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The Expanding Democrat Tax-Hike Proposal: Who Really Gets Hurt?

Executive Summary

- Since the 2003 tax cuts were enacted, Democrats have stepped up their attacks on upper-income taxpayers. These attacks have evolved from targeting "millionaires," to those in the top tax bracket, and now to individuals with taxable income of $200,000.

- However, Democrats may have to dig even deeper into the wallets of American taxpayers given Democrats' growing appetite for spending – estimates of Senator John Kerry's spending proposals total $2 trillion over 10 years.

- And who will really bear the burden of such a tax increase? Most likely, it will be the small business owners that the Democrats say they want to help.

- In fact, of the taxpayers reporting more than $200,000 in taxable income (and so would be subject to the Democrats' proposed tax hike), more than half – some 1.3 million – are likely to be small business owners. These small business owners are already paying more than 37 percent of all income taxes collected in this country.

- Raising taxes will reverse the economic success that the 2003 reductions in individual tax rates have meant for small businesses:

  ➢ Capital expenditures by non-corporate businesses, including the majority of small enterprises, increased by 8.3 percent in the year ending in the first quarter of 2004, as opposed to only 4.4 percent by corporate businesses.

  ➢ As many as 1.9 million net new jobs could be attributed to small businesses since August of last year, with small businesses historically contributing from 60 percent to 80 percent of new jobs.

- If Democrats are serious about ensuring continued economic growth in this country, the most effective legislative initiative they could embrace is one that Republicans have continually advocated: Make the 2003 tax cuts – *all of them* – permanent.

Introduction

American taxpayers have seen a dramatic decline in their tax rates since the start of the Bush Administration. This is due to the enactment of the Jobs and Growth Tax Relief Reconciliation Act of 2003,[1] which fully implemented the reductions in the individual income-tax rates that originally were scheduled to be phased-in over a six-year period under the 2001 tax legislation.[2]

Chart 1
Change in Individual Tax Rates under the Bush Administration

2000 Tax Rates	2003 Tax Rates
15%	10%
	15%
28%	25%
31%	28%
36%	33%
39.6%	35%

Source: Internal Revenue Code

In his acceptance of the Democratic presidential nomination, Senator John Kerry (D-MA) signaled his intention to make further changes to the individual tax rates in the United States: "I will reduce the tax burden on small business. And I will roll back the tax cuts for the wealthiest individuals who make over $200,000 a year . . . ."[3] Yet, there is an inherent contradiction in his promises: the latter part of his plan, which is the culmination of the Democrats' expanding tax hike on upper-income taxpayers, is likely to end up hurting a significant number of the small businesses that he purports to want to help in the first part of his plan.

Democrats Must Raise Taxes to Pay for Their Spending Plans

Since the 2003 tax cuts were enacted, Democrats have stepped up their attacks on upper-income taxpayers. These attacks, however, have gradually evolved to include a larger and larger portion of taxpayers to supply the Democrats' growing appetite for spending. And, with their

[1]H.R. 2, 108th Congress, 2d Session, Public Law 108-27, May 28, 2003.

[2]Economic Growth and Tax Relief Reconciliation Act of 2001, H.R. 1836, 107th Congress, 1st Session, Public Law 107-16, June 7, 2001.

[3]Senator John Kerry, remarks before the 2004 Democratic National Convention, July 29, 2004. See also: Democratic Platform for America, July 10, 2004, p. 25.

spending proposals totaling an estimated $2 trillion over 10 years,[4] Democrats likely will have to dip even deeper into taxpayers' wallets.

Initially, when the Senate considered the Fiscal Year 2005 budget resolution in March 2004, Democrats advocated raising taxes on "millionaires" to pay for a variety of spending initiatives.[5] In fact, six amendments to the budget resolution proposed to reduce the tax breaks for individuals with incomes in excess of one million dollars per year – each ostensibly to provide additional funding for an array of spending programs from law enforcement to assistance for dislocated workers.[6]

Next, Democrats expanded the number of taxpayers subject to their tax hike, setting their sights on all taxpayers in the current top tax bracket, which applies to individuals with taxable income of more than $319,100 in 2004.[7] For example, during the Senate's consideration of the National Defense Authorization Act for Fiscal Year 2005 (S. 2400), Senator Joseph Biden (D-DE) proposed an amendment that would have raised the tax rate for individuals in the top tax bracket – this time to pay for additional funding for military activities in Iraq.[8]

Now, Democrats are expanding their tax hike to include even more American taxpayers – those with more than $200,000 in taxable income. What this lower threshold conveniently glosses over is the fact that Democrats are now proposing to raise taxes on individuals in the *top two tax brackets*. In fact, targeting individuals with $200,000 in income will require the creation of a new tax bracket since $200,000 is near the middle of the current 33-percent tax bracket.

