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HOUSE HEALTH BILL'S HIGH-INCOME SURCHARGE IS SOUND AND WELL TARGETED

Would Affect Fewer Than 2 Percent of Small Businesses

by Chuck Marr

A 5.4 percent surcharge on couples with incomes over $1 million, a key financing feature of the House health reform bill, is sound and well targeted. It would affect just a fraction of 1 percent of taxpayers, a group whose incomes have soared and tax burdens have fallen in recent years, and would have only a modest impact on small businesses.

Reforming the health care system to provide universal health coverage and slow the growth of health care costs is an urgent national priority. But with huge budget deficits projected for future decades, health reform must be fully financed and achieve long-term savings. The House bill adheres to these goals, and the surcharge — which would raise an estimated $460.5 billion over ten years — contributes significantly to these efforts. The bill as a whole would reduce deficits by $138 billion over its first ten years and by small amounts in later decades, according to the Congressional Budget Office.[1]

The surcharge would apply only to income in excess of $1 million for couples who file jointly and in excess of $500,000 for singles. Moreover, it would have *no impact at all on more than 98 percent of small business owners* (broadly defined as any taxpayer with any business income), according to the Urban Institute-Brookings Institution Tax Policy Center. And many of the 1.6 percent of "small business" owners it *would* affect are wealthy investors with a passive investment in a business,[2] not people who actually operate a small business. Nor does recent history support the charge that tax increases on high-income households weaken small business job growth. Moreover, other provisions of the House bill would benefit small businesses by enhancing their ability to offer affordable health insurance to their employees.

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[1] Congressional Budget Office, Letter to the Honorable John Dingell, November 20, 2009, http://www.cbo.gov/ftpdocs/107xx/doc10741/hr3962Revised.pdf. See also Congressional Budget Office, "Preliminary Analysis of the Affordable Health Care for America Act," October 29, 2009, http://www.cbo.gov/ftpdocs/106xx/doc10688/hr3962Rangel.pdf.

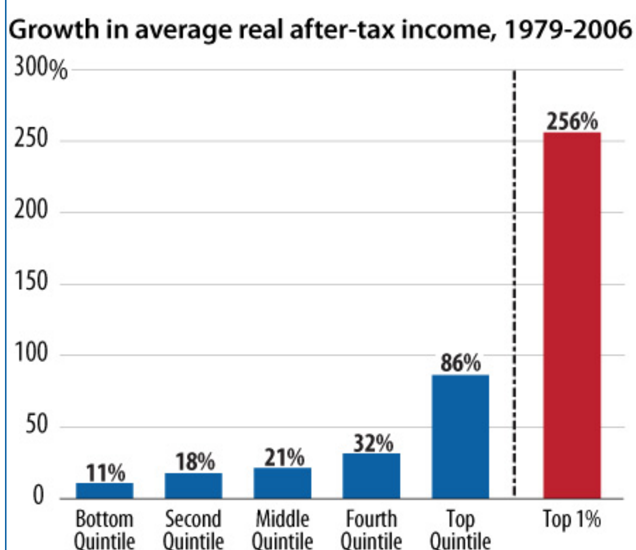
[2] Tax Policy Center, "Distribution of Tax Units with Business Income, by Modified Adjusted Gross Income Level, 2019," October 30, 2009, http://www.taxpolicycenter.org/numbers/Content/PDF/T09-0426.pdf.

To finance its own health reform bill, the Senate Finance Committee included an excise tax on high-cost insurance plans that would raise about $200 billion over ten years. This provision has strong appeal because it would put downward pressure on health costs. (The House bill includes important provisions on the spending side that would slow the growth of health care costs.[3]) A reasonable House-Senate compromise could combine a smaller version of the House surcharge with a modified version of the Senate's excise tax. Congress could later enact the rest of the House surcharge to raise revenue for deficit reduction.

