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ADMINISTRATION TAX-CUT RHETORIC AND SMALL BUSINESSES

By Joel Friedman

The Bush Administration has consistently asserted that its tax cuts, and especially the reduction in the top income tax rate and repeal of the estate tax, are of great value to small businesses. These assertions have been at the heart of both the Administration's claims regarding the virtues of its tax cuts and its calls to make the tax cuts permanent.

An examination of the relevant data demonstrates, however, that the Administration's statements seriously exaggerate the benefits of its tax cuts — and especially of the top-rate reduction and estate tax repeal — to the vast majority of small businesses. Claims that the top-rate reduction and estate tax repeal are of substantial benefit to small-business enterprises hold true primarily for a small, rather elite group of businesses — those whose owners have very high incomes and have accumulated significant wealth. For the overwhelming majority of households with small-business income — about 99 percent of them — the reduction in the top income tax rate and the repeal of the estate tax offer no benefits at all.

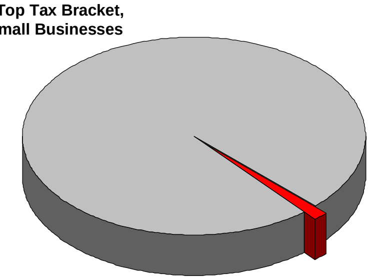
Top Rate Reduction Affects Very Small Number of Small Businesses

The top income tax rate was reduced to 35 percent in 2003, and will return to 39.6 percent after 2010, if the tax-cut legislation is allowed to expire. The Administration argues that making the top-rate reduction permanent is vital for small business. It says that a large share of those who face the top rate are people with small-business income, a group the Administration often refers to as "small-business owners."

Analysis by the highly respected Urban Institute-Brookings Institution Tax Policy Center shows, however, that the number of tax filers with small-business income who face the top rate represents only a tiny fraction of all tax filers with small-business income.

- Tax Policy Center data show that only 436,000 tax filers with small-business income — just *1.3 percent* of the 32.8 million filers in the nation with small-business income — are subject to the top income tax rate and hence benefit from the top-rate reduction. The remaining 99 percent of households with small-business income are not affected by this change.

Few Tax Filers with Small-Business Income Face the Top Tax Rate



Source: Tax Policy Center

- The small number of tax filers with small-business income who *do* face the top rate are an elite group. The Tax Policy Center data show they will have average income of $1.5 million in 2004.

- Moreover, these Tax Policy Center estimates tend to overstate the benefits of the top-rate reduction to households with small-business income, because these estimates are based on an expansive definition of "small business" that the Treasury Department and the Administration employ (and which the Tax Policy Center adopted in these analyses to be consistent with the Treasury definition). The Treasury definition relies on information from tax returns to identify small-business owners, even though these data are not well suited for singling out the type of "hands-on entrepreneur" that the term "small-business owner" brings to mind (see box on page 4). Indeed, President Bush and Vice President Cheney have both reported income that would classify them as "small-business owners" under the Treasury definition.

  Treasury's broad definition captures millions of tax filers, many with very high incomes, whose business income has little to do with the popular image of a small business. Under this definition, wealthy doctors and lawyers who organize their practices as partnerships are considered small-business owners, as are CEOs receiving fees for sitting on corporate boards. The definition also includes substantial numbers of wealthy investors who simply have "passive" investments in a business and have little or nothing to do with its day-to-day operations.

Miniscule Number of Small Businesses Affected By Estate Tax

The story is similar with regard to the estate tax. Repeal of that tax is slated to be in place for one year — 2010 — and then to expire. The Administration argues that making estate-tax repeal permanent is essential for small businesses and farms, because estates with small businesses or farms otherwise will face the prospect of having to liquidate the enterprise to pay the estate tax.

The Tax Policy Center has conducted relevant analysis here, as well, by examining the impact of the estate tax on small businesses and farms. The Tax Policy Center defines "small" as a business or farm worth $5 million or less. It identifies estates in which a small business or farm constitutes a majority of the assets in the estate. The Tax Policy Center uses this approach because, in estates where a business or farm represents only a *minority* of the assets, the other assets can be used to pay the estate tax and thereby shield the business or farm from liquidation.

- Only 340 estates nationwide in which small business or farm assets represent a majority of the estate will owe any estate tax in 2004, the Tax Policy Center found. This year, estates valued at less than $1.5 million for an individual and $3 million for a couple are exempt from the estate tax.