Even at this lower threshold, the proposed tax hike is estimated to raise only about $300 billion of the $2 trillion that the Democrats are estimated to need over the next 10 years.[9] As a result, the $200,000 level likely will fall further, exposing more and more Americans to higher income taxes. The next obvious stopping point is the bottom of the existing 33-percent tax bracket, capturing all individuals with taxable income in excess of $146,750.[10]

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[4] *Wall Street Journal*, "Kerry's Deficit-Cutting Math May Not Add Up," July 30, 2004; Eric M. Engen and Kevin A. Hassett, "An Analysis of the Ten-Year Costs of Senator Kerry's Spending Proposals," American Enterprise Institute, August 12, 2004 – http://www.aei.org/publications/pubID.21053/pub_detail.asp.

[5] Senate Concurrent Resolution 95, 108th Congress, 2d Session.

[6] See e.g., Senate Amendment 2710 to Senate Concurrent Resolution 95, proposed by Senator Tom Daschle (D-SD), March 9, 2004, defeated 44 - 53, Record Vote Number 34; Senate Amendment 2774, proposed by Senator Daschle, March 11, 2004, defeated 42 - 54, Record Vote Number 52; Senate Amendment 2777, proposed by Senator Jon Corzine (D-NJ), March 10, 2004, withdrawn March 12, 2004; Senate Amendment 2783, proposed by Senator Barbara Boxer (D-CA), March 11, 2004, defeated 41 - 53, Record Vote Number 41; Senate Amendment 2793, proposed by Senator Byron Dorgan (D-ND), March 11, 2004, defeated 41 - 55, Record Vote Number 44; Senate Amendment 2807, proposed by Senator Joe Lieberman (D-CT), March 11, 2004, defeated 40 - 57, Record Vote Number 50.

[7] Internal Revenue Service (IRS) 2004 Tax Rate Schedules.

[8] Senate Amendment 3379 to S. 2400, proposed by Senator Biden, June 17, 2004, defeated 44 - 53, Record Vote Number 130.

[9] *Wall Street Journal*, "Kerry's Deficit-Cutting Math May Not Add Up."

[10] IRS 2004 Tax Rate Schedules.

Consequences of the Democrats' Proposed Tax Hike

Small Businesses in the Cross Hairs

A fundamental point that many Democrats fail to grasp is that upper-income taxpayers are more likely to be small business owners, as shown in Chart 2 below. As a result, the expanding scope of their tax-hike proposal is likely to increase – not decrease, as Senator Kerry promises – the tax burden on small businesses.

The most recent data available from the Internal Revenue Service shows that there were more than 2.5 million tax returns filed in 2001 that reported taxable income exceeding $200,000. As the chart below illustrates, more than half – 1.3 million – of those returns included income from likely small business entities – that is, "flow-through" entities, such as sole proprietorships, partnerships, and S corporations. Typically, small businesses adopt these organizational structures for tax purposes because the business income flows through to the owners where it is taxed at the individual level. While the top individual tax rate now equals the corporate tax rate – both 35 percent – these organizational structures free small businesses from the corporate-level ("double") taxation borne by most major corporations.

Chart 2
2001 Tax Returns with Likely Small Business Income

Adjusted Gross Income	Total Number of Tax Returns		Returns with Sole Proprietorship, Partnership, or S-Corporation Income		Returns with Business Income as a Percentage of Total Returns
$1 under $50,000	91,316,961		9,649,482		10.8%
$50,000 under $100,000	26,463,672		4,311,734		16.3%
$100,000 under $200,000	8,469,199		2,101,132		24.8%
$200,000 under $500,000	2,018,372		951,726		47.2%
$500,000 under $1,000,000	355,617	2,567,218	221,368	1,308,619	62.3%
$1,000,000 or more	193,229		135,525		70.1%

Source: IRS Statistics of Income Division
Based on 2001 Tax Returns

Nearly all of the business income reported on these 1.3 million returns with taxable income exceeding $200,000 arguably comes from small businesses, based on the federal government's definition of a small business, and noting the Small Business Administration estimates that 99.7 percent of the 23.7 million U.S. businesses meet that definition.[11]

[11]U.S. Small Business Administration (SBA) Office of Advocacy, "Small Business by the Numbers," December 2003 – http://www.sba.gov/advo /stats/sbfaq.pdf. The SBA defines a small business as "an independent business having fewer than 500 employees."

