Statement of

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Tax Issues Related to Small Business Job Creation

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Chairman Baucus, Ranking Member Grassley, and members of the Committee:

Thank you for inviting me to testify today on tax issues related to small business job creation. I will limit my comments today to how recently proposed incentives for small business may help economic recovery. These incentives are only a small component of broader policies to accelerate recovery from the deep recession we have experienced in the past two years and reduce unemployment.

The criteria for assessing tax policies to promote economic recovery differ from those used to assess how policies might affect sustained economic performance and growth. With unemployment still around 10 percent of the labor force, the most important immediate need is to increase demand for goods and services in the U.S. economy. Over time, we need to reform the tax system so that it is fairer, simpler, and more conducive to economic growth. If more revenues are needed to close a long-term budget gap, we should look to tax policies that do not retard the saving and investment, including investment in human capital, needed to add to the nation's wealth and productive potential. But over the next year or two, we need instead to encourage personal and business spending so that we can bring unemployment down more rapidly. The challenge is how to provide more fiscal stimulus in the short run, while taking credible steps to persuade financial markets worldwide that we have the discipline to reduce our deficits once the economy has recovered.

For immediate job creation, the size of the overall fiscal stimulus matters more than its composition. And both small and large businesses will benefit from policies that increase demand for goods and services. But not all tax cuts have the same effects on the pace of recovery. Policies that provide tax cuts to those consumers and businesses most likely to spend them quickly will do the most to accelerate recovery.

I comment on three tax incentives in the president's fiscal year 2011 budget that are designed to help small businesses—the targeted jobs tax credit, the extension of increased limits on Section 179 expensing, and the eliminating of capital gains taxation on small business stock. The Tax Policy Center has recently posted a summary and assessment of these and other tax proposals in the president's budget.[1]

Targeted jobs tax credit

The president is proposing a new temporary jobs tax credit for companies that hire additional employees, expand hours, or increase wages in 2010. The credit proposal is described in a White House fact sheet, which estimates its cost at $33 billion. The proposal is not discussed in the budget documents, except for a reference to a line item called "allowances for jobs initiatives" that calls for incentives that will cost $12 billion in fiscal year 2010, another $33 billion in fiscal years 2011 and 2012, and $5 billion more in fiscal years 2013 and 2014.

[1] Tax Policy Center, "Tax Proposals in the 2011 Budget" at http://www.taxpolicycenter.org/taxtopics/2011_budget.cfm

The jobs credit is modeled in part on a temporary credit for increasing employment that was enacted during the first year of the Carter administration in 1977, with some modifications. The 1977 credit was in effect for two years as the economy was recovering from the 1974–75 recession and was then replaced by the Targeted Jobs Tax Credit, which was more narrowly focused on disadvantaged workers.

The new proposal would give employers a $5,000 tax credit against payroll taxes for net increases in employment in 2010 compared with 2009. Employers could also receive a credit of 6.2 percent of any increase in total real wages they pay in 2010 below the Social Security taxable maximum of $106,800 per worker. This second credit would effectively exempt employers from paying their share of Social Security payroll taxes on these higher wages. The total amount of credits for any single employer could not exceed $500,000, enough to provide an incentive to hire an additional 100 workers. This total limitation would make most of the credit go to small businesses. New firms with no employees in 2009 would be eligible for half the subsidy existing firms would receive for any increase in employment or wages. Nonprofit organizations would be eligible for the credit, but government agencies at all levels would not be eligible.

Various provisions would prevent employers from receiving a subsidy for hiring more workers while reducing total hours or wages, or for increasing total payroll while reducing the number of workers. These provisions aim to prevent, for example, employers from claiming an employment credit for replacing high-wage workers with many low-wage workers or for substituting more part-time for fewer full-time workers. To prevent this abuse, the proposal would make any business that reduces either its total employment or its payroll in 2010 ineligible for the credit and would limit the maximum jobs credit to 25 percent of the increase in the Social Security payroll wage base.

The credit would be based on the difference between average employment and payroll over the entire year 2010 compared with employment and payroll in 2009. But firms would not have to wait until filing their full-year tax return to claim the credit; they could instead claim credits in every quarter of 2010 based on their estimated tax benefit for the entire year. They would, however, have to settle up when they file their 2010 tax return.