Affected Households Are Receiving Growing Share of Nation's Income — And Would Pay Taxes at Well Below Pre-Reagan Levels Even With Surcharge

The surcharge would affect only the highest-income 0.5 percent of households in 2019, according to the Tax Policy Center,[4] leaving more than 99 percent of taxpayers completely unaffected. These very high-income households have prospered in recent decades, both absolutely and compared to the rest of the population. Congressional Budget Office data show that between 1979 and 2006 (the most recent year for which these data are available):[5]

FIGURE 1:
Income Growth Concentrated at the Top



Source: Congressional Budget Office

- The *before*-tax income of the top 1 percent of U.S. households increased by 226 percent, on average (after adjusting for inflation), compared to an increase of just 15 percent for families in the middle fifth of the income spectrum.
- The effective overall federal tax rate for the top 1 percent of households — i.e., the share of their income that they owe in taxes — fell substantially, from 37 percent to 31.2 percent.
- The *after*-tax income of the top 1 percent of households increased by 256 percent, after adjusting for inflation, compared to an increase of 21 percent for families in the middle income quintile. (See Figure 1.)
- As a result, the share of the nation's total after-tax income going to the top 1 percent of households *more than doubled,* from 7.5 percent of total income in 1979 to 16.3 percent in 2006. Altogether, households in the top 1 percent of the population had $617 billion

[3] Edwin Park *et al.,* "House Bill Expands Coverage, Lowers Health Cost Growth, and Reduces Deficits," Center on Budget and Policy Priorities, Updated November 6, 2009, http://www.cbpp.org/cms/index.cfm?fa=view&id=2973.

[4] Tax Policy Center, "America's Affordable Health Choices Act of 2009 Surcharge on High Income Individuals, Baseline: Current Law, Distribution of Federal Tax Change by Cash Income Percentile, 2019," October 29, 2009, http://www.taxpolicycenter.org/numbers/Content/PDF/T09-0422.pdf.

[5] Congressional Budget Office, "Data on the Distribution of Federal Taxes and Household Income," April 2009, http://www.cbo.gov/publications/collections/taxdistribution.cfm.

more income in 2006, and the other 99 percent of households had $617 billion less, than they would have had if the 1979 income distribution still prevailed.[6]

Not only is the income gap widening between very high-income households and the rest of the country, making the House surcharge a reasonable way to help finance health reform, but these households' tax burdens would remain moderate by historical standards even with the surcharge. If Congress enacted the surcharge and also let the Bush tax cuts expire for people over $250,000 a year as President Obama has proposed — *and,* in addition, allowed the tax rate on dividends to return to 39.6 percent when the 2001 tax law expires, which almost certainly will not happen (the President has proposed a top rate of 20 percent) — then the top 1 percent of households would face an effective federal tax rate of 34.2 percent, according to the Tax Policy Center.[7] This would mean a tax burden roughly half-way between the Bush years and that which prevailed just prior to the Reagan tax cuts.[8]

Few Small Businesses Would Owe Surcharge — And Many More Would Benefit From Other Elements of House Bill

Some critics claim that the surcharge would hit a large share of small businesses and thereby substantially weaken job growth. Both parts of this claim are unfounded, as explained below. In addition, the House bill contains several provisions designed to help small businesses provide their employees with health coverage: it would bar insurers from raising premiums for small businesses based on their workers' health status, help small businesses reduce administrative costs by allowing them to buy coverage through a health insurance exchange, and provide the smallest firms with tax credits to help them offer coverage. (See the box on the next page for more details.) Many more small businesses would benefit from these provisions than would owe the surcharge.

- **More than 98 percent of people with business income would not face the surcharge.** Just 1.6 percent of taxpayers with business income would face the surcharge in 2019, according to the Tax Policy Center.[9] Moreover, many taxpayers in this group would severely stretch the definition of "small business owners." Most Americans would not describe the nation's wealthiest 400 people as "small business owners," for example, but these "Top 400" receive a substantial amount of business income. IRS income data show that in 2006 (the most recent year for which we have these data), the top 400 had more than $15 billion just in S corporation and partnership income.[10] The IRS also found that the top 400 taxpayers paid just 17.2 percent of their income in federal income taxes in 2006.

