An Analysis of President Bush's Tax Proposals and the Alternative of Payroll Tax Relief

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Authors' Note: February 16, 2004: Martin & Wall, P.C. is a CPA firm located in Washington, D.C. and Chicago, IL. Since our original article, radical tax reform has been passed, the cornerstone being the dividend tax cut. In our opinion, payroll tax relief is the main obstacle to business growth and tax fairness. While the tax code has been altered, in this original writing we do set forth an academic and practical argument for permanent cuts in the payroll tax as a key toward job creation and tax fairness. We are highly disappointed that all of the Presidential candidates have displayed a shocking lack of understanding and thoughtful debate on tax reform. Accordingly, we encourage all readers to carefully consider the payroll tax reduction plan we advocate and contact their elected officials if they believe, as we do, that it will help our country.

Authors' Note: January 10, 2003: Many of our clients are small business owners and individual & married taxpayers and gay & lesbian domestic partnerships. Hence our concern about the new tax "relief" proposals being promoted by President Bush. Politicians like to pay "lip" service to small business owners, lower and middle income taxpayers and typically ignore gay & lesbian couples altogether. In the coming months, as the debate heats up on tax policy, you will undoubtedly hear competing claims of fact by countless numbers of economists and policy wonks, let alone politicians whose lack of understanding of the challenges facing ordinary Americans is not only appalling, but dangerous. Contrary to President Bush's elementary proclamations of economic theories in his January 7, 2002 speech, predicting the economic behavior of investors, consumers, entrepreneurs, and corporate managers can never be done with a high level of confidence. Apparently, his top economic advisors were not very good at this either, which lead to their replacement. We do not have PhD's in economics and we have never been asked to testify before Congress or appear on CNN. What we offer is the perspective of people with a wealth of personal experience building our own business and working with over a 1,000 clients in a similar situation. We have prepared this analysis of current tax proposals in order to educate our clients and encourage informed participation in the political process. The level of analysis provided is intended to be a high-level policy analysis and should not be construed as specific advice on tax or investment strategies. We conclude this article with our own ideas for real tax reform that is simple and has the highest impact on job creation.

Synopsis of Bush Plan

In thirty minutes that changed America, President Bush, in a speech to the Economic Club of Chicago on January 7, 2003, outlined his proposal for tax "reform" in order to provide "necessary" tax incentives for businesses to produce jobs and for individual Americans to reap immediate benefits. The "Ten Commandments" of the core of his proposal are:

1. Eliminate individual income taxes on corporate dividends paid to individuals.

2. Accelerate the tax rate reductions, enacted under the 2002 Tax Act, which were scheduled for implementation between 2002-2009.

3. Accelerate the "relief" for the "marriage penalty."

4. Extend unemployment benefits.

5. Immediately make permanent the elimination of the "death tax" (estate tax).
6. Immediately increase the tax credit for dependent children from $600 to $1,000.

7. Reorganize the lower tax brackets (10% & 15%) to include more taxpayers.

8. Increase the ability of businesses to deduct capital expenditures immediately from the current $25,000 per year to $75,000 per year.

9. The creation of "Personal Re-employment Accounts" (PRA) to be funded up to $3,000 per eligible unemployed citizen to help pay for some of their job search related expenses during their period of unemployment.

10. Reduction in corporate Alternative Minimum Taxes (AMT).

Analysis of Bush Proposals

Overall Rationale

The overall rationale for the Bush plan was posted on the Treasury Department's website on January 7: "Today, President Bush is going to announce a legislative package that will encourage consumer spending that will 1) continue to boost the economic recovery, 2) promote investment by individuals and businesses that will lead to economic growth and job creation and 3) deliver critical help to unemployed citizens."

We think the Bush tax proposals are similar to a diet pill – unsubstantiated, grandiose promises and claims with unintended consequences. Essentially, the Bush Administration has taken the traditional Keynesian argument – federal government spending during recessions on labor-intensive public goods like infrastructure, education, and health care helps "kick start" the economic cycle of hiring, consumer spending, increased production, more hiring, etc. – and twisted it to meet the financial interests of his campaign contributors, executives of publicly-traded companies and the wealthiest Americans, who are essentially one in the same. Bush's variation on Keynes is that cutting taxes puts more money in people's pockets, despite where we are in the business cycle, will lead to increased consumer spending, increased production, more hiring, etc.

How ironic that Bush chooses the Economic Club of Chicago as a place to announce such a policy, when the father of the so-called Chicago School of economics, Nobel Prize laureate Milton Friedman, passionately argued that artificially spiking up consumer demand would lead to inflation, not growth, as dollars chased after goods. How ironic also, that it was President Bush's father, in his 1980 debates with Ronald Reagan, who warned the public that economic recovery programs based solely on tax cuts were "voodoo economics." Hmmm.