- Moreover, the Tax Policy Center found that by 2009, when estates worth up to $3.5 million for an individual and $7 million for a couple will be exempt from the tax, only *40 estates in the nation* in which small business or farm assets represent a majority of the estate will face any estate tax. In 2009, an average of only one such small business or farm per state will be subject to the tax. All other estates with small business or farm assets will be exempt.

- Even when estates with larger businesses or farms are included — that is, businesses or farms valued at *over* $5 million — the number of estates subject to the estate tax in which the majority of the estate consists of business or farm assets remains very small. In 2009, only 170 such estates nationally will owe any estate tax.

Only this extraordinarily small number of small businesses and farms face any prospect of being liquidated to pay the estate tax. Accordingly, despite the high cost of estate tax repeal to the Treasury, only a tiny number of small businesses and farms will gain protection from the risk of liquidation when the large estate-tax exemptions that will be in place in 2009 give way to repeal of the estate tax in 2010.

The Tax Cuts for "Small Businesses" Are Flowing Primarily to Those With High Incomes

If the reduction in the top rate and repeal of the estate tax do not affect the overwhelming majority of small businesses, the question arises as to whether the *overall package* of tax cuts enacted since 2001 offers something special to a wide range of small businesses. Artfully presented statements by the Administration and other tax-cut proponents leave that impression.[1]

In fact, the tax cuts essentially affect small businesses in the same way that they affect the population as a whole. As studies by the Congressional Budget Office, the Tax Policy Center, and other institutions have shown, the tax cuts enacted since 2001 disproportionately benefit those with the highest incomes.[2] To the extent that filers with small-business income have high incomes, they benefit handsomely from the tax cuts.

[1] Typically, the Administration and its allies note that a high percentage of people who face the top rate have small-business income, creating the impression that many or most small-business people face the top rate. As noted above, using the Treasury Department definition of small business, the Tax Policy Center finds that only 436,000 of the 32.8 million filers with small-business income pay at the top rate. (Only 141,000 of these filers are sole proprietors.) Another 423,000 households with small-business income pay are in the next highest tax bracket, the 33 percent income tax rate. This means that a total of just *2.6 percent* of the households with small-business income are in either of the top two tax brackets. Further, these estimates change little if filers with no taxable income are excluded. The Tax Policy Center totals include 7.2 million filers with small-business income who have no taxable income and thus face a so-called "zero" marginal tax rate. Looking just at those filers with small-business income who face a marginal tax rate of at least 10 percent, the Tax Policy Center estimates show that only 1.7 percent of these taxpayers face the top rate and 3.3 percent are in either the top tax bracket or the next-to-the-top bracket.

[2] Congressional Budget Office, "Effective Federal Tax Rates Under Current Law, 2001-2014," August 2004. For a discussion of the CBO findings, see David Kamin and Isaac Shapiro, "Studies Shed New Light on Effects of Administration Tax Cuts," revised September 13, 2004. For a discussion of the Tax Policy Center data, see Isaac Shapiro and Joel Friedman, "Tax Returns: A Comprehensive Assessment of the Bush Administration Tax Cuts," Center on Budget and Policy Priorities, April 2004.

Who Is a "Small-Business Owner"?

The potency of the term "small business" lies in the images it evokes in the public imagination. Typically, it brings to mind risk-taking entrepreneurs who are involved in the hands-on management of their small firms. To some people, it calls to mind the corner grocery store or the local auto mechanic. To others, it reflects a start-up firm, such as a new business developing a new type of software.

Yet the Treasury Department's definition of small-business owner — a person or couple who files an individual income tax return that includes *any* income (or loss) from a sole proprietorship, farm proprietorship, partnership, S corporation, or rental income — includes large numbers of tax filers who are not hands-on entrepreneurs. In general, the expansive Treasury definition suffers from two basic problems: it includes businesses that are not small; and it includes wealthy individuals who are passive investors and have nothing to do with operating the business in question (and may have never set foot in it).

What does "small" mean? As the Joint Committee on Taxation has noted, "while many small businesses are arranged as a sole proprietorship, a partnership, or an S corporation, not all of the businesses organized in those forms are small…"* Using IRS data from 2000, the Joint Tax Committee showed that the Treasury definition of "small business" included 650,000 businesses with gross receipts of over $1 million and 75,000 companies with gross receipts of over $10 million. Businesses with gross receipts of more than $10 million accounted for two-thirds of the gross receipts of all partnerships and S corporations.