The credit aims to accelerate recovery by reducing the cost to employers of hiring new workers or increasing wages in 2010. A similar incentive to raise employment levels or payroll could be achieved by offering a temporary $5,000 per-worker credit or credit against employer contributions to Social Security for all employees. The purpose of making the credit apply only for increases in employment or payroll above a base amount is to increase the share of the subsidy that supports additional employment instead of baseline employment or wages that would have been paid without any subsidy. In theory, by reducing subsidies to these baseline wages or employment, an incremental credit yields more "bang for the buck"—that is, more additional payroll or jobs per dollar of government budgetary cost. Put another way, making the credit incremental enables the government to provide a larger incentive for adding new employment at the same budgetary cost than it could with a credit that applies to all jobs, up to the $500,000 per firm maximum.

Because of anti-abuse provisions and inclusion of a subsidy to both additional employment and additional payroll, the administration's proposal may be a more cost-effective wage subsidy than the subsidy Congress enacted in 1977. But any incremental credit is an imperfect incentive because government cannot know what firms would have done without the credit. The proposed credit supports only new employment if 2009 employment and payroll represent what firms would have done in 2010 without any wage subsidy. But many firms would have either increased or reduced employment without the credit. In those circumstances, an incremental credit rewards growing firms with rising demand that would have hired more workers without a subsidy, but fails to provide an incentive for firms with falling demand to lay off fewer workers. It has arbitrary and capricious distributional effects, rewarding firms and workers in expanding industries and regions of the country, while failing to help industries and firms still experiencing economic stagnation.

How well the credit would work in creating new jobs is a matter of dispute. Injecting an additional $33 billion of employment tax cuts into the economy provides some stimulus to consumer demand, but how much stimulus depends on how quickly beneficiaries spend the tax cut. The credit would raise wages to the extent it encourages firms to hire more workers or pay them more, but to the extent it simply pays firms for what they otherwise have done, it will instead raise the profits of business owners, who have higher incomes and are likely to spend less from an additional tax cut than their employees.

So how much will the reduction in net wage costs encourage businesses to hire more workers or increase payroll? On the surface, the subsidy appears fairly large—a $5,000 tax cut is 12.5 percent of the wage of a worker making $40,000 per year and if permanent could make a difference between an additional hire being profitable or unprofitable. But the subsidy is only for one year, while for many firms, recruiting and training costs for new workers are fairly high relative to their productivity in the first year on the job. Taking account of these costs and the reluctance of many firms to hire workers they will not be able to retain, the effective subsidy could be quite small for many firms.

Rules to prevent abuse may make it difficult for small firms or their personnel departments to assess whether hiring an additional worker would qualify them for a subsidy or not. This may deter many firms from responding to the incentive or may lead them only to calculate their eligible benefit after the fact and not while making hiring decisions. For example, a subsequent Labor Department study of the 1977 new jobs tax credit found that most firms were either unaware of the credit or did not respond to it. Research based on data in that survey found that only 6 percent of firms that knew about the credit said it prompted them to hire more workers.[2]

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[2] Jeffrey M. Perloff and Michael L. Wachter, "The New Jobs Tax Credit: An Evaluation of the 1977–78 Wage Subsidy Program," *American Economic Review* 69-2: 173–179. May 1979.

Limiting the credit to $500,000 per firm effectively directs most of its benefits and all of its incentive to small firms, which represent the vast majority of employers. Larger firms and their employees would benefit indirectly, however, to the extent the credit raises demand through increased spending by those newly employed and business owners with increased profits. But limiting the credit to $500,000 per firm also raises its cost per additional job because larger firms otherwise increasing jobs by more than 100 workers receive some of the credit, but no direct incentive to hire more workers.

There are some reasons, however, to think the credit may have some beneficial effect on employment. Because it is only available for hires in 2010, it could encourage some firms to hire workers late in 2010 who they otherwise would have hired in 2011. This acceleration of jobs would not directly increase employment in 2011 and beyond, but could indirectly raise jobs in 2011 if the new hires help accelerate the economic recovery by spending some of their increased wages.

