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July 24, 2012

Democrats' Tax Plans: Raise Taxes

On July 9, President Obama called for tax increases on small businesses. One week later, Senator Patty Murray said that if Democrats do not get their wish to increase taxes on hardworking small businesses, they would increase taxes on all taxpayers. This ultimatum and the brinkmanship behind it are bad enough for the economy; the specifics of the various Democratic proposals to address the expiration of current tax policy are even worse.

Democrats' Tax Increases Would Hurt the Economy

Democrats are so fragmented on the issue of tax policy that there are actually three separate avenues Democrats may take. The first is the bill introduced by Senate Democrat Leader Reid, S. 3412, which would adopt the President's position that taxes should be raised on those making more than $200,000, but it takes a different approach to both dividends and the estate tax. The second is the President's proposal to raise taxes on taxpayers making more than $200,000 and to increase dividend taxes to regular income rates, which could reach nearly 45 percent. The third is the Murray option, which would raise taxes on all taxpayers and bring some very low-income families back onto the tax rolls, all in pursuit of Democrats' agenda to raise taxes on small businesses.

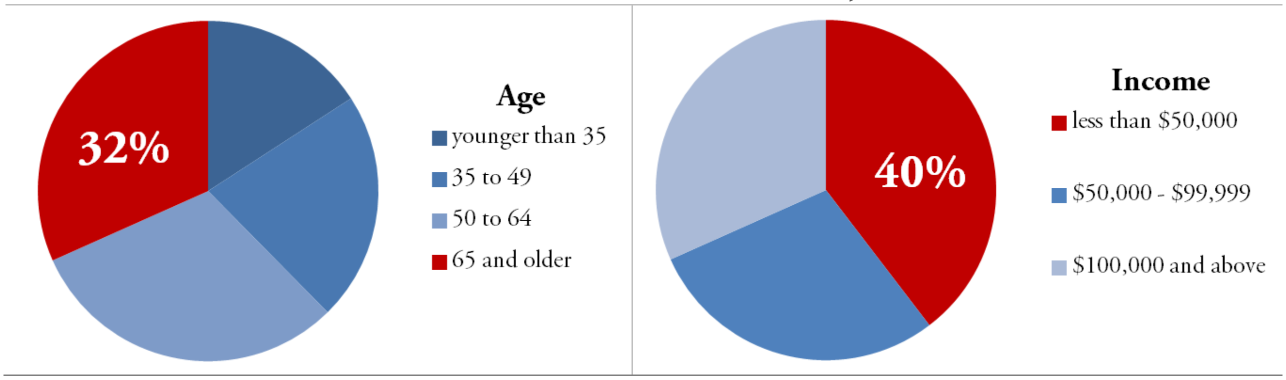
Raising taxes on small businesses and other taxpayers making more than $200,000 will have many bad effects on the economy:

- **Lower Growth, Lower Standard of Living.** These tax hikes will destroy 710,000 jobs, reduce the economic growth we would otherwise see by 1.3 percent, and lower after-tax wages by 1.8 percent.
- **If You Want Less of Something, Tax It.** The economic damage done by these tax hikes is not surprising, since raising taxes on small businesses will tend to decrease hiring and investment. According to the Congressional Budget Office, "higher marginal tax rates do reduce economic activity."
- **One Out of Four Employees Works at Businesses Hit.** Businesses employing 25 percent of the American workforce would be hit with higher taxes.
- **Majority of Small Business Income Affected.** An estimated 53 percent of all business income reported on individual tax returns will be affected by the President's tax increase.
- **One Million Small Businesses Caught.** Approximately 940,000 small businesses would be hit by President Obama's tax hike.

- **America's Competiveness Hurt.** Raising the dividend and capital gains rates will result in a 68.6 percent integrated dividend tax rate (the highest among industrialized countries) and a 56.7 percent integrated capital gains tax rate, second highest among these nations (behind Italy). Such a high rate will drive investment and jobs overseas. This is in addition to having the highest corporate tax rate among industrialized countries.