What makes someone a "small-business owner"? The Treasury definition includes many individuals who clearly do not meet the popular image of a small-business owner. For instance, the Treasury definition includes people who passively invest in a business and have nothing to do with its day-to-day operations. According to the Tax Policy Center, passive income from partnerships and S corporations represents some or all of the small-business income of *2.9 million* tax filers termed "small-business owners" under the Treasury definition. For 850,000 of these filers, *all* of their "business income" comes in this passive form. This is of particular note because the prevalence of passive business income increases at higher income levels. Passive investment income constitutes all or part of the business income of about 35 percent of the "small-business owners" with income above $200,000 and 58 percent of the "small-business owners" with incomes over $1 million.

The Treasury definition also counts as small-business income the fees that CEOs are paid for sitting on corporate boards, as well as honoraria that journalists receive for giving speeches. This turns a number of corporate CEOs and journalists employed by large media corporations into "small-business owners." Doctors and lawyers who organize their practices as sole proprietorships, partnerships, or S corporations are considered small-business owners as well, under this definition. Indeed, the President and Vice President are considered "small-business owners" under this definition.

Counting as "small-business owners" large numbers of people whose business income comes from firms that cannot be categorized as small, who are merely passive investors, or who are corporate executives receiving fees for sitting on corporate boards has a distorting effect. It inflates the tax-cut benefits that are said to go to small businesses. These anomalies are especially prevalent with regard to S corporations and partnerships, since the income from those entities is highly concentrated among high-income individuals. IRS data show that in 2001, about 40 percent of all S corporations and partnership income was earned by "small-business owners" with incomes of more than $1 million.

These anomalies in the data should make one highly skeptical of claims advanced by policymakers or lobbyists who seek to promote various tax cuts on the basis of the tax cuts' purported value to "small businesses" or "small-business owners."

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* Joint Committee on Taxation, "Background and Proposals Relating to S Corporations," JCX-62-03, June 19, 2003.

Most households with small-business income, however, do *not* have high incomes. The Tax Policy Center data show that about three-fifths of the households with small-business income have incomes *below $75,000.* Three-quarters have incomes below $100,000. Just eight percent of these households have incomes above $200,000.

A related Tax Policy Center analysis examines the impact of the overall package of tax cuts enacted in 2001 and 2003 on tax filers with small-business income.[3] The Tax Policy Center assessed how the tax cuts would affect tax filers with some business income (or losses), as defined by the Treasury Department. (The Tax Policy Center used the Treasury definition of small-business income to be consistent with Administration analyses of this matter.[4]) The Tax Policy Center found that a small minority of the households with small-business income — namely, those with the highest incomes — are receiving the majority of the tax-cut benefits that go to people with small-business income.

- Tax filers with small-business income whose total income *exceeds $1 million* will receive an average tax cut of over $130,000 in 2004, the Tax Policy Center found. This group consists of 208,000 filers, just 0.6 percent of all households with small-business income. Yet it will receive 27 percent of all of the tax-cut benefits being provided to people with small-business income.

- In addition, households with small-business income whose total income exceeds $200,000 — a group that represents eight percent of all households with small-business income — will receive 51 percent of the tax cuts going to people with small-business income.

- By contrast, households with small-business income whose total income is less than $75,000 — a group that represents 62 percent of all households with small-business income — will receive only 16 percent of the tax cuts going to households with small-business income.

- Similarly, households with small-business income whose total incomes fall below $100,000 constitute three-quarters of the households with small-business income but receive one-quarter of the tax-cut benefits going to such households.

This analysis by the Tax Policy Center is likely to understate the disparities in the distribution of the tax cuts; the analysis looks only at the tax cuts themselves and does not incorporate the effects of measures that ultimately will be needed to offset the costs of the tax cuts. The current approach, of financing the tax cuts through borrowing and higher deficits, is not sustainable over the long run. At some point, we will have to make up for the revenue losses and pay for the tax cuts. As with a credit card, paying the bill can be postponed but cannot be avoided indefinitely.

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[3] The Tax Policy Center analysis assesses the impact of the individual and corporate income tax cuts enacted in 2001 and 2003.

[4] See William Gale, "Small Businesses and Marginal Income Tax Rates," Tax Notes: Tax Facts Column, April 26, 2004.

