would be $400,000 ($500,000 minus the amount of payroll over $500,000). Over the phase-in range, the cost of adding a dollar of payroll would be $0.16 per dollar (the dollar would result in its own penalty of $0.08 and the phase-in would add another $0.08) until the phase-in is complete. The penalty after the phase-in is $0.08 per dollar. A similar phase could be applied to a plan based on employee size, as in the Senate proposal.

Credits for Smaller Firms

One important difference between the proposals is that the Senate credit would be offered through a government program while the House credit would be an income tax credit. For the House proposal, employers that do not pay income taxes would not receive a benefit and firms with limited income tax liabilities would not receive the full benefit. In addition, firms with no profits and nonprofit organizations would not be eligible for the House credit; firms with small profits would receive only a partial credit.

The credits are intended to encourage coverage and are targeted at the firms not subject to penalties (as discussed above). For very small firms and very low-income workers, the subsidy is significant, but it declines as incomes and firm size rise. The full subsidy is larger in the House proposal than in the Senate plan given the general cost of insurance. For example, if the insurance cost for a single worker is $4,700, then 72.5% of the cost is about $3,400, and 50% of that cost would be $1,700, covered by the subsidy. The House subsidy is phased out quickly as average wages rise, however. In both plans almost all exempt businesses would be eligible for the full subsidy because they have 20 or fewer employees. Without more data on the dispersion of wages within the firms it is not possible to estimate how many employees would be in firms eligible for the employer credit. The House subsidy is phased out smoothly without any cliffs; the Senate proposal has cliffs (see discussion of cliffs in the previous section) based on firm size.

Benefits of Community Rating

For some small firms, the ability to buy insurance through the insurance pool that restricts variation in premiums, including disallowing charges for preexisting conditions and limiting differences by age, will be a significant benefit. As with individuals, very small firms that have individuals or families whose health care is more costly will be more easily able to purchase insurance. These additional costs will be spread across many other individuals and will remain attractive to many healthy individuals because of the individual subsidies. Thus, they should reduce the problem of adverse selection.[13] Firms with healthier employees would see a rise in costs.

The Income Tax Surcharge for High-Income Individuals

On July 14, 2009, the House Ways and Means Committee announced several revenue- and tax-related provisions to fund health care reform. Of the $583.1 billion for FY2010-FY2014 estimated by the Joint Committee on Taxation to be raised to fund health care reform in H.R. 3200, $543.9 billion results from a surtax on individual taxpayers. This surtax is imposed on adjusted gross income (not taxable income) and would be 1% on income from $350,000 to $500,000, 1.5% on income from $500,000 to $1 million, and 5.4% on income over $1 million.[14] (Adjusted gross income is modified for this purpose by allowing a deduction for investment interest.) The 1% and 1.5% rates would double in 2013 unless a certain amount of savings occurs in health programs; they could also be eliminated. The income levels are for married couples; singles would have the tax imposed at income levels that are 80% of those for married couples.

The surtax on high-income individuals would be concentrated on the top 1.2% of taxpayers.[15] Those subject to the highest surtax would constitute only two-tenths of 1% of taxpayers. Thus, the proposal is highly progressive.[16]

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[13] These issues are discussed in Executive Office the President, Council of Economic Advisers, *The Economic Effects of Health Care Reform on Small Businesses and Their Employees*, July 25, 2009, http://www.whitehouse.gov/assets/documents/CEA-smallbusiness-july24.pdf.

[14] Adjusted gross income is income from wages, interest, dividends, capital gains, business profits, pension income and a few other items, reduced by certain adjustments such as contributions to individual retirement accounts. Taxable income is adjusted gross income minus personal exemptions and either the standard or itemized deductions. For high-income taxpayers, the main effect of using adjusted gross income rather than taxable income is that the surtax will apply to itemized deductions such as mortgage interest, taxes, and charitable contributions. For this purpose, a modified adjusted gross base that allows a deduction for investment interest would be used.

[15] Data from the Joint Committee on Taxation reported by the Ways and Means Committee in "Paying for Reform," http://waysandmeans.house.gov/media/pdf/111/pfr3200.pdf.

[16] Tax Policy Center, table T09-0348, Distribution of Federal Tax Change by Cash Income Percentile, http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=2423&DocTypeID=2.

Particular concerns have been expressed about the effect of the surtax on small businesses, job creation and entrepreneurship. Most smaller businesses are unincorporated or treated as such by the tax system with income flowing through to the proprietor or partner and are thus subject to the individual income tax. Only about 4% of businesses would be affected by the surtax, however.[17]

A larger share of income, as opposed to taxpayers, would be affected. For example, returns with over $1 million account for 15.1% of adjusted gross income, according to IRS statistics, but only 0.2% of returns. Taxpayers with income over $500,000 account for 22.4% of income, but 0.7% of returns.[18] These statistics indicate the degree to which income is concentrated at higher income levels.