Accordingly, we are suspect of economic policies that claim to add value to our economy by fiddling with the tax code, instead of relying on market forces to allocate resources, or using debt to pump up consumer spending (interest on the national debt was $332.5 billion in FY 2002, which is more than double the federal deficit and about a third of all individual taxes collected).

Below is a more detailed analysis of each of Bush's 10 tax proposals.

No Taxes on Corporate Dividends

The President is proposing that income from dividends paid by a corporation to an individual be exempt from taxation. Note that corporations are not allowed to deduct dividends as an expense against net income before paying corporate income tax, and the Bush proposal will not change this. Advocates of eliminating the tax on dividends believe this will provide a one-time boost to stock prices (making stock investments more attractive due to a reduction in dividend taxes), as well as encourage corporations to pay a portion of their cash reserves retained for investment to individuals, which could stimulate the economy by increasing consumer spending. Opponents of elimination the tax on dividends believe this will do little to spur new investments in new products and services, plant and equipment, education and training, and other economic activities that boost productivity and reduce costs, and will simply by a "give-away to the rich."

What is unclear is whether the tax exemption for dividends will apply only to dividends paid by a publicly-traded corporations, or whether this proposal will also include small businesses (closely-held, family-owned and owner-operator corporations). It is our belief that since the President's overriding goal seems to be increasing investments in the stock market, not private companies, the details of the proposals would <u>exclude</u> dividends paid by small businesses to their owners.

Although the non-taxation of dividends on the surface seems like a smashingly good idea, it has limits on its effectiveness and desirability. During his the President stated that fifty percent of Americans own dividend paying stock. However, most Americans probably own this stock through their retirement plans which would not subject the holder to any taxes immediately anyway.

We believe that some **limits** must be placed in order to ensure fairness and tax equity. While it is a laudable goal to not tax income in order to help certain classes of people who may need it (i.e., senior citizens living on fixed incomes), a "cap" on the non-taxable portion of the dividends must be enacted. Perhaps allowing a limit of $5,000 for individuals and $10,000 for married couples filing jointly should be permitted. This will allow for some tax relief for the middle class while not unduly benefiting the wealthiest one percent who apparently will receive 64% of the benefit if this dividend tax exclusion gets implemented without a "cap."

The non-taxation of dividends, without the caps we suggest, is a total "give away" for the wealthy and of extremely limited value for the not-so-wealthy. The table below shows the distribution of benefits by income group from eliminating taxes on dividends. The Average Tax Change ($) column is the most interesting to those concerned about tax fairness.

Exempt Dividends from Individual Income Taxation:
Distribution of Income Tax Change by AGI Class, 2003[1]

AGI Class (thousands of 2001 dollars)[2]	Returns		Returns with Dividends		Percent Change in After-Tax Income[3]	Percent of Total Income Tax Change	Average Tax Change ($)	Average Income Tax Rate[4]	
	Number (thousands)	Percent of Total	Number (thousands)	Percent of Total				Current Law	Proposal
Less than 10	25,755	19.2	3,063	10.2	0.1	0.4	-6	-6.7	-6.9
10-20	23,602	17.6	2,633	8.8	0.1	1.0	-18	-3.0	-3.1
20-30	18,644	13.9	2,519	8.4	0.2	1.7	-39	3.8	3.6
30-40	13,534	10.1	2,223	7.4	0.2	2.1	-65	7.0	6.9
40-50	10,307	7.7	2,227	7.4	0.3	3.3	-135	9.0	8.7
50-75	17,874	13.4	5,142	17.2	0.4	8.9	-208	10.3	9.9
75-100	10,224	7.6	3,936	13.1	0.4	8.2	-336	12.3	11.9
100-200	9,906	7.4	5,480	18.3	0.8	20.9	-885	16.0	15.4
200-500	2,395	1.8	1,852	6.2	1.5	19.8	-3,463	23.0	21.9
500-1,000	418	0.3	366	1.2	1.8	9.3	-9,372	27.7	26.4
More than 1,000	226	0.2	210	0.7	2.0	24.3	-45,098	28.8	27.4
All	133,835	100.0	29,933	100.0	0.7	100.0	-313	13.9	13.3

Source: Urban-Brookings Tax Policy Center Microsimulation Model.
(1) Calendar year. Does not adjust for the amount of mutual fund distributions that are interest payments but are reported as dividends on tax returns.
(2) Returns with negative AGI are excluded from the lowest income class but are included in the totals.
(3) After-tax income is AGI, plus any untaxed portion of dividends, less individual income tax net of refundable credits.
(4) Average income tax, net of refundable credits, as a percentage of average AGI plus any untaxed portion of dividends.