How the Tax Cuts Enacted in 2001 and 2003 are Being Distributed Among "Small-business owners"* (Data are for 2004)					
Cash Income	Returns of "small-business owners"		Tax cuts going to "small-business owners"		Percent change in after-tax income
	Number	Percent of total	Percent of total	Dollar amount	
Less than $30,000	9,404,000	28.6%	2.8%	-$301	2.2%
$30,000 - $50,000	5,277,000	16.1%	5.1%	-978	2.9%
$50,000 - $75,000	5,702,000	17.4%	8.3%	-1,465	2.9%
$75,000 - $100,000	3,833,000	11.7%	9.1%	-2,376	3.5%
$100,000 - $200,000	5,588,000	17.0%	23.0%	-4,133	4.0%
$200,000 - $1 million	2,309,000	7.0%	24.5%	-10,670	4.1%
Over $1 million	208,000	0.6%	26.9%	-130,111	6.6%
All	32,845,000	100.0%	100.0%	-3,058	4.2%
<u>Addendum</u> "small-business owners" who pay at the top rate	436,000	1.3%	28.4%	-65,427	6.8%

*Using Treasury Department definition of "small-business owner" (see box page 4).
Source: Urban-Brookings Tax Policy Center; returns with negative income are not included in the lowest income category but are included in the totals.

Once the cost of paying for the tax cuts is taken into account, only small-business owners with high incomes are likely to end up better off as a result of the tax cuts. The disproportionately large tax cuts that high-income households are receiving are likely to more than offset whatever costs they ultimately bear to help defray the costs of the tax cuts. But for small-business owners who do not have high incomes, the opposite is likely to be the case. Another Tax Policy Center analysis shows that between 58 percent and 70 percent of small-business owners are likely to be worse off as a result of the tax cuts, once the effects of measures to cover the cost of the tax cuts are taken into account. (See box on page 7.)

The Tax Cuts and the Economy

The Administration emphasizes the benefits of its tax cuts for small businesses in making the case that the tax cuts will boost long-term economic and job growth. The tax cuts are said to be a great boon for small businesses generally, and small businesses are said to be the engine of job growth. This linkage is used to advance the claim that making the tax cuts permanent is essential for job creation.

Claims about the positive long-term effects of the tax cuts on the economy are sharply at odds, however, with a growing array of studies from such respected institutions and analysts as the Joint Committee on Taxation, and the Congressional Budget Office, the International Monetary Fund, Brookings Institution economists, Federal Reserve economists, and the business-based Committee for Economic Development. Taken together, these various studies indicate that the tax cuts enacted since 2001 are likely to have only small effects on economic growth over the next ten years and are more likely to *slow* economic growth over the long term than to enhance it. These analyses take into account the effects of the tax cuts on the entire economy, including the small-business sector.

The Tax Cuts Could Ultimately Make Middle-Income Small-Business Owners Worse Off

Estimates of the impact of the tax cuts on households with small-business income generally reflect only the "benefit" side of the equation. But unless the estimated impacts of the types of measures that ultimately will have to be taken to cover the costs of the tax cuts also are taken into account, an assessment of the effects of the tax cuts on households with small-business income (or any other households, for that matter) will be incomplete — and will not be accurate.

To date, the tax cuts have not been paid for; they have been financed by increased borrowing, reflected in the nation's higher deficits and growing debt. Although some may try to claim that repayment can be postponed indefinitely, this is not the case. Given the nation's large underlying long-term fiscal imbalance (even without the tax cuts), indefinite postponement of measures to defray the cost of the tax cuts is not possible. Eventually, these and other tax cuts (as well as program expansions) will have to be paid for to avert fiscal crisis. Borrowing postpones, but does not eliminate, the need to pay for these tax cuts. Paying for the tax cuts ultimately will require reductions in federal programs, increases in federal taxes, or some combination of the two.

The precise mix of program cuts and tax increases that ultimately will be adopted to offset the costs of the tax cuts is not known, but the Tax Policy Center has examined two possible scenarios. Under one scenario, each household would pay the same dollar amount to finance the tax cuts.* This type of effect could occur if the tax cuts ultimately are paid for largely or entirely through cuts in federal programs. Under the other scenario, each household would pay the same percentage of its income to offset the costs of the tax cuts. That type of effect could result if the tax cuts ultimately are paid for by a combination of program cuts and progressive tax increases. Taking into account the cost of paying for the tax cuts, the Tax Policy Center found that the majority of small-business owners *would not benefit from the tax cuts* and would end up losing more than they gain under either scenario.

