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EXTENSION OF HIGH-INCOME TAX CUTS WOULD BENEFIT FEW SMALL BUSINESSES; JOBS TAX CREDIT WOULD BE BETTER

By Chuck Marr and Gillian Brunet

Proponents of extending President Bush's 2001 and 2003 tax cuts for people with incomes over \$250,000 argue, in part, that allowing them to expire after 2010 would weaken the economy by hurting small businesses. In reality, however, extending the tax cuts would do little for small business because only the top 3 percent of people with *any* business income, let alone income from a small business, would benefit.¹ Over the long term, an extension would likely harm the economy — and thus small business — by adding about \$1 trillion to deficits and debt over the next decade and even larger amounts in subsequent decades.²

Extending the high-income tax cuts for one or two years, as some have proposed, would be highly ill-advised as well. It would make it much more likely that Congress would later act to extend the tax cuts indefinitely, increasing deficits and the debt for as far as the eye can see and thereby adding to the economic risks that already unsustainable long-term deficit and debt levels pose.

While conceding that this would benefit only a tiny share of people with business income, some proponents of extending the high-income tax cuts argue that Congress should extend the tax cuts anyway because this relatively small group of people receives a large proportion of the nation's business income. While true, this fact reflects the reality that large amounts of "business income" go to concerns like large corporate law practices, accounting firms, and wealthy people who invest in financial and real estate partnerships. These are not what most Americans think of when they hear the term "small business." It also reflects the reality of income inequality at levels not seen in this country for decades. These are hardly reasons to extend the high-income tax cuts.

¹ Unless otherwise noted, we follow the Joint Committee on Taxation's definition of business income, as defined in JCT's letter of April 6, 2009: "For purposes of this analysis, business income consists of income from sole proprietorships (Schedule C); farm income (Schedule F); and income from rental real estate, royalties, partnerships, subchapter S corporations, estates and trusts, and real estate mortgage investment conduits (Schedule E)."

² Based on President Obama's 2011 budget, table S-8, which reflects Treasury Department estimates. The \$1 trillion figure includes the costs (relative to President Obama's proposals) of extending the current top two marginal income tax rates, the 15 percent tax rate on income from capital gains and dividends, and the repeal of the Pease and PEP provisions, for households with income above \$250,000 for couples and \$200,000 for single filers. The figure also includes the cost of reducing the tax rate on dividends for households above the \$250,000/\$200,000 thresholds from the ordinary tax rates that will be in place after 2010 under current law to President Obama's proposed rate of 20 percent for these households, as estimated by JCT. Some \$838 billion of the \$1 trillion increase in the deficit would come from revenue losses. The other \$180 billion would come from increased interest payments on the national debt.

Policymakers who are rightly concerned that nearly one in ten Americans cannot find a job should allow the high-income tax cuts to expire on schedule and channel the resulting revenues in the first year to a robust job-creation tax credit. The Congressional Budget Office (CBO) estimates that a cut in employer payroll taxes for firms that hire more workers would create *four to eight times* as many jobs per dollar of cost as extending the high-end tax cuts. Moreover, such a tax credit would be strictly temporary and thus would add only negligible amounts to long-term deficits.

Tax-Cut Extension Would Not Generate New Customers for Business

CBO has explained that firms will not hire workers or make new investments unless they have — or expect to have — enough customers to justify the increased capacity. Whether a firm’s taxes modestly rise or fall matters much less in this regard than the level of demand for the firm’s products or services.

A CBO analysis noted that some small businesses would profit from an extension of the current top tax rates, but pointedly rejected the argument that Congress should extend these tax cuts to create jobs in a weak economy. CBO explained that “increasing the after-tax income of businesses typically does not create much incentive for them to hire more workers in order to produce more, because production depends principally on their ability to sell their products.”³

The most efficient way to ensure that businesses have customers is to bolster the incomes of people who tend to spend quickly much or all of any extra income they receive, such as lower-income families. This is why measures such as providing adequate unemployment insurance benefits deliver the largest bang-for-the-buck in stimulating the economy, according to CBO. As former Federal Reserve Vice Chairman Alan Blinder highlighted in the *Wall Street Journal* recently: “the unemployed worker struggling to make ends meet will likely spend the entire dollar right away.”⁴

Robust Job-Creation Tax Incentive a Preferable Alternative

Opponents of letting the high-income tax cuts expire on schedule often cite the potential impact on small-business job creation. But when CBO analyzed the job-creating efficiency of various stimulus policies, extending the high-end Bush income tax cuts came in *dead last*.

