

ISSUE BRIEF

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Obama's Small-Business Tax Proposals Will Not Create Jobs

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President Obama recently sent Congress a series of policies as part of his “Startup America Initiative.”¹ The goal of the program is to help startups and small businesses to create jobs.

The proposal includes four tax provisions that he also included in his budget. Some of these policies have their roots in sound principles, but they do not go nearly far enough to spur the robust job creation the economy needs. To fully remove the burden that taxes put on job creation, the President needs to pursue fundamental tax reform.

1. Capital Gains Tax Cut Too Limited. In 2010, President Obama signed into law a temporary elimination of the capital gains tax on new investment in small businesses. In his startup proposal, he

asks Congress to make this policy permanent.

President Obama's instinct to reduce the capital gains tax is right. A lower capital gains rate translates into a lower cost of new capital. A lower price means businesses will have access to more capital, and more capital in the economy leads to more jobs. Eliminating the capital gains tax on all investment, as proper fundamental tax reform would do, would have a tremendously positive impact on job creation.

By limiting this otherwise sensible policy to small businesses, President Obama therefore greatly limits the number of jobs it will help create. Small businesses are certainly important job creators, but so are bigger businesses. A job created by a bigger business is as valuable as one created by a small business. With 12.8 million Americans looking for work, this is no time to be choosy about the size of businesses creating jobs.

The President's focus on lowering the capital gains tax rate for small business illuminates a glaring contradiction. At the same time he advocates this policy, President Obama intends to raise the capital gains rate for all other forms of investment.

As part of the Patient Protection and Affordable Care Act (Obamacare), the President has already signed into law a 3.8 percent surtax on capital gains for taxpayers earning more than \$250,000 a year. In each of his budgets, including this year's, he has called for increasing the capital gains tax rate from the current 15 percent to 20 percent. And his “Buffett Rule” would set the effective rate on a large portion of capital gains at 30 percent—more than double what it is today. These policies would destroy far more jobs than a reduction of the capital gains tax for small-business investment would create.

The President's inclination to eliminate the capital gains tax for small-business investment is the right start, but he should expand that policy to *all* capital gains as part of a tax reform plan and drop his damaging agenda to raise the tax for all other forms of investment.

2. Recycled Hiring Tax Credit Still Won't Work. In 2010, Congress passed and President Obama signed into law a tax credit for businesses that added new workers. The President proposes to try this failed policy again. His latest iteration would be an income tax

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credit equal to 10 percent of new payroll added by small businesses in 2012. Congress should reject this remake of an old policy because, just like the original, it will fail to create long-lasting jobs.

The original credit did not work because businesses add new workers when those additional employees will increase profitability over the duration of their tenure. A temporary one-year credit does little to tip this basic calculation in favor of adding new positions, because most businesses expect to retain workers for longer than a year.

There are some industries, like retail, food, and hospitality, where workers typically stay in a position for less than a year. The hiring credit could entice businesses in these industries to add a marginal worker if the credit makes that extra worker profitable. But when the worker predictably moves on, the business will not fill the position, because doing so would no longer be profitable without the credit.

At best, reviving the credit would create a few temporary jobs. These are not the kinds of long-lasting jobs that are needed to lower the unemployment rate permanently to acceptable levels.

If Congress borrows more money or raises other taxes to finance the credit instead of cutting spending, it will take resources out of the private sector that are supporting jobs there now. In this likely scenario,

the number of jobs destroyed by the hiring credit would be greater than the number of temporary positions created, because the private market allocates those resources more efficiently than would the government-designed hiring credit.²

A further downside of the hiring credit is that Congress cannot effectively design it to differentiate between jobs that businesses already planned to add and temporary positions that they might add because of the credit. The credit would end up subsidizing businesses that already planned to add new payroll, because they would receive the credit for jobs they were going to add without the credit.

3. Increasing Deduction for Startup Costs Wrong Approach.

Under current law, startup businesses can deduct \$5,000 in their first year for expenses related to launching the business like business analysis, advertising, salaries and wages for employees they are training, travel for setting up the business, and payments for professional services. They can deduct the remaining portion of those expenses in future years. President Obama wants to double the initial deduction amount to \$10,000.

Reducing startup costs would help entrepreneurs get their ideas off the ground, but President Obama's policy will not reduce those costs enough to move the needle on job creation. It is the total cost of starting a business

that discourages entrepreneurs, not how fast they can deduct those costs once they get the business going.

The thicket of regulations that businesses must comply with before beginning operations causes those costs to mount rapidly.³ Policies designed to weed out unnecessary regulations would be a more effective way to lower startup costs.

4. Expensing Helps in the Long Term. Since the beginning of 2011, businesses of all sizes have been able to deduct 100 percent of the cost of investments from their taxable income immediately. This policy is known as expensing.

Expensing is the proper treatment of capital expenditures. The cumbersome depreciation system usually in place for capital purchases increases the cost of capital by raising its after-tax price. Expensing eliminates the tax-imposed price increase and returns the cost of capital to its market level.

The temporary expensing policy expires at the end of February with the payroll tax holiday. President Obama proposes to keep it in place through the end of the year. Congress should adopt this proposal and then work to make it permanent as part of fundamental tax reform. Expensing will not cause an immediate job boom, but it will set up the economy for stronger job creation.

Bold Reform Needed. President Obama's tax policies in his Startup America Initiative do nothing more

1. Press release, "On One-Year Anniversary of Startup America Initiative President Obama Sends Startup America Legislative Agenda to Congress," The White House, January 31, 2012, at <http://www.whitehouse.gov/the-press-office/2012/01/31/one-year-anniversary-startup-america-initiative-president-obama-sends-st> (February 14, 2012).

2. Curtis S. Dubay, "Hiring Tax Credit Will Not Create Long-Term Jobs," Heritage Foundation *WebMemo* No. 2791, February 3, 2010, at <http://www.heritage.org/research/reports/2010/02/hiring-tax-credit-will-not-create-long-term-jobs>.

3. Scott James, "Before Ice Cream Shop Can Open, City's Slow Churn," *The New York Times*, February 3, 2012, at http://www.nytimes.com/2012/02/03/business/smallbusiness/before-ice-cream-shop-can-open-citys-slow-churn.html?_r=4 (February 14, 2012).

than nibble around the edge of the serious burden that taxes put on job creation. Only fundamental tax reform that lowers marginal tax rates for all individuals and businesses, removes existing distortions and inequities, and eliminates taxes on saving and investment can completely lift that burden.

Such a bold reform requires leadership from the presidential level.

Tax reform will be more difficult to achieve than passing a small collection of ineffectual policies, but the reward for the economy will be an abundance of new jobs far above what the President could hope for from his small-business tax policies.

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