Dividend Tax Hike to Hit Seniors and Low-Income

Tax Returns With Dividend Income, 2009



Source: Ernst & Young, The Beneficiaries of the Dividend Tax Rate Reduction, May 2012

Reid Bill -- S. 3412

- Raises taxes on "high-income" taxpayers -- those making more than $200,000 for individuals; $225,000 for taxpayers who are filing as head of household; and $250,000 for those who are married and filing jointly, or surviving spouses. Extends current tax policy for those making less than these amounts.
- Reinstates the personal exemption phaseout (PEP) and overall limitation on itemized deductions (Pease) for these "high-income taxpayers." The accounting firm Ernst & Young estimates that reinstating Pease will result in approximately 1.3 percentage points in increased taxes.
- Raises the capital gains and dividends rate to 20 percent for high-income taxpayers (this will become 23.8 percent with the President's health care law's Medicare tax. Extends current capital gains and dividend policy for taxpayers making below the threshold.
- Extends the American Opportunity Tax Credit, the expanded Child Tax Credit, and the expanded Earned Income Tax Credit. The bill also extends a provision that disregards refundable tax credits and does not count them as income when determining eligibility for other federal assistance programs.
- Extends Section 179 expensing.
- Includes an Alternative Minimum Tax (AMT) "patch" for 2012 only.
- Says that the budgetary effects will not be entered on the PAYGO scorecard.
- Returns gift and estate taxes to Clinton-era levels: a $1 million exemption and a top rate of 55 percent. Current policy is a $5.1 million exemption and 35 percent top rate.
- The bill would decrease revenue by $249.6 billion relative to current law.

Obama Proposal

The President's position largely agrees with Senator Reid's bill, with two notable exceptions:

- The President would tax dividends as ordinary income. This means that after other tax increases he is proposing or has already passed, dividend rates could reach nearly 45 percent.
- The President is proposing an estate tax exemption of $3.5 million, with a 45 percent top rate.

Murray Option

Senator Murray's speech presumably matches the President's thinking, as it came a few days after a meeting Obama had with Democratic leaders. She favors allowing all tax cuts to expire in order to try to gain a little negotiating leverage – a shameful position. This option risks a recession, and no amount of pointing fingers at Republicans changes this fact for Democrats. We already know that policy uncertainty hurts the economy. With the Murray option, the Democrats are making that uncertainty even worse.

Hatch/McConnell Bill -- S. 3401

In contrast to the tax hikes proposed by Democrats, the Hatch/McConnell bill takes the common sense approach that we should not raise taxes in a weak economy. In fact, President Obama used to agree with this approach before he entered campaign mode. Earlier in his term, the President said, "you don't raise taxes in a recession." At the time of the 2010 tax rate extension, President Obama said that raising taxes "would have been a blow to our economy." At that time, GDP growth was 3.1 percent. But our economy is even weaker now than it was then; GDP growth over the last four quarters has been 2.0 percent, and some forecasts show it further declining.

Provisions:

- Extends current tax policy for individual income taxes, as well as estate and gift taxes.
- Extends dividend and capital gains current policy.
- Contains a two year AMT patch.
- Extends Section 179 business expensing through 2013.
- Requires the Senate Finance Committee to report tax reform legislation within one year. The tax reform bill must:
  - Simplify the tax code by broadening the base and lowering the rates, with a top rate significantly below 35 percent;
  - Permanently repeal the AMT;
  - Be revenue neutral or lower revenue when compared to current policy;
  - Have a positive effect on the economy, which may result in increased revenue;
  - Use any increased revenue for further rate reductions;
  - Keep the tax code progressive;
  - Include corporate tax reform that would include a top rate of no more than 25 percent and move to a territorial tax system.
- The bill would decrease revenue by $404.9 billion relative to current law. If this bill matched the Democrats' one-year AMT patch, it would decrease revenue by $300.7 billion relative to current law; a difference of about $50 billion from the Reid proposal. The revenue impact is small, but the policy differences are large.