For several reasons, the official revenue estimates are likely to deviate significantly from these tabulations based on IRS data.
See "Interpreting Dividend Relief Estimates" (http://www.taxpolicycenter.org/commentary/dividend/double_tax.pdf)

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President Bush has presented the elimination of taxes on dividends paid to individuals as a way to end the so-called double taxation of corporate profits. The argument being that if income is taxed at the corporate level, then why should it be taxed a second time when the individual receives a dividend? The same argument could be made with regard to capital gains.

The reality of the situation is that we live in a world with a very complex legal and financial system. Most multinational businesses choose the corporate form over limited partnerships or other legal forms that allow for passive investor participation because there are clear tax advantages to doing so that make the effective tax rate for corporations fairly low compared to individuals. For example, in fiscal year 2002 (12 months ended September 30, 2002), individual income taxes accounted for 49 percent of federal receipts, compared to 10 percent for corporate income taxes (source: OMB, President's FY 2003 Federal Budget). The remainder is largely Social Security. If you allocate the Social Security burden evenly between individuals and corporations (which does not account for the self-employed paying double FICA), individuals pay for about 69 percent of the federal budget, compared to 29 percent for corporations.

More important than tax fairness, we believe the non-taxation of dividends may be harmful to job creation and innovation by providing tax-driven incentives to shift investments from "growth" companies that innovate for the future and reward investors with capital gains to "income producing" companies that earn a steady stream of profits from existing lines of business and pay a portion of the profits to investors each year in the form of dividends thereby, potentially, not investing in additional employees and lines of business.

Advocates of eliminating the tax on dividends theorize that this will provide an incentive for individuals to invest in companies that pay dividends. Typically, these "income producing" companies are well-established industrial companies and utilities. In contrast, "growth" companies organized to invent and bring to market tomorrow's technologies typically reinvest their profits in research and development instead of paying dividends. The fact that Microsoft does not pay a dividend and has some $40 billion in cash is often cited as an example of this economic phenomenon. If Microsoft were to paid out its retained earnings to investors as a dividend instead of retaining it for R&D, the argument for job creation would have to measure the potential "stimulative" (or inflationary) effects of flowing dollars today into consumer spending, versus Microsoft hiring more engineers and investing in better products, services and technologies for tomorrow. In general, we believe encouraging investment that leads to new products, services, and technologies is more advantageous to the economy in the long-term than temporary, tax-driven boosts to spending or stock prices in the short term.

Further antagonizing the inhibition of "growth" companies will be a substantially reduced amount of investments made by individuals. Taxpayers will be confronted with a choice to invest in a "growth" company (which does not typically pay dividends but rather "reinvests" in the company to grow it further) versus an "income" company. A "growth" company anticipates capital appreciation in the form of a rise in the stock price. Likewise, the "capital gain" would be taxed at the prevailing capital gains rate, in contrast to dividends that will be tax free. The potential for reducing investment in "growth" companies by providing a tax preference for dividend-paying companies could undermine the expansion of the economy since these types of corporations will be compelled to pay dividends to stay competitive with their "income" corporate counterparts.

Acceleration of Tax Rate Reductions

As widely discussed under the 2002 Tax Act, the marginal tax rates (tax brackets) for all taxpayers are scheduled to be adjusted downward over the next few years. President Bush is proposing to "accelerate" these changes to be effective immediately in 2003. Although there is some tax relief for the lower and middle income brackets, again, the upper income brackets will benefit more since it is a <u>percentage</u> reduction rather than an <u>absolute</u> dollar reduction (1% of 50,000 is $500 whereas 1% of $5,000,000 is $50,000). The natural counter argument to this is that the wealthy pay more taxes to begin with and, therefore, deserve a larger "break." Although there is some logic to this argument, the wealthy are benefiting enough from other tax relief options being proposed.

Clearly, we agree that lower taxes in general are a good thing, *however*, it is the lower and middle income brackets that needs to benefit from it more greatly. One only needs to look at what the tax savings would be spent on to see the validity of the above statement. The lower and middle income groups would tend to buy consumer goods not the least of which might be heavy consumer durables (which would spur economic activity for certain). The wealthy are more inclined to use their tax savings bounty on more investments that no doubt pay dividends, thus not providing the economic stimulus expected and exaggerating an already expanding national debt.

By "accelerating" the rate reductions in the <u>lower brackets only</u> while maintaining the higher tax brackets and percentages where they currently are, the benefits would be more equally shared since an <u>absolute dollar limit on the tax savings</u> regardless of income would be realized.

Marriage Penalty Relief

The "marriage penalty" is a term used to reference current tax code provisions that result in circumstances where married couples will pay more taxes "married filed jointly" than if they were unmarried and each filing as "single." We agree that any "marriage penalty" should be eliminated. However, under the current Bush proposal, there could, in fact, be a "marriage bonus" that would be extremely unfair to unmarried domestic partners (including gay and lesbian couples who are legally prohibited from getting married).