In addition, business income is more concentrated in higher income levels than other types of income. Overall, labor income accounts for about three-quarters of overall income, with the remainder divided almost evenly between passive capital income (interest, dividends, and capital gains), pensions, and business income. In the top 1%, labor income is less than half of income. Individuals with incomes over $1 million account for 27% of unincorporated business net income for businesses with positive income, and individuals with incomes over $500,000 account for 38%. This concentration primarily reflects partnership and Subchapter S firms rather than proprietorships.[19] Returns with adjusted gross income of $1 million or more accounted for 7.5% of total proprietorship income, whereas returns with income over $500,000 accounted for 12.6%. For partnerships and Subchapter S firms (corporations that elect to be taxed as partnerships), returns over $1 million accounted for 40.8% of net income and returns with income over $500,000 accounted for 55.7% of net income. Supporting this finding, a 2007 Treasury study indicated that taxpayers at the top tax rate (constituting a similar share of returns to those covered by the surcharges) are responsible for 61% of business flow-through income. [20]

Some of the income in partnership and proprietorship incomes may reflect passive income and income from tax shelters, however. According to IRS data, almost 85% of partnership income is in limited liability companies or limited partnerships. Thus, these business income shares include passive income, rather than income involved in active business, and also significant income that is in businesses that are not the new and innovative firms that are often the focus of those concerned with entrepreneurship and job creation. The Treasury study indicated that these high-income taxpayers accounted for only 46% of active, positive business income. Supporting this notion that many of these businesses are not active, the Tax Policy Center found that of the returns affected by the surtax with business income, only 22.8% had business income that was more than half of total income.[21] This small income share also suggests much of this income is passive investment income that, absent the current rules that permit firms to operate with limited

[17] Data from the Joint Committee on Taxation, reported by the Ways and Means Committee in "Paying for Reform," http://waysandmeans.house.gov/media/pdf/111/pfr3200.pdf.

[18] Internal Revenue Service, Statistics of Income, 2006.

[19] Unincorporated business income for tax purposes is in three forms: businesses run by a single owner (proprietorships), businesses run by partnerships (multiple owners) and Subchapter S corporations (small businesses that are incorporated but elect to be taxed as proprietorships or partnerships). See CRS Report R40748, *Business Organizational Choices: Taxation and Responses to Legislative Changes*, by Mark P. Keightley.

[20] Treasury Conference on Business Taxation and Global Competitiveness, July 23, 2007, http://www.treas.gov/press/releases/reports/07230%20r.pdf.

[21] Tax Policy Center, Table T09-0351, Distribution of Tax Units with Business Income, http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=2426&DocTypeID=7.

liability but not be subject to the corporate tax, would be in the form of corporate dividends and capital gains, not active business operations.

Data suggest that while business income may be somewhat more concentrated than income overall, much of small business income is associated with passive investments, stockbrokers, lawyers, doctors, and accountants who are unlikely to be innovators or important sources of job creation for lower and moderate income individuals. Trade, construction, and most services are also unlikely to be important sources of innovation, which is an argument advanced for providing relief to small businesses. Thus, very little of the increased tax revenue is likely to be collected from the businesses that are associated with innovation, entrepreneurship, or important sources of new jobs.

About two-thirds of partnership income reflects finance, real estate, oil and gas extraction (which includes passive partnerships), and services (such as doctors and lawyers).[22] About 8% of total income was from real estate and oil and gas respectively, 19% from finance and insurance (with almost 80% of that total from securities and investment firms), 15% in professional services (with about 60% of the total legal services) and 5% in health (with about half of that total for physicians and dentists).

Subchapter S firms are more broadly distributed. Subchapter S income is about 40% of the total of Subchapter S and partnership income. According to the IRS data for 2006, the single largest share of Subchapter S income is in trade (19%) followed by manufacturing (14%), construction (13%) and professional services (11%). Finance, insurance, and real estate accounts for about 9%. Most of the remaining third is in some form of services.[23]

In addition, questions could be raised about the argument that small businesses are important as sources of new jobs. Small businesses create more jobs but also are the greatest sources of job loss. They create more net new jobs, but, according to Edmiston, this evidence is not entirely clear because of migration across size classifications; moreover, although this sector of the economy may offer more opportunities to women and minorities, it pays less, is less stable, and has fewer fringe benefits.[24]

Aside from the issue of the number and quality of jobs, standard economic theory suggests that there is no need for a permanent policy to create jobs in general. While a stimulus aimed at creating jobs may be needed in an economic downturn and programs to improve skills of marginal workers could increase labor force participation, economic theory, again, suggests that a permanent policy directed at job creation would be unnecessary, and also inefficient if it misallocates resources. As the economy grows, it naturally creates its own jobs as evidenced by the growth in the employment over time.

If a major objection to the surtax is the effect on small businesses, income from selected types of business operations (presumably not for lawyers, doctors, or stockbrokers) could be excluded from the surcharge. Flow-through income is a larger share of income of the top 1% (about a

[22] Internal Revenue Service, Statistics of Income, 2006.

[23] Internal Revenue Service, Statistics of Income, 2006.

[24] Kelley Edmiston, "The Role of Small and Large Businesses in Economic Development," Federal Reserve Bank Kansas City, Economic Reviews, 2nd Quarter, 2007, pp. 73-97.

quarter) than of the population as a whole (about 9%).[25] An exclusion of all flow-through income would sacrifice around a quarter of revenue, but the loss would be much smaller if passive income and income from finance, real estate, insurance, oil and gas extraction, and professional services were not permitted an exclusion.

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[25] CRS Report RL33285, *Tax Reform and Distributional Issues*, by Jane G. Gravelle.