



JOINT ECONOMIC COMMITTEE

Senator Sam Brownback, Ranking Republican Member

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A New Small Business Surtax = New Small Business Job Killer

Larry Summers, director of the White House National Economic Council, recently opined: “I don’t think the worst is over... It’s very likely that more jobs will be lost. It would not be surprising if GDP has not yet reached its low.”ⁱ This is cause for concern at a time when unemployment, at 9.5%, stands at its highest level in 26 years. An additional 2.6 million American workers have lost their jobs since President Obama took the oath of office. More jobs were lost in June than in May. Against this backdrop, congressional Democrats want to increase taxes on the engines of job growth and innovation for our economy – small businesses.

Small businesses—defined as having 500 employees or less—employ over half of U.S. workers, and their role in the labor market is on the rise. Since 1992, small businesses have been responsible for between 74% and 81% of gross job gains, and 63% of the net new jobs created. Remarkably, in the current and most recent recessions, small businesses have been responsible for 79% of the job gains compared to 75% of the job losses. Small businesses’ share of job gains have been higher and their share of job losses have been lower than in non-recessionary quarters.ⁱⁱ With small businesses leading the way in job preservation and creation during recent recessions, policy makers should exercise a higher degree of caution when pursuing policies that will disproportionately and negatively impact small businesses

Under the Democrats’ proposal, many of the most successful small businesses would be hit by a series of job-killing tax hikes:

- Raising the brackets from 33% and 35% to statutory marginal rates of 36% and 39.6%;
- Bringing back the “hidden tax increases” of PEP (the Personal Exemption Phaseout) and Pease (the limitation on itemized deductions) which raise the effective marginal rates in the top two brackets to 41% for a family of four. Note that PEP causes families with more children to face higher effective tax rates. For example, a family with four children and \$255,000 in income would face a marginal tax rate of 43.4% while the same family with \$400,000 in income would face a marginal rate of 40.8%. This is known as a regressive income tax;
- Creating a graduated surtax of 2%, 3% or 5.4% on those earning \$280,000 or more (\$350,000 for families) to partially pay for the government takeover of health care.ⁱⁱⁱ This would raise the marginal tax rate for a family of four in the top two brackets to a range from 43.3% to 46.2%.^{iv}
- Additionally, income distributed as wages to a small business owner would be subject to an extra 2.9% Medicare tax.

All combined, small businesses could be subject to marginal tax rates as high as 49%. This would not include an average 7% in state and local taxes. It would also not include the Democrats’ wage tax of up to 8% on businesses that do not offer health insurance or do not pay for “enough” of their employees’ coverage or the Democrats’ 2.5% income tax on individuals who have not purchased

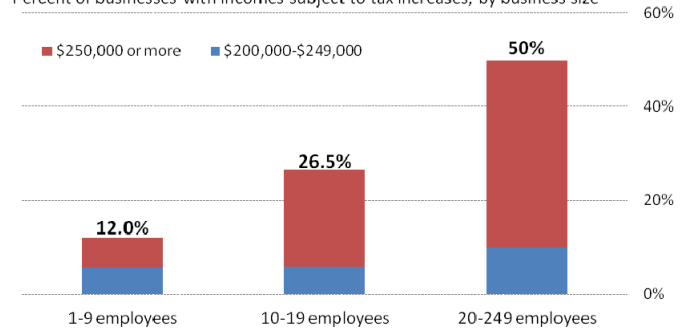
health insurance. Furthermore, the Democrats' plan to limit itemized deductions for taxpayers in tax-brackets above 35% would act as an additional tax on small businesses.

Empirical research shows that higher individual tax rates discourage both the demand for new workers and the total amount of a firm's wages.^v Raising the income tax burden on the top two individual tax brackets (those making over \$171,550 (single) or \$208,850 (married) in 2009) will have a negative effect on small business job growth and job retention because many small businesses, in order to avoid the taxation of income at both the corporate level and at the individual level, choose to pay taxes on business revenue through the individual income tax system.^{vi} These businesses, referred to as flow-through entities, include partnerships, S corporations, and sole proprietorships.

According to a 2007 U.S. Treasury paper on Business Taxation and Global Competitiveness, flow-through small businesses account for 93% of all businesses, and their income is concentrated in the top tax brackets.^{vii} Data from the Joint Committee on Taxation shows that at least 55% of the revenue raised by increasing the top two rates would come from small business income.

A 2007 Gallup poll for the National Federation of Independent Business (NFIB) shows that the Democrats' tax increases will raise taxes on half of all small businesses with 20-249 employees.^{viii} The percentage of small business owners hit by the Democrats' higher taxes increases as the number of employees increases. Businesses with more employees tend to have higher incomes. Although the study did not survey businesses with 250-499 employees, it is a fair assumption that more than 50% of small businesses that employ 250-499 would be subject to the Democrats' proposed tax increases.

Small Businesses with Tax Increases Under the Democrats' Proposal
Percent of businesses with incomes subject to tax increases, by business size



Source: National Federation of Independent Businesses: National Small Business Poll, 2007

At a time when creating jobs should be a priority, it is important to minimize harm to small businesses. According to the Small Business Association, one-third of new employer establishments fail within two years, and a major factor in a firm's survivability is their ability to grow large enough to hire employees.^{ix} The Democrats' proposed tax increases will make it more costly for small businesses to hire employees. The Congress should look at policies which promote job growth, rather than penalize small business employers.

ⁱ Chrystia Freeland, *Lunch with the FT: Larry Summers*, <http://www.ft.com/cms/s/2/6ac06592-6ce0-11de-af56-00144feabdc0.html> (July 10 2009).

ⁱⁱ Joint Economic Committee Republican Staff calculations utilizing the BLS Business Employment Dynamics data series. Available data range from 3rd quarter 1992 through the 3rd quarter 2008.

ⁱⁱⁱ The 2% and 3% surtax will start in 2011 at 1% and 1.5%, respectively, but will go up to 2% and 3%, respectively, unless OMB determines in 2012 that health care savings of greater than \$675 billion will be achieved by the end of 2019. Senate Committee on Finance Republican Staff. *Questions and Answers on the Effect of the Tax Increases on Small Business Proposed by President Obama and House Democrats*. (July 2009).

^{iv} Under the Democrats' proposals, effective marginal income tax rates can be expressed as follows: for upper-middle class earners: $36\% + (n \times 1.05\%) + 1.08\% + 2\%$, where n equals the number of exemptions (i.e., husband, wife, and children), and for the highest income earners: $(39.6\% + 1.19\% + 5.4\%) = 46.19\%$.

^v Robert Carroll, Douglas Holtz-Eakin, Mark Rider, Harvey Rosen, *Income Taxes and Entrepreneurs' Use of Labor*, NBER Working Paper No. W6578. <http://ssrn.com/abstract=160693> (May 1998).

^{vi} Non-flow-through small businesses ("C" corporations) are taxed like conventional corporations. According to the Joint Committee on Taxation publication, *Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity*, only 6.3% of businesses filed as C-corporations and the rest were flow-throughs. <http://www.jct.gov/publications.html?func=startdown&id=1291> (June 4, 2005).

^{vii} US Department of the Treasury, *Treasury Conference on Business Taxation and Global Competitiveness, Background Paper*. <http://ustreas.gov/press/releases/reports/07230%20r.pdf> (July 23, 2007).

^{viii} Dennis Jr., William J. *Finance Questions, Volume 7, Issue 7*. <http://www.411sbfacts.com/files/Financial%20Questions.pdf> (2007).

^{ix} The SBA Office of Advocacy: <http://web.sba.gov/faqs/faqIndexAll.cfm?areaid=24>