Under the Bush proposal a "marriage bonus" would be created if there were a substantial gap in the earnings of each spouse, resulting in a lower tax rate than if the higher-income-earning spouse were single. This "marriage bonus" is a result of increasing the dollar amount of earnings subject to lower tax rates, despite the fact that the second spouse earns little or no income. We believe that in order for a married couple to be allowed to reap the benefit of this legislation, both spouses need to have income.

We believe there is a better approach to correcting the "marriage penalty" without creating a "marriage bonus." Since the tax reforms proposed use as a basis the tax brackets for individuals, we propose the same logic be used for a married couple. For example, if one spouse earns $50,000 and the other spouse earns $5,000, we would propose that the 15% tax bracket be expanded over the single taxpayer bracket by the amount of the lower partner's earned income.

Using 2002 tax law, the end of the 15% bracket for single filers is $27,950. As we understand the proposal to eliminate the “marriage penalty” this bracket limit for married filing jointly would be double the amount for single filers or $55,900 in our example. Under our proposal, the married couple above would enjoy the 15% tax bracket up to $32,950 (which is $27,950 for the single filer plus the $5,000 spousal income).

Of course, critics of this approach will be quick to point out that this idea could actually increase the amount of tax a married couple would pay based upon current law. As the law now stands, a married couple, filing jointly, is now in the 15% bracket until their joint income exceeds $46,700. However, if we are truly trying to obtain tax equity for all classes of taxpayers, then our proposal makes sense. Why should married filing jointly enjoy benefits that other filing statuses do not have? Of course, it may be that the government is trying to influence family planning through tax policy, but doing so disenfranchises those who cannot marry legally.

The obvious compromise position is to not alter the current law (nobody ever wants to see a current tax benefit disappear), but only to allow the 15% bracket to be increased to double that of the single bracket if the joint taxable income (as contributed by each spouse) exceeds the current bracket threshold. The personal exemption, for each, would still be allowed in full.

We all want tax equity and the law as written does not even begin to address the other filing statuses which would be beyond the scope of this discussion. Sufficient to say that much work needs to be done in this area.

Extend Unemployment Benefits

The President’s proposal includes extending the period in which unemployment benefits will be paid. This proposal helps the lower and middle income earners as it provides additional income that otherwise would not be available. Since the vast majority of unemployment benefits funding occurs at the state level, it needs to be made clear how these additional benefits will be financed, or this will simply be an “unfunded mandate” resulting in higher state and local taxes.

Elimination of the “Death Tax”

President Bush’s proposal is to eliminate all estate taxes. Currently, the law allows for a healthy exemption of $1,120,000 in estate value before any taxation occurs. Although we agree that there are problems with the current estate tax laws, we do not favor the complete elimination of any tax on the wealth transfer between generations. This new proposal when combined with the dividend tax exemption discussed at length above, truly illustrates that the wealthiest of Americans are the principal beneficiaries of the new proposed tax law changes with the lower and middle income Americans receiving mere “table scraps” around the edges of the new proposal.

We believe a better approach to reforming the estate tax would be raising the exemption amount to about $10,000,000 and lowering the estate tax rates to about 15 percent. This would balance out some of the concerns on both sides of this issue. To our knowledge, no consideration of altering the exemption limits and or the tax rates has been considered. It seems as if it is an "all or nothing" issue with the President.

Raising Tax Credit for Dependent Children

Currently, the tax law allows a tax credit of $600 per child (subject to income restrictions and "phase outs"). President Bush is proposing that the scheduled increase in this credit over the next few years be accelerated to immediately allow for a $1,000 tax credit per child.

Since the credits are "phased out" above $110,000 of adjusted gross income (AGI), this proposed tax law change will primarily benefit lower and middle income Americans, but is a mere "table scrap" by comparison to the elimination of the estate tax and the non-taxation of dividends.

It strikes us as strange that Republican advocates of smaller government with a limited role in the lives of citizens would promote a tax policy where the federal government pays families to simply have children, as opposed to the adoption credit which encourages families to take-in needy children. We question the wisdom of taxing workers without children at higher rates than those with children. If the goal is to promote the welfare of children, fully funding Head Start or eliminating payroll taxes on anyone under 18 years old to reduce teenage unemployment rates, would be far more effective approaches. Perhaps the compromise position could be that there is a "cap" of two children eligible for the credit in any one household.

Reorganize The Lower Tax Brackets

Currently, the tax law is that the first $6,000 of income is taxed at 10% (versus 15%). At the time of this writing it is unclear how the lower bracket(s) would be "reorganized" but the most obvious answer is that the $6,000 bracket threshold would be increased. For example, if it were to be increased to $10,000, the taxpayer(s) would enjoy a tax reduction of $200 (10% versus 15% rate on $4,000).