In addition, a recent study by the Tax Foundation revealed that as income rises, the percentage of taxpayers with business income increases significantly – nearly three-quarters of the top 1 percent of taxpayers (which approximates the top tax bracket) reported business income on their tax returns.[12] Moreover, these taxpayers are not merely passive investors in small enterprises.

Chart 3
Breakdown of Small Businesses Income

Adjusted Gross Income	Returns with Sole Proprietorship, Partnership, or S-Corporation Income: Total		Active Income		Passive Income	
$1 under $50,000	9,649,482		9,248,205		401,277	
$50,000 under $100,000	4,311,734		3,911,047		400,687	
$100,000 under $200,000	2,101,132		1,785,212		315,920	
$200,000 under $500,000	951,726		779,452		172,274	
$500,000 under $1,000,000	221,368	1,308,619	177,191	1,067,493 (82%)	44,177	241,126 (18%)
$1,000,000 or more	135,525		110,850		24,675	
Source: IRS Statistics of Income Division Based on 2001 Tax Returns						

In fact, as Chart 3 demonstrates, nearly 82 percent of these small business owners are actively involved in the day-to-day operations of their business. Meanwhile, those that are not actively involved represent an important source of capital for the businesses they own. These upper-income individuals are referred to in the venture-capital sector as "angels" because they are significant providers of equity capital for entrepreneurial ventures at their earliest stages, enabling them to invest in new equipment, develop new products and services, and, most importantly, create new jobs.[13]

In the end, the Democrats' tax-hike proposal is based on the misguided belief that upper-income taxpayers have more disposable income and, therefore, can afford to pay more of the federal tax bill. In their rush to raise taxes on "wealthy" taxpayers, however, many Democrats overlook that more than half of these taxpayers are actually small business owners. In addition, they fail to recognize that those business owners with taxable income of $200,000 will pay a

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[12] Scott A. Hodge and J. Scott Moody, "Wealthy Americans and Business Activity," Tax Foundation, No. 131, August 2004, p. 1 – http://www.taxfoundation.org/sr131.pdf.

[13] John Freear, Jeffrey E. Sohl, and William Wetzel, "Angles on angels: Financing technology-based ventures – an historic perspective," *Venture Capital: An International Journal of Entrepreneurial Finance*, Vol. 4, No. 4, 2002. Angels tend to be affluent, self-made individuals, who prefer to invest in the industries in which they made their money.

remarkable 37.4 percent of all income taxes in this country, while filing less than 2 percent of all individual tax returns in 2004.[14]

Continued Economic Growth and Job Creation are Potentially at Risk

While the Democrats promise to "roll back the Bush tax cuts for those making more than $200,000," doing so would put in jeopardy the stimulative economic effects that the 2003 tax cuts were designed to achieve (in part by leaving more earnings in the hands of small business owners to reinvest in their business and create new jobs). As Dr. Robert Berney, then-chief economist for the SBA's Office of Advocacy, testified, "Every dollar of profit or tax relief tends to be re-invested in the [owner's] firm."[15] Refining that principle, the Joint Economic Committee (JEC) noted last year that "research suggests that cutting marginal tax rates – particularly the top . . . rate faced by many small businesses today – is an effective way of encouraging entrepreneurs to invest in and expand their businesses."[16]

Despite the limited data, the effects of the 2003 rate reduction are already proving this point – businesses are investing and expanding their operations. Capital expenditures by non-corporate businesses, including flow-through entities, rose by more than $195 billion in the year ending in the first quarter of 2004, an 8.3-percent year-over-year increase.[17] In contrast, capital expenditures by corporate businesses increased only 4.4 percent during the same period.[18] The NFIB Research Foundation survey of small businesses confirm that small businesses' capital expenditures have continued to rise since the enactment of the 2003 tax-rate reductions, growing by 7 percent in the 13 months since June 2003.[19] Moreover, according to the August survey, 32 percent of small business owners plan on making capital expenditures in the next three to six months – well off the 25-percent record low in August 2002.[20]

Similarly, the 2003 rate cut was intended to increase the potential that small business owners would hire employees and lead to higher wages for those workers.[21] In fact, a significant portion of the nearly 1.7 million net new payroll jobs added to the economy since August of 2003[22] can be attributed to small businesses, since they have historically contributed from 60

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[14]Hodge and Moody, p. 3.

[15]Robert Berney, then-Chief Economist, U.S. Small Business Administration Office of Advocacy, testimony before the Senate Committee on Finance, March 28, 2001.