Some economists point to the 1977 experience as a successful model, citing a research finding that firms that were aware of the credit increased employment about 3 percent more than other firms.[3] This may reflect a positive incentive effect; alternatively, firms that were planning to hire additional workers may have been more likely to find out about the credit. Overall employment grew substantially in the years the credit was in effect, notably in industries with many small firms, such as construction and retailing.[4] Employment growth slowed considerably after the credit expired at the end of 1978, but this may have been caused by factors other than the credit's expiration, such as the spike in oil prices in 1979.

I conclude by expressing significant uncertainly about how much this proposal will raise jobs. In theory, a temporary incremental jobs credit could be a cost-effective way of accelerating increases in employment, and there is some evidence, though inconclusive, that the 1977 credit increased jobs. The effectiveness of the subsidy will depend greatly on the details of the proposal and how eligible employers perceive its potential benefits when making hiring decisions. Additional restrictions on the use of the credit, such as limits on the categories of workers who are eligible or limits on the number who qualify for the subsidy, are likely to reduce the cost-effectiveness of the credit, even as they limit its budgetary costs.

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[3] Timothy J. Bartik and John H. Bishop, "The Job Creation Tax Credit," Economic Policy Institute Briefing Paper #248, October 2009, at http://www.epi.org/publications/entry/bp248/

[4] John H. Bishop, "Can a Tax Credit for Employment Growth in 2009 and 2010 Restore Animal Spirits and Help Jump Start the Economy?" at http://digitalcommons.ilr.cornell.edu/articles/184

Increased Expensing for Small Businesses

Section 179 of the Internal Revenue Code allows small businesses to deduct immediately instead of capitalizing and recovering through depreciation the first $25,000 of qualifying investments (machinery and equipment). The amount of spending available for the deduction decreases dollar for dollar for investments in excess of $200,000.

In 2003, Congress increased the amount that could be expensed to $100,000 and the start of the phase-out to $400,000 through tax year 2009. These limits were raised to $125,000 and $500,000 for tax years 2007 through 2010 and then subsequently to $250,000 and $800,000 for 2008 and 2009. In 2010, the limits are scheduled to revert to $125,000 and $500,000, and in 2011, they will be further reduced to their pre-2003 levels of $25,000 and $200,000.

The administration is proposing to extend the 2008 and 2009 limits of $250,000 of expensing with a phase-out beginning at $800,000 in 2010. The administration's baseline also assumes that the post-2006 limits of $125,000 and $500,000 will be extended after 2010.

Section 179 reduces the cost of capital for firms that use qualifying machinery and equipment and reduces compliance costs by eliminating the need to apply tax depreciation rules and keep track of the basis of assets. IRS-sponsored research on compliance finds that depreciation rules contribute significantly to compliance costs for small businesses.[5] Section 179 produces little benefit for firms whose capital consists mainly of structures or inventory and no benefit for firms whose investment exceeds the sum of the maximum expensing amount and the beginning of the phase-out limit ($1,050,000 in 2008 and 2009, $625,000 in 2009 and 2010, and $225,000 after 2011). The benefit of expensing is larger for longer-lived equipment than for shorter-lived equipment, such as computers, that could otherwise be amortized over three years.

It is hard to know how much this proposal would boost the economy in the short run. There have been no studies on the effect of Section 179 expensing on the long-term level or timing of investment. A temporary tax incentive could accelerate some investments, but since generous expensing rules have been in place for several years, some capital purchases that may otherwise have been accelerated already have occurred. And if taxpayers believe the higher limits in 2010 will be permanent, their short-term stimulus effect would be smaller because taxpayers would have no incentive to accelerate the timing of investments.