Although certainly a step in the right direction, it is another example of a "table scrap" being thrown to the lower class. The tax law, as proposed, does nothing to stop the stranglehold of the Social Security and Medicare taxes being levied at a rate of 7.65% from the first dollar of earnings (see additional discussion below). It is quite possible for a low income earning American to pay more in Social Security and Medicare taxes then in federal income taxes. The real "relief" needs to be addressed in the levying of these payroll taxes.

Increase in Deduction of Capital Expenditures for Businesses

Currently, the law allows a business to deduct in the current year up to $25,000 in capital expenditures immediately. The new law, as proposed, would allow a business to deduct up to $75,000 in capital expenditures immediately.

Years ago, President Reagan pioneered the concept of accelerated depreciation for business capital expenditures, including real estate. The theory the Reagan administration espoused was that accelerated depreciation would encourage businesses to reinvest into heavy durables (furniture, equipment etc) faster thereby increasing economic activity due to all the tax incentive purchases. It is up to the reader to determine if the Reagan administration was successful in that goal. We believe it was not. The catastrophic deficits of the 1980s, in our opinion, were caused in large part by the government's financing, via tax deductions, of these corporate expenditures at such excessive levels that market discipline as to what is and is not a profitable investment was compromised, leading to spending driven by tax benefits, not economic realities.

The impact on the tax savings for the lower and middle income brackets is non-existent. Most small businesses do not spend anywhere near $25,000 in capital expenditures so the benefits, again, will vest with the wealthy corporations. We believe the law is generous as currently written and should not be changed, especially in an economy that is over 70% based on services, and large capital expenditures are required by a smaller and smaller segment of the economy.

Creation of the Personal Re-employment Accounts (PRAs)

Nothing like this currently exists under the tax law and this could be quite an interesting idea. The proposed tax law changes would "give" up to $3,000 to an unemployed person to enable them to look for a job by paying for job hunting related expenses. As discussed by the President in his speech, there would be great "flexibility" in how these funds could be spent by the unemployed person. Additionally, as an added incentive for the unemployed person to find a job, they would be allowed to keep the remaining amount of money in their PRA if they successfully procured employment in under thirteen weeks.

This would seem to us to be a good idea, but one in which the implementation and on-going monitoring would be difficult to achieve. The additional question of what entity would be funding this also comes into focus.

Since most wealthy taxpayers will be living off tax free dividends, low capital gains tax rates, and the complete elimination of the estate tax, this benefit would probably not be of much concern for them, but would help those out of work, in the lower and middle income brackets, greatly. It is not clear if this benefit will be subject to some form of income test (perhaps based upon prior year's earnings) and or subject to "phase outs." All in all, this is an intriguing proposal to help mitigate the misery of the recent two-year rise in unemployment and slow down in the economy.

Reduction in Corporate AMT

Most taxpayers do not even know what the Alternative Minimum Tax (AMT) is, let alone how it might affect them. The new tax law proposal does not address the growing problem of AMT on the individual (who receives tax breaks, only to have them taken back by AMT), but rather seeks to benefit large, publicly-traded corporations (most small corporations would not earn nearly enough money to be concerned about corporate AMT issues).

The AMT was developed with the concept in mind that nobody (corporation or individual) should be able to defeat the tax system through "loopholes" and otherwise large deductions. The AMT is an alternate calculation for taxes that does not consider most tax deductions, but rather concentrates on gross income (with a few deductions and exemptions allowed).

The reduction in corporate AMT will probably allow large, publicly-traded corporations to pay even less tax then they do now, which will favor the shareholders, who, no doubt, will receive larger dividends, which will not be taxed. Certainly, one can figure out who benefits under this proposal.

Summary of Bush Proposal's Impact on Tax Fairness

January 7, 2003 was a good day to be a wealthy Republican! This is the day that the Republicans formally gained control of both houses of Congress and effectively gave President Bush "carte blanche" to help his wealthy supporters. President Bush wasted no time to spend this newfound political capital to propose one of the most aggressive tax law changes to favor the wealthy class of taxpayers and disenfranchise those who are not-so-wealthy. According to the Department of Treasury and Labor, the "static deficit effect" (i.e. cost) of the Bush tax proposals is $102 billion in 2003, and $674 billion over 10 years. One could argue that he is being true to his ideology and rewarding his supporters. This is a day of reckoning for the richest 1% of our population!

The Democrats, for multiple reasons, lost the Presidency in 2000 and the Senate (therefore the Congress) in 2002. They lost, in part, due to a lack of a coordinated tax policy aimed at the majority of Americans. Their lack of message was truly lost in the background as the Republicans sold everyone on their version of tax reform (who does not want tax cuts??).