If policymakers want to pursue further stimulus through tax policy, it would be far more efficient to reward small (and large) businesses that create jobs by giving them a tax credit. CBO estimates that an employer payroll tax cut for firms that hire more workers would create four to eight times as many jobs per budget dollar as extending the high-income tax cuts.

³ Congressional Budget Office, *Policies for Increasing Economic Growth and Employment in 2010 and 2011*, p. 26, January 2010, <http://www.cbo.gov/ftpdocs/108xx/doc10803/01-14-Employment.pdf>.

⁴ Alan S. Blinder, “Obama’s Fiscal Priorities Are Right,” *The Wall Street Journal*, July 19, 2010, http://online.wsj.com/article/SB10001424052748703394204575367490020828732.html?mod=WSJ_Opinion_LEADTop.

History Shows Businesses Can Prosper at Tax Rate Slated for 2011

History refutes the notion that small businesses would be unable to thrive under a 39.6 percent tax rate. Small businesses do not need an exemption from that rate to prosper.

During the 1990s, when the top tax rates were at the levels to which they are slated to return in 2011, small business employment rose by an average of 2.3 percent — or 756,000 jobs — per year. In contrast, between 2001 and 2006, when tax rates were lower as a result of the 2001 tax law, small business employment rose at only a 1.0 percent annual rate (367,000 jobs per year) — less than half as much.

In short, the 1990s tax rates did not deter a robust, job-creating economic expansion, and the lower tax rates after 2001 did not prevent a recovery that proved very disappointing in generating job growth.^a

^a Average annual small business job growth (firms with 20-499 employees), calculations based on data from the Small Business Administration and the U.S. Census Bureau.

A job-creation tax credit would also be more fiscally responsible. It would be temporary and thus would add only very small amounts to long-term deficits. In contrast, even a temporary extension of the high-income tax cuts would likely lead to future extensions and mounting long-term costs. (This is especially likely given the expected outcome of the November election, in which more politicians who seek to make *all* of the Bush tax cuts permanent — including the tax cuts for high-income households — are likely to gain seats.)

Simply put, both for near-term job creation and long-term fiscal sustainability, it is far better to encourage businesses to hire workers now through a temporary tax credit for new hires than to extend the Bush tax cuts for the highest-income people. Such a temporary tax incentive, if adopted, should not be limited to small businesses; if the goal is job creation, there is no economic rationale for excluding jobs that larger companies create.

Extension of High-End Tax Cuts Would Be Poorly Targeted

An additional problem with extending the Bush high-income tax cuts to aid small businesses is that it would be very poorly targeted. Most small businesses are just that — small — so their incomes are not high enough to face the top marginal rates. Allowing the two top tax rates to return to their pre-2001 levels would have *no impact whatsoever on 97 percent of taxpayers with business income*, according to the Joint Committee on Taxation.⁵ Only the top 3 percent of such taxpayers are in the top two brackets.

Those who claim that raising the top rates would seriously harm small businesses also tend to rely on an extremely broad definition of “small business.” Because the IRS does not publish specific, satisfactory data on the taxes that small businesses pay, analysts are left to examine various sources of business income that individuals receive. Some analysts define *any* taxpayer who shows *any* business income on a tax return — including passive income that very wealthy investors secure —

⁵ Calculated using estimates from the Joint Committee on Taxation, “Present Law and the President’s Fiscal Year 2011 Budget Proposals Related To Select Individual Income Tax Provisions Scheduled to Expire Under the Sunset Provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001,” July 14, 2010, p. 10, <http://www.jct.gov/publications.html?func=startdown&id=3691>.

as a small business. Defining small businesses in this manner greatly overstates the actual number of small businesses, particularly among households with very high incomes.⁶

For example, most Americans would not describe the nation's wealthiest 400 individuals, some of whom are billionaires, as small businesses. Yet the "Top 400" individuals have a great deal of money to invest and consequently receive significant business income — which means that they qualify as "small business owners" under the broad definition of the term. The 400 highest-earning taxpayers received *nearly \$17 billion* in S corporation and partnership income in 2007 (the most recent year for which we have these data) — an average of *\$83 million* each, according to the IRS.⁷ In addition to the wealthiest 400 taxpayers, the following types of individuals are commonly included in the definition of "small business" used in tax debates:

- partners in very large corporate law firms,
- partners in lucrative medical practices, and
- Wall Street bond traders who receive multi-million dollar bonuses and invest some of their income in investment partnerships.