- If each household paid the same dollar amount to offset the costs of the tax cuts, 58 percent of households with small-business income would lose more than they gain from the tax cuts when the tax cuts are phased in fully.
- If each household paid the same percentage of income to finance the tax cuts, 70 percent of these households would lose more than they gain.

Under either scenario, most households with small-business income would end up paying more through benefit reductions or tax increases than they receive in tax cuts. This result — that the majority of households with small-business income would be net losers — reflects the fact that the bulk of the tax cuts are going to households with high incomes and that most households with small-business income are not in this high-income group. Unless the measures ultimately adopted to cover the costs of the tax cuts are aimed at high-income households to the same disproportionate degree that the tax cuts benefit these households, the net effects for the majority of small-business households will be negative.

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*See William Gale, Peter Orszag, and Isaac Shapiro, "The Ultimate Burden of the Tax Cuts: Once the Tax Cuts are Paid For, Low- and Middle-Income Households Likely to Be Net Losers, On Average," Center on Budget and Policy Priorities and Tax Policy Center, June 2, 2004.

In particular, studies by CBO and the Joint Committee on Taxation, both directed by Republican appointees, have concluded that the effects of the tax cuts on economic growth over the next ten years will likely be small and are as likely to be negative as positive. For instance, in its analysis of the tax cuts enacted since 2001, CBO concluded that they "…will probably have a net negative effect on saving, investment, and capital accumulation over the next 10 years….The tax laws' net effect on potential output is uncertain during the first five years of the 2004-2013 projection period but will probably be negative in the second five years."[5]

Furthermore, if the tax cuts are made permanent, they may do harm over the long term. The federal government is on an unsustainable fiscal course, with hefty deficits extending as far as the eye can see. Making the tax cuts permanent would further enlarge these deficits. In a comprehensive new study of the effects of budget deficits on the economy, Brookings Institution economists William Gale and Peter Orszag find that persistent large deficits reduce national saving and impede economic growth. Due to the effects of the tax cuts enacted in recent years in swelling long-term deficits, Gale and Orszag conclude that "...making the 2001 and 2003 tax cuts permanent would raise the cost of capital for new investment, and reduce long-term investment and economic growth."[6] These adverse long-term economic effects, such as an increase in the cost of new investment, would apply to small and large businesses alike.

Conclusion

Small business typically evokes positive images in the public mind, and the Administration has frequently sought to associate its tax cuts with the small-business sector. Yet the benefits that the Administration claims will flow to small businesses as a result of its tax cuts generally, and of the reduction in the top income-tax rate and repeal of the estate tax in particular, are greatly exaggerated. Few small businesses will see any benefit from the reduction in the top rate or estate-tax repeal. Only business owners with high incomes or large accumulations of wealth will benefit from these costly tax changes.

Studies by CBO, the Tax Policy Center, and others have shown that the benefits of the tax cuts enacted since 2001 will accrue disproportionately to those with the highest incomes. This turns out to be the case for households with small-business income, as well. The majority of the tax cuts going to households with small-business income are accruing to the eight percent of such households that have incomes exceeding $200,000. By contrast, only 16 percent of the tax cuts for households with small-business income are going to the 62 percent of such households with incomes below $75,000.

Finally, although the Administration often associates its tax cuts with small businesses and uses that association to support its assertion that the tax cuts will spur major economic and job growth, studies by Joint Committee on Taxation and CBO find that the tax cuts can be expected to have only small effects on the economy over the next ten years. Further, studies by economists at the Brookings Institution and other institutions also conclude that if the tax cuts are made permanent, the economic effects may be negative over the long run, as the high cost of the tax cuts swells the already-unsustainable deficits that the nation faces.

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[5] CBO, *The Economic Outlook*, August 2003. In a newer study, CBO examined the potential effects of the President's 2005 budget proposals, which include making most of the 2001 and 2003 tax cuts permanent, and concluded that they would have an ambiguous effect in the short run and probably lead to slight economic gains from 2010-2014. Claims of large economic gains, however, are not borne out by the study.

[6] William G. Gale and Peter R. Orszag, "Budget Deficits, National Saving, and Interest Rates," prepared for the Brookings Panel on Economic Activity, September 2004.