As briefly alluded to above, some of the changes proposed are good, most of the changes, however, favor the wealthy and distort the true facts of what is going on in the economy and the tax lives of people in the lower and middle income brackets. Since people define "wealthy" in different ways, below are two tables showing estimated impacts of the Bush proposals on individual taxpayers first by AGI, then by percentage.

PRELIMINARY ESTIMATES - Updated January 8, 2003

Administration Stimulus Proposal:

Distribution of Income Tax Change by AGI Class, 2010[1]

AGI Class (thousands of 2001 dollars)[2]	Returns: Number (thousands)	Returns: Percent of Total	Percent Change in After-Tax Income[3]	Percent of Total Income Tax Change	Average Tax Change ($)	Average Income Tax Rate[4]: Current Law	Average Income Tax Rate[4]: Proposal
Less than 10	28,558	19.4	0.1	0.4	-4	-8.0	-8.2
10-20	25,545	17.4	0.1	2.0	-28	-4.2	-4.4
20-30	19,338	13.1	0.2	3.4	-62	3.4	3.3
30-40	14,425	9.8	0.2	4.1	-100	7.1	6.9
40-50	10,975	7.5	0.3	4.6	-146	9.1	8.9
50-75	18,082	12.3	0.3	9.5	-185	10.8	10.7
75-100	11,364	7.7	0.2	7.3	-225	13.0	12.9
100-200	13,861	9.4	0.4	21.5	-545	16.9	16.8
200-500	3,157	2.1	0.7	18.0	-1,998	23.4	23.3
500-1,000	531	0.4	0.9	8.1	-5,373	25.5	25.4
More than 1,000	267	0.2	1.0	20.9	-27,468	26.5	26.4
All	147,114	100.0	0.4	100.0	-238	14.5	14.3

Source: Urban-Brookings Tax Policy Center Microsimulation Model.
(1) Calendar year. Table measures the impact of the elements of the stimulus proposal that differ from current law in 2010: the exclusion of 100 percent of dividend income from taxation; width of the 10-percent bracket. Does not include any potential behavioral response.
(2) Returns with negative AGI are excluded from the lowest income class but are included in the totals.
(3) After-tax income is AGI less individual income tax net of refundable credits.

PRELIMINARY ESTIMATES - Updated January 8, 2003

Administration Stimulus Proposal:

Distribution of Income Tax Change by Percentiles, 2010[1]

AGI Class[2]	Percent Change in After-Tax Income[3]	Percent of Total Income Tax Change	Average Tax Change ($)	Average Income Tax Rate[4]: Current Law	Average Income Tax Rate[4]: Proposal
Lowest Quintile	0.1	0.4	-4	-8.0	-8.1
Second Quintile	0.2	2.6	-31	-3.4	-3.6
Middle Quintile	0.2	6.8	-81	5.6	5.4
Fourth Quintile	0.3	14.1	-168	10.3	10.0
Next 10 Percent	0.3	10.3	-245	13.4	13.2
Next 5 Percent	0.3	9.6	-462	16.3	16.1
Next 4 Percent	0.6	21.4	-1,274	21.2	20.7
Top 1 Percent	0.9	34.8	-8,318	25.9	25.2
All	0.4	100.0	-238	14.5	14.1

Source: Urban-Brookings Tax Policy Center Microsimulation Model.
(1) Calendar year. Table measures the impact of the only elements of the stimulus proposal that differ from current law in 2010: the exclusion of 100 percent of dividend income from taxation, and the width of the 10-percent bracket. Does not include any potential behavioral response.
(2) Returns with negative AGI are excluded from the lowest quintile but are included in the totals. The income thresholds are (in 2001$): second quintile, $9,939; middle quintile, $21,746; fourth quintile, $39,512; next 10 percent, $74,656; next 5 percent, $109,944; next 4 percent, $150,560; and top 1 percent, $346,186.
(3) After-tax income is AGI less individual income tax net of refundable credits.
(4) Average income tax, net of refundable credits, as a percentage of average AGI.

Martin & Wall Plan: Permanent Cut in Payroll Taxes

Social Security and Medicare are valued social programs, but their financing has been done on the backs of lower and middle income earners. While trust funds exist in theory, all the money is commingled together in the U.S. Treasury. Social Security is essentially a defined benefit pension program, without a pension trust fund. Unfortunately, there is no such thing as a Social Security trust fund that is separately invested the way General Motors, for example, maintains a segregated pension trust. The unfortunate reality of what has happened over the past 20 years, starting with the Reagan administration, is that politicians claim to be cutting taxes by lowering marginal tax rates, but hit the working poor and middle class on the back-end with higher payroll taxes, which are never called tax increases; this is called protecting seniors (who have the highest voter turnout of any demographic group). In reality, whether seniors are paid out of general tax revenues or payroll tax receipts is irrelevant to the level of benefits.