The commonly used definition of "small business" also includes many wealthy executives of the nation's largest corporations and financial institutions, who are considered "small business owners" if they rent out their vacation homes.⁸

Severe Income Inequality Surely No Rationale for Extending Tax Cuts

Some proponents of extending the high-income tax cuts, while conceding that this would benefit only a tiny share of people with business income, argue that Congress should do it anyway because this relatively small group of people receives a large proportion of the nation's business income. Small business income is indeed concentrated among the wealthy because *all* income is concentrated among the wealthy — before the recession, the share of income going to the top 1 percent hit its highest level since 1928. But if anything, this fact argues for letting the high-income tax cuts expire in order to lean against, rather than exacerbate, this trend.

The upward shift in income and wealth in recent decades is stunning:

- The gaps in after-tax income between the richest 1 percent of Americans and the middle and poorest fifths of the country more than tripled between 1979 and 2007, according to

⁶ See Chye-Ching Huang and James R. Horney, "Big Misconceptions About Small Businesses and Taxes," Center on Budget and Policy Priorities, Feb. 2, 2009, <http://www.cbpp.org/files/8-29-08tax.pdf>.

⁷ Some 202 out of the 400 taxpayers with the highest adjusted gross income reported net income from partnerships and S corporations. IRS, "The 400 Individual Income Tax Returns Reporting the Highest Adjusted Gross Incomes Each Year, 1992-2007," p. 4, <http://www.irs.gov/pub/irs-soi/07intop400.pdf>.

⁸ Such rental income would be filed under Schedule E, causing these individuals to be included in the commonly used definition of taxpayers with small business income.

Congressional Budget Office data.⁹

- Between 2002 and 2007 — that is, during the expansion that preceded the recent recession — *two-thirds* of the nation’s total income gains flowed to the top 1 percent of households.¹⁰ Between 1995 and 2007, the real income of the median family grew by less than 13 percent. During that same period, the average real income of the 400 richest people in the country *multiplied* by five times.¹¹

Thus, when supporters of extending the high-income tax cuts argue that the top tax rates cannot be allowed to return to their pre-Bush levels because about half of all “pass-through” business income (i.e., income from partnerships, S. corporations, and sole proprietorships) flows to people in the two top brackets, they are essentially arguing that because income has become so much more concentrated among a very elite group, that elite group must maintain its lavish tax cuts and cannot be asked to pay taxes at the same marginal rates as in the prosperous Clinton years.¹²

Indeed, if all of the Bush tax cuts are extended, those at the pinnacle of the income scale — people who make over \$1 million — will receive average annual tax cuts of \$128,832 apiece, according to the Urban Institute-Brookings Institution Tax Policy Center.¹³ This is *more than double* the total annual income of the typical American family.

The increasing concentration of income and wealth is a reason to make the tax code more progressive, rather than less so. It is not a reason to extend the most regressive of the Bush tax cuts, especially when as noted above, these tax cuts are highly inefficient — and largely ineffective — at creating jobs in a weak economy.

Exempting Business Income from Rate Increase Would Promote Tax Avoidance

Some have proposed letting the top marginal tax rate on regular income rise to 39.6 percent but extending the current 35 percent rate for *business* income. This, however, would give wealthy

⁹ Arloc Sherman and Chad Stone, “Income Gaps Between Very Rich and Everyone Else More Than Tripled In Last Three Decades, New Data Show,” Center on Budget and Policy Priorities, June 25, 2010, <http://www.cbpp.org/files/6-25-10inc.pdf>.