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[6] This $617 billion figure would equal $656 billion in 2009 dollars.

[7] Between 2002 and 2006, the effective rate for the top 1 percent averaged 31.7 percent. In 1979 it was 37 percent, according to CBO data. For projected effective rates with the surcharge, see Tax Policy Center Table T09-0418, "America's Affordable Health Choices Act of 2009 Surcharge on High Income Individuals," October 29, 2009, http://www.taxpolicycenter.org/numbers/Content/PDF/T09-0418.pdf.

[8] Congressional Budget Office, "Effective Federal Tax Rates for All Households, by Comprehensive Household Income Quintile, 1979-2006," April 2009, http://www.cbo.gov/publications/collections/tax/2009/effective_rates.pdf.

[9] See Tax Policy Center Table T09-0426, "Distribution of Tax Units with Business Income, by Modified Adjusted Gross Income Level, 2019," October 30, 2009, http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=2501&DocTypeID=7.

[10] IRS, "The 400 Individual Income Tax Returns Reporting the Highest Adjusted Gross Incomes Each Year, 1992-2006," p. 4, http://www.irs.gov/pub/irs-soi/06intop400.pdf.

Several Elements of House Plan Designed to Help Small Businesses

The House plan would help small businesses offer affordable health insurance to their employees. At present, smaller firms are much less likely than large firms to offer health benefits to their workers. When they do offer health benefits, the plans tend to provide less-comprehensive benefits and impose higher deductibles. Moreover, workers with family coverage in small firms typically contribute significantly more to the cost of insurance than workers in large firms. The House bill would:

- **Bar insurers from increasing premiums for small businesses based on their workers' health status and other factors.** In many states, insurers currently can vary the premiums they charge small businesses based on a number of factors, such as firm size, industry, geographic location, and the characteristics of their employees. If a small business has a disproportionate number of older workers (or if even a single employee incurs unusually high health expenses), it may find that decent-quality health insurance is unavailable or is priced out of reach. The House plan would prohibit insurers from varying premiums due to health status and other factors, and it would sharply limit their ability to increase premiums for firms with older workers.

- **Allow small businesses to buy health coverage through a new health insurance exchange in order to lower administrative costs and ensure access to quality plans.** At present, small employers pay more and get less for their health insurance dollars than large corporations do, in part because their administrative costs for health insurance are considerably greater. The House bill would allow businesses with up to 100 workers to purchase health insurance for their workers through the new health insurance exchange, significantly reducing their administrative costs. It would also require all plans purchased through the exchange to meet certain minimum benefit standards. As a result, the exchange would make it easier for small businesses to find comprehensive health plans at a more affordable price.

- **Provide tax credits for the smallest firms to help them offer coverage.** The smallest businesses, particularly those with larger shares of low-wage workers, tend to be the least able to offer health coverage. The House bill would provide a tax credit of up to 50 percent of the health insurance costs of very small firms.

The House bill's requirement that employers provide health insurance or otherwise contribute to the cost of coverage for their workers should not have a major effect on small businesses. As the Congressional Budget Office has explained, employers would largely pass through the cost of meeting this type of requirement to their employees in the form of lower wages than the firm otherwise would pay, just as firms that *do* offer coverage pass through the costs to their workers. Because employees rather than employers would bear most of the cost, CBO finds that this type of requirement would have only a relatively minor effect on business employment.[a] For the same reason, such a requirement should not substantially affect employers' bottom lines.

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[a] Congressional Budget Office, "Effects of Changes to the Health Insurance System on Labor Markets," July 13, 2009.