[16]JEC, "How the Top Individual Income Tax Rate Affects Small Businesses," May 6, 2003, p. 2 (citing Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen. "Entrepreneurs, Income Taxes, and Investment," in *Does Atlas Shrug*, Joel B. Slemrod, ed. (Russell Sage Foundation, 2000)) – http://jec.senate.gov/_files/SmallBusiness.pdf.

[17]Federal Reserve, "Flow of Funds Accounts of the United States, Flows and Outstandings, First Quarter 2004," June 10, 2004, Table R.103 – http://www.federalreserve.gov/releases/Z1/Current/z1.pdf.

[18]Federal Reserve, Table R. 102.

[19]NFIB Research Foundation, "Small Business Economic Trends," August 2004, p. 16 – http://www.nfib.com/page/researchFoundation.

[20]NFIB Research Foundation, p. 17.

[21]JEC, p. 2 (citing Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen. "Income Taxes and Entrepreneurs' Use of Labor." *Journal of Labor Economics* XVIII (1999)).

[22]Bureau of Labor Statistics (BLS), "Employment Situation: August 2004," USDL 04-1728, September 3, 2004 – http://www.bls.gov/news.release/empsit.nr0.htm.

percent to 80 percent of new employment opportunities, according to the SBA.[23] Applying this historical data to the Bureau of Labor Statistic's (BLS) household survey, which provides a better reflection of self-employed individuals[24] and the jobs created by newly formed small enterprises in this country,[25] as many as 1.9 million net new jobs could be attributed to small businesses since August of 2003.[26]

Moreover, as employment has increased, wages have followed suit. For the year ending in August 2004, weekly payroll wages for private-sector production or non-supervisory workers increased by 2.9 percent.[27] Similarly, the NFIB Business Research Foundation's surveys find that since the tax-rate reductions were enacted in 2003, an increasing number of small businesses report that they have increased wages, and the August survey suggests that they will continue doing so in the next three months.[28]

The economic data indicate that the 2003 tax-rate reductions are achieving their goal of stimulating investment and employment, especially in the small business sector of the economy. Accordingly, the Democrats' expanding tax hike on small business owners earning more than $200,000 is even more disturbing. These are the taxpayers who will slow their investment in new equipment – or stop expanding their businesses altogether. These are the taxpayers who will see more of their revenues sent to Washington rather than reinvested in their businesses to continue the impressive record of new jobs that they have created in the past year. And, as Chart 3 demonstrates, if the Democrats expand their tax hike below the $200,000 level to raise additional revenues, another 2 million businesses are immediately at risk.

Conclusion

Since the start of the Bush Administration, the American economy has weathered a series of economic shocks – the terrorist attacks of September 11, 2001, the 2001 recession, corporate-management scandals, and the continuing war on terror, with major commitments in Afghanistan and Iraq. Despite the potential that these events could have caused extraordinarily severe economic crises, the American economy responded with amazing resilience, generating 11 consecutive quarters of growth in the nation's Gross Domestic Product through the second

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[23] SBA Office of Advocacy.

[24] For example, as a *Wall Street Journal* commentary noted: "[T]he payroll survey estimates that there are 311,000 realtors in the United States. But the National Association of Realtors claims a million members. Moreover, 80 percent of all realtors are independent contractors. They do not pay unemployment insurance and therefore are not counted by the [payroll survey]." Brian Westbury, "Job Alert," *Wall Street Journal*, May 11, 2004.

[25] BLS, "The Employment Situation: August 2004," Explanatory Note – http://www.bls.gov/news.release/empsit.tn.htm; BLS, Employment from the BLS household and payroll surveys: summary of recent trends, September 3, 2004, pp. 8-9 – http://www.bls.gov/cps/ces_cps_trends.pdf. See Brian Westbury, "The True Rock-Stars of the Economy," *Wall Street Journal*, August 11, 2004.

[26] BLS, Current Population Survey, August 2004.

[27] BLS, "The Employment Situation: August 2004," Table B-3.

[28] NFIB Research Foundation, p. 11.

quarter of 2004.[29] With the help of the 2003 tax cuts, small businesses have been the vanguard of the current economic expansion. Why would anyone want to risk the sustained growth of the economy by increasing taxes on those most responsible for its strength?

If Democrats are serious about ensuring continued economic growth, helping small businesses to succeed, and ultimately raising the standard of living of the middle class, the most effective legislative initiative they could embrace is one that Republicans have continually advocated: Make the 2003 tax cuts – *all of them* – permanent.

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[29]Bureau of Economic Affairs, "National Income and Product Accounts," BEA 04-39, August 27, 2004, Table 1 – http://www.bea.gov/bea/newsrelarchive/2004/gdp204p.pdf.