¹⁰ Avi Feller and Chad Stone, “Top 1 Percent of Americans Reaped Two-Thirds of Income Gains in Last Economic Expansion,” Center on Budget and Policy Priorities, September 9, 2009, <http://www.cbpp.org/cms/index.cfm?fa=view&id=2908>. This paper was based on analysis of IRS data by economists Thomas Piketty and Emmanuel Saez.

¹¹ See U.S. Census Bureau, Historical Income Tables, Table H-5, <http://www.census.gov/hhes/www/income/data/historical/household/index.html>, and IRS, “The 400 Individual Income Tax Returns Reporting the Highest Adjusted Gross Incomes Each Year, 1992-2007,” p. 4, <http://www.irs.gov/pub/irs-soi/07intop400.pdf>.

¹² See Joint Committee on Taxation, “Present Law and the President’s Fiscal Year 2011 Budget Proposals Related To Select Individual Income Tax Provisions Scheduled to Expire Under the Sunset Provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001,” July 14, 2010, p. 10, <http://www.jct.gov/publications.html?func=startdown&id=3691>. In addition, nearly half of all qualified dividends and 72 percent of capital gains go to people with incomes above \$500,000.

¹³ Tax Policy Center, “Extend the 2001 and 2003 Tax Cuts and Permanently Extend AMT Patch, Baseline: Current Law, Distribution of Federal Tax Change by Cash Income Level, 2011,” July 8, 2010, <http://www.taxpolicycenter.org/numbers/Content/PDF/T10-0132.pdf>.

taxpayers a powerful incentive to reconfigure various business and financial arrangements in order to reclassify their regular income as business income. For example, if pass-through income qualified for the lower tax rate, the opportunities for wealthy taxpayers to avoid paying the 39.6 percent top rate would be virtually endless.

Even a carve-out just for active income that high-income individuals receive from S corporations would greatly aggravate tax compliance and tax avoidance problems. The Treasury's Inspector General for Tax Administration, the Joint Committee on Taxation, and the Government Accountability Office (GAO) all have noted that wage compensation paid by S corporations is heavily underreported and, correspondingly, distributions of profits from S corporations — which are not subject to payroll taxes — are overreported. The GAO calculated that in 2003 and 2004, S corporations underreported about \$23.6 billion in wage compensation to shareholders, “which could result in billions in annual employment tax underpayments.”

This current compliance problem flows from the structure of the Medicare tax,¹⁴ which applies to the wages and salaries of S corporation shareholders but *not to the shares of the firm's profits* they receive. This gives shareholders an incentive to convert wages to distributions of firm profits (or to understate their wages and overstate the distribution of profits), since every dollar they receive in distributed profits rather than wages saves them 2.9 cents in Medicare taxes. The recently approved health reform legislation increases the Medicare tax, levying a 3.8 percent rate on income above a threshold of \$250,000 for married couples and \$200,000 for singles, starting in 2013. The increased rate on income exceeding the threshold will apply to investment income as well as wage income, which will *generally* reduce the incentive for tax avoidance. But active S corporation income will *continue to be exempt* from the Medicare tax, increasing the incentive for shifting to that type of income.

Exempting active S corporation income from the scheduled increase in the top tax rates would *more than double* shareholders' incentive to convert wages into distributions or to misreport wages as pass-through income. Every dollar they received or reported in distributed profits rather than wages would save them not only 3.8 cents in Medicare taxes (starting in 2013) but also 4.6 cents in income tax.¹⁵ Instead of addressing an existing tax-compliance problem, Congress would be making it substantially worse.

In addition, providing pass-through entities with a lower tax rate ignores the fact that they already enjoy a tax advantage over competitors organized as traditional corporations (known as C corporations): pass-through entities are not subject to the corporate income tax.

Firms often organize themselves as pass-through entities to avoid the corporate tax and reduce their tax liability. They are free to organize, or re-organize, themselves as Schedule C corporations if that becomes more advantageous for them from a tax standpoint.

¹⁴ We focus here on the Medicare tax and not the Social Security payroll tax because the Medicare wage tax base is uncapped. Including both the employer and employee shares of the tax (both of which are ultimately born by employees), the current Medicare tax rate is 2.9 percent.

¹⁵ That 4.6 cents represents the difference between the 39.6 percent rate these individuals would pay on ordinary wage and salary income and the 35 percent rate they would pay on their profits.