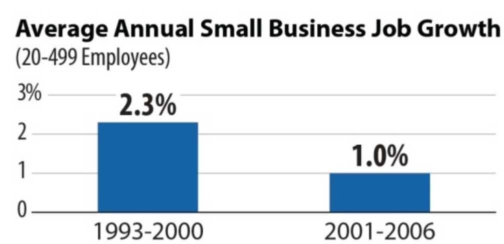
Along with many of the wealthiest 400 taxpayers in America, the following types of individuals also meet the definition of "small business owner": a partner in a large law or accounting firm, a corporate executive or other wealthy individual who rents out his or her vacation home (such rental income is filed under Schedule E), and a Wall Street bond trader who receives a multi-million dollar bonus and invests some of it in an investment partnership.[11]

- **Only a very small share of those paying the surcharge would be small businesses owners.** Claims that most affected taxpayers would be small business owners are not correct. Only about one in every four taxpayers who would pay the surcharge (28 percent) derives more than half of his or her income from a business or businesses, according to the Tax Policy Center. And even that figure should be placed in context: only 0.6 percent of tax filers who have business income both derive more than half of their income from business sources *and* would face the surcharge.[12]

- **During the current recession, small businesses are receiving tax *cuts* from the federal government, not tax increases.** The economic recovery package enacted in February includes tax cuts specifically aimed at small businesses. For example, its net operating loss provision allows small businesses to use losses they incurred in 2008 to secure refunds for taxes they paid going back five years, instead of the usual two years. (Note: this provision is in the process of being extended.) Meanwhile, the surcharge proposal, which would affect just a tiny share of small businesses as noted above, would not go into effect until 2011, by which time the economy should be stronger.

- **Businesses can structure themselves in ways that would reduce their tax burden.** Some critics have asserted that the surcharge would place so-called "pass-through entities" — Subchapter S corporations, sole proprietorships, and partnerships — at a tax disadvantage compared to Schedule C corporations, since only the former would potentially owe the surcharge. (Schedule Cs pay corporate income taxes, while the surcharge would apply only to individual income taxes.) But firms often organize themselves as pass-through entities specifically to reduce their tax liability. They could choose to organize themselves as Schedule C corporations instead if the surcharge made that preferable from a tax standpoint.

FIGURE 2:
Small Business Job Growth Stronger in 1990s Despite Higher Tax Rates



Source: Small Business Administration, U.S. Census Bureau

- **Recent history contradicts the claim that raising taxes on high-income households weakens small-business job growth.** Critics of proposals to increase taxes on upper-income

[11] A recent Joint Committee on Taxation analysis found that one-third of the revenues from the surcharge would come from business income paid under the individual income tax system. This figure is misleading, however, because it includes the income of the law and accounting firm partners and others filing schedules C, E, and F, who are not what many people think of as small business owners. Joint Committee on Taxation, "JCT Memorandum Providing Revenue Estimates for 5.4 Percent AGI Surtax on Business Income in H.R. 3962, Affordable Health Care for America Act," November 3, 2009.

[12] Tax Policy Center Table T09-0426, "Distribution of Tax Units with Business Income, by Modified Adjusted Gross Income Level, 2019," October 30, 2009, http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=2501&DocTypeID=7.

households often argue that they would harm *middle*-income households by placing their jobs at risk. Critics of President Clinton's economic plan made this argument in the early 1990s. Subsequent history contradicted this claim: small-business job growth was more than twice as strong during the Clinton years, when Congress raised taxes on high-income households, than during the Bush years (before the current recession set in, i.e., from 2001-2006), when Congress cut them. (See Figure 2.) As this experience shows, other factors affect job growth to a much greater extent than tax rates on high-income individuals.[13]

[13] Jason Levitis and Chuck Marr, "History Contradicts Claim That President's Budget Would Harm Small Business Job Creation," Center on Budget and Policy Priorities, March 26, 2009, http://www.cbpp.org/cms/index.cfm?fa=view&id=2742.