Elimination of Capital Gains Tax on Qualified Small Business Stock

Individual taxpayers may exclude 50 percent of the gain from the sale of certain small business stock acquired at original issue and held for at least five years. The exclusion

[5] Donald DeLuca, John Guyton, Wu-Lang Lee, John O'Hare, and Scott Stilmar, "Estimates of U.S. Federal Income Tax Compliance of Small Businesses," presented at 2007 National Tax Association meetings, Columbus, Ohio, November 2007.

was increased to 75 percent for stock acquired between February 17, 2009, and December 31, 2010. The administration is proposing to raise the exclusion to 100 percent for stock acquired after February 17, 2009, eliminate the current AMT preference for gains benefiting from the exclusion, and require additional documentation to prevent noncompliance.

. Under current law, long-term capital gains are taxed at a maximum rate of 15 percent. But gains on small business stock before 2009 faced a 28 percent rate before application of the 50 percent exclusion, for an effective rate of 14 percent. The result is that, with capital gains rates in effect after 2003, small business stock received little additional preference and will receive little preference when the current 75 percent exclusion expires. If the maximum rate on capital gains rises to 20 percent, as the administration is also proposing, some of the targeted subsidy to small business stock will be restored.

Since its original enactment in the 1993, use of the partial capital gains exclusion on small business stock has been quite limited. To be eligible for the exclusion, the stock must be held for at least five years. The maximum amount of eligible gain is ten times the taxpayer's basis in the stock issued by the corporation and disposed of during the year or $10 million, reduced by the gain excluded in prior-year sales of the corporation's stock. To qualify as a small business, the corporation may not have gross assets exceeding $50 million, including proceeds of the newly issued stock.

Numerous other requirements constrain eligibility for the benefit. The stock must be issued by a subchapter C corporation, even though most small businesses today accounting for the majority of gross revenues from small businesses are organized as flow-through enterprises—partnerships, limited liability companies, and subchapter S corporations. Corporations in a wide variety of specified activities are ineligible, as are any corporations in a trade or business where the principal asset is the reputation or skill of one or more employees. There are limits on the amount of real property a qualified small business can hold and ownership of, dealing in, or renting real property is not treated as an active trade or business. Most firms that do qualify are in manufacturing, food processing (but not farming, which is ineligible), construction, transportation, and wholesale and retail trade.

Eliminating all capital gains on qualified small business stock will greatly increase use of the benefit. For example, OMB estimates that capital gains exclusion for small business stock cost only $50 million in 2010. But Treasury estimates the annual revenue loss from expansion of the incentive will reach $2.2 billion by 2020.

The benefit will reduce taxes on investors in some start-ups and could encourage some new entrepreneurial activity in small businesses that qualify. The short-term stimulus effects are likely very small, however, as the incentive is more likely to redirect savings to favored sectors than to encourage new investment. The proposal will direct capital to qualifying investments at the expense of potentially more productive investments that do not receive a special tax benefit.

Noncompliance with the provision is also a potentially serious issue. Individuals report their entire gain and their exclusion for qualified small business stock on two adjoining rows of line 8 of Schedule D of Form 1040. But the IRS receives no reporting from brokers or issuers of stock of the qualified exclusion amount and therefore has no way, short of a detailed audit, to verify that the exclusion is appropriate and satisfies all the relevant criteria. In contrast, the IRS receives third-party information on interest, dividends, and sales of capital assets and will receive reports from brokers on the basis of capital assets purchased after January 1, 2011. With the expansion of the benefits from the exclusion, additional reporting requirements may become necessary to prevent abuse.

Conclusion

The best way to promote job creation in small and large businesses and accelerate recovery is through policies that produce more fiscal stimulus in the short run that will increase demand for goods and services, while at the same time initiating steps that persuade markets that the United States will have the ability to address its fiscal deficits as the economy recovers. In addition to general fiscal stimulus, however, the administration has also proposed new targeted incentives for small business. The proposed targeted incremental jobs credit may encourage some acceleration of hiring from 2011 into 2010, but its overall effects are uncertain. Extension of higher limits for small business expensing will reduce compliance costs of businesses and could lead to some acceleration of investment. But businesses that built up their assets to take advantage of the temporary benefit for the past two years are less likely to respond to an additional extension. The proposed exemption of capital gains tax on selected small business investments is unlikely to provide much short-run stimulus to demand, may divert capital from more productive investments in less tax-favored assets, and will require additional reporting requirements to prevent abuse.