We strongly believe that a permanent reduction in the FICA tax and reform of how the FICA tax is levied is a much better approach to tax reform than President Bush's proposals that allocate most of the tax benefits toward the wealthiest Americans. If done correctly, payroll tax reform could provide a real incentive for hiring new workers.

The most onerous tax, by far, is the payroll tax for Social Security and Medicare taxes (FICA). These taxes are imposed from the very first dollar of earnings at a rate of 7.65% (6.20% for Social Security and 1.45% for Medicare). In FY 2003, OMB estimates the federal government will collect $749.2 billion in FICA taxes, compared to $205.5 billion in corporate taxes and $1,006.4 billion in individual income taxes.

Because of the regressive manner in which the FICA tax is levied, it is quite possible that someone in the lower and middle-income brackets will pay more in FICA taxes than in regular federal income tax. For example, someone earning $30,000 (assuming 1 dependent but no itemized deductions) would pay $2,235 in FICA taxes and approximately $815 in federal taxes (after considering the child tax credit of $1,000). Clearly, it is obvious that the FICA tax is much more of a burden for people in lower and middle-income brackets than individual federal income taxes.

Interestingly, the Social Security portion (6.2%) of the FICA tax stops getting imposed once a taxpayer earns in excess of $84,900! So, while the lower and middle-income people struggle with this burdensome tax, the richest people in our country get a true tax rate reduction! This is a "double edged" problem to be sure. However, the FICA tax problem is easily corrected. Our plan for doing so is presented below.

With all the above benefits proposed for the wealthiest of taxpayers, it would seem reasonable to spread this FICA tax proportional to the wealth. The Urban-Brookings Tax Policy Center estimates the cost of eliminating the employee portion of the FICA tax on the first $10,000 of wages would cost approximately $101 billion in 2003. The tables below show the distribution of those payroll tax savings by AGI class (dollars and percentage).

$10,000 Exemption for Employee Portion of Payroll Taxes: Distribution of Tax Burden by Income Class, 2003[1]

AGI Class (thousands of 2001 dollars)[2]	Returns		Tax Change		Average Tax Change ($)	Percent Change in After-Tax Income[3]
	Number (thousands)	Percent of Total	Dollars (millions)	Percent of Total		
Less than 10	25,755	19.2	-8,610	8.5	-334	6.5
10-20	23,602	17.6	-15,248	15.1	-646	4.3
20-30	18,644	13.9	-13,105	13.0	-703	3.0
30-40	13,534	10.1	-10,663	10.5	-788	2.5
40-50	10,307	7.7	-8,872	8.8	-861	2.2
50-75	17,875	13.4	-17,936	17.7	-1,003	1.9
75-100	10,223	7.6	-11,769	11.6	-1,151	1.6
100-200	9,907	7.4	-11,102	11.0	-1,121	1.0
200-500	2,394	1.8	-2,727	2.7	-1,139	0.5
500-1,000	418	0.3	-474	0.5	-1,135	0.2
More than 1,000	226	0.2	-257	0.3	-1,137	0.1
All	133,835	100.0	-101,070	100.0	-755	1.8

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Calendar year. Applies to social security (OASDI) and medicare (HI) taxes on wages and self-employment income.
(2) Returns with negative AGI are excluded from the lowest income class but are included in the totals.
(3) After-tax income is AGI less (1) income tax net of refundable credits; (2) the employee portion of social security and medicare taxes; and (3) self-employment tax.

$10,000 Exemption for Employee Portion of Payroll Taxes: Distribution of Tax Change by Percentiles, 2003[1]

AGI Class[2]	Tax Change		Average Tax Change ($)	Percent Change in After-Tax Income[3]
	Dollars (millions)	Percent of Total		
Lowest Quintile	-8,654	8.6	-335	6.5
Second Quintile	-17,415	17.2	-651	4.2
Middle Quintile	-19,806	19.6	-740	2.8
Fourth Quintile	-24,720	24.5	-924	2.0
Next 10 Percent	-15,084	14.9	-1,127	1.6
Next 4 Percent	-6,073	6.0	-1,134	0.8
Top 1 Percent	-1,520	1.5	-1,135	0.2
All	-101,070	100.0	-755	1.8

Source: Urban-Brookings Tax Policy Center Microsimulation Model.
(1) Calendar year. Applies to social security (OASDI) and medicare (HI) taxes on wages and self-employment income.
(2) Returns with negative AGI are excluded from the lowest quintile but are included in the totals.
(3) After-tax income is AGI less (1) income tax net of refundable credits; (2) the employee portion of social security and medicare taxes; and (3) self-employment tax.

We propose an exemption of FICA taxes on the first $10,000 of earnings and a rate reduction from the current 7.65% to 3%. To make up for the difference in tax collections, the new rate would be applied on **all** wages (above $10,000) with <u>no "cap"</u> on earnings.

This would be true tax reform and would allow for the sharing, by **all** taxpayers, in benefits of the tax reform. If the wealthiest of taxpayers gain the aforementioned advantages (dividend tax exclusions etc) then our proposal would seem to establish some equitability. Furthermore, since the wealthy are eligible for Social Security benefits without any "means" testing, it also seems reasonable to shift the burden of paying for the FICA tax cut onto them.

To date, very few of our lawmakers have been interested in such a proposal (commonly being referred to as a "payroll tax holiday"). Of late, the Democrats have been discussing the idea of a one-year exemption on the employee-paid payroll taxes on the first $10,000 of wages (which is discussed above). Another supporter of this idea is Senator John McCain. But no one is seriously talking about the kind of permanent reductions in the payroll tax rate, and applying the reduction to both employee-paid and employer-paid portions that we are proposing.

The effects of our proposal to reduce FICA taxes on the working class by providing an exemption amount and a rate reduction would be a strong incentive for employers to increase hiring, especially teenagers who experience high unemployment rates in certain communities.

For many years, we have provided tax, financial, and business advice to hundreds of truly small businesses. Time and time again, we have seen how FICA taxes are a true impediment to job creation. Likewise, taxpayers like the one discussed above who earned $30,000 and paid $2,235 in FICA taxes under the current law would pay $600 under our proposal. The $1,635 revenue "shortfall" would be made up by someone who earned $139,400 or more (there would be no more "cap"). We believe in shifting this tax to those who can afford it rather then giving a 6.2% tax rate cut after a certain "cap" is reached in earnings.

Of equal concern is how small businesses (sole proprietors as referred to by President Bush) are taxed for FICA purposes. Since, as discussed above, an employer is required to "match" the FICA tax paid by their employees, it falls upon the self-employed person (the sole proprietor) to "match" their own FICA contributions. In other words, they are currently subjected to **DOUBLE** the FICA tax as a person employed by a business entity not owned by them. So, in our example of the person earning $30,000 per year (which incurred a $2,235 FICA tax under the current law) if that amount were earned as a self-employed person, the FICA tax would be **DOUBLE,** amounting to a whopping $4,470! While it is true the current tax law allows for an adjustment to gross income for the employer share of FICA paid, it is also true in many cases, that this deduction would be of no real value since the taxpayer in question would probably only be in the 15% tax bracket anyway.

In our tax example above, under current law, if the person was not self-employed, the total taxes to be paid would be $3,050 ($2,235 in FICA taxes and $815 in Federal income taxes). However, if the person had the entrepreneurial "itch" and earned $30,000 (net of business expenses) their total tax bill would be (allowing for the deduction of the "employer" share of FICA taxes) $5,950! The double taxation of FICA taxes on the self-employed is truly a disincentive to go into your own business! We could literally recall hundreds of conversations in our offices to self employed people who went almost into shock over their tax bills. True tax "relief" is needed desperately in this area of the tax code.

We propose that the "matching" contribution is also reduced to 3% on the self employed as well. Additionally, the same $10,000 exemption should exist for the self employed as proposed for the standard employee. President Bush stated over and over again that there would be tax breaks for small businesses. The only items that we are aware of that represent any form of tax cuts for businesses involve corporate AMT reduction and the raising of the capital expenditure deduction limit (section 179) from $25,000 to $75,000 neither of which truly help the small businesses like our plan. We call upon President Bush and his Republican dominated Congress to be honest with the American people about their claims to help small business. Nothing could be further from the truth! At the very least, we call upon the Democrats to propose legislation that truly supports all Americans instead of meekly going along with a President who is clearly serving only his constituency.

Under our proposed adjustments to the tax proposal made by President Bush, the effects on the economy would be much more substantial than the original proposed version as it would allow people a great deal more of disposable income in the lower and middle income brackets. The level of debt by the average individual would probably be reduced and the purchasing of heavy consumer durables, so important to the health of our economy, would probably dramatically increase. College savings would increase thereby giving us a more educated population in the future, which would lead to more wealth creation and more tax revenue.

By putting money into the hands of people who need it the most, the government and the President would be showing great concern and compassion. By producing <u>genuine</u> incentives to business to hire more employees by reducing the payroll tax, the government and the President would be showing great wisdom. Although there are some benefits for everyone under the new proposed plan, there remains a wide gap in how much the benefits will affect individual taxpayers. **ALL** taxpayers should be allowed to share equitably in any tax cuts, not just the top 1%!