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Academic Research Suggests That the American Jobs Act Will Produce Few Jobs

By
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Introduction

On September 8, 2011, President Obama proposed the $447 billion American Jobs Act (AJA) to a joint session of Congress. The AJA includes more than $250 billion in tax credits and incentives that are intended to induce more hiring and spur more consumer and business spending. The remainder of the package is dedicated to new spending on infrastructure and "make-work" projects.

However, a review of the academic literature on these sorts of tax policies suggests that they will have little, if any, impact on spurring job creation or aggregate demand. Indeed, because these temporary tax measures would be offset by some $460 billion in permanent tax increases, the whole package could actually do much more economic harm than good.

Incentive Components

The key tax measures in the AJA include:[1]

Three Hiring Incentives:

- A 50 percent cut in employer payroll taxes for 98 percent of businesses and a bonus payroll tax cut for new jobs/wages. Expected revenue loss = $65 billion.
- A "Returning Heroes" hiring tax credit for veterans. Expected revenue loss = N/A. (The Congressional Budget Office has not scored this credit yet.)
- A $4,000 tax credit to employers for hiring long-term unemployed workers. Expected revenue loss = $8 billion.

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[1] The White House, "Fact Sheet: The American Jobs Act." http://www.whitehouse.gov/the-press-office/2011/09/08/fact-sheet-american-jobs-act.

A Consumer Demand Incentive: A 50 percent cut in payroll taxes for over 160 million workers in 2012. Expected revenue loss = $175 billion.

A Business Investment Incentive: Extension of the one-year allowance of 100% expensing of qualifying business deductions. Expected revenue loss = $5 billion.

A review of the economic research suggests that "jobs" incentives tend to be ineffective in spurring new hiring, while the three most recent "demand-side" tax cut plans failed to induce new consumer spending. The business-expensing provision – while a good idea – will only have a modest impact on economic growth because of its temporary nature.

The Poor Record of "Jobs" Credits

The challenge for researchers in measuring the effectiveness of hiring credits is to determine how to differentiate "new" hiring from the hiring that would have occurred without the incentives. Indeed, a study by Bishop and Montgomery found that, "…at least 70 percent of the tax credits granted to employers are payments for workers who would have been hired even without the subsidy."[2]

Two other studies have found that targeted job creation tax credits are only modestly used by firms and do little to change their behavior. A 1981 study authored by Dave M. O'Neill found that these policies are "hardly utilized when measured against the actual number of eligible hires that take place."[3] Another study put it more candidly: "Employers are happy to claim such credits if they meet the credit's rules, but they are reluctant to change their behavior in response."[4]

Businesses must weigh the short-term benefits of any tax incentives against the long-term costs of hiring a new employee. Consider, for example, an employer who is contemplating hiring a new employee at an entry-level salary of $25,000. Depending on the characteristics of the new hire, the business could be eligible for three types of tax incentives under the AJA:

- $4,000 if the worker is a non-veteran
- $5,600 if the worker is a U.S. Armed Forces veteran
- $9,600 if the worker is a veteran who is disabled due to a combat-related injury

These tax incentives would reduce the first-year cost of that $25,000 salary to between $15,400 (if the employee is a disabled veteran) and $21,000 (if the employee is a non-veteran). However, over the next five years, that same employee will cost the employer a total of $125,000 in salary, $14,500 in payroll taxes, and more in benefits. Thus, each employer must weigh a modest one-year incentive against those larger long-term costs.

Another concern regarding job tax incentives is that they can be gamed by employers. Though the AJA says that employers will receive a credit for hiring a qualifying worker, it does not state that a layoff cannot accompany the new hire. Simply put, a firm can fire an employee, hire a new one to do the same job, and collect up to $9,600 for its efforts–which results in a $9,600 loss to the Treasury, deadweight loss to the economy, and no net reduction in unemployment.

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[2] John H. Bishop and Mark Montgomery, "Does the Targeted Jobs Tax Credit Create Jobs at Subsidized Firms?" *Industrial Relations*, Vol. 32, No. 3. 1993.
[3] Dave M. O'Neill, "Employment Tax Credit Programs: The Effects of Socioeconomic Targeting Provisions," *Journal of Human Resources*, vol. 18, issue 3, 449-459, 1982. http://www.jstor.org/pss/145591
[4] Timothy J. Bartik, "Not all job creation tax credits are created equal," Economic Policy Institute, 2010. http://www.jstor.org/pss/145591

The goal of employer-targeted tax incentives is to reduce unemployment. However, the economic research suggests that such incentives are ineffective at best.

Little Demand from "Demand-Side" Tax Cuts

In addition to extending the Bush-era tax provisions through 2013, the compromise tax plan enacted in December 2010 (the "Tax Relief, Employment Insurance Reauthorization, and Job Creation Act of 2010") reduced the employee share of payroll taxes by 2 percentage points for one year, to 5.65 percent from 7.65 percent. The AJA would take this measure a step further by cutting the payroll tax rate in half for 2012 with the goal of stimulating demand by putting more money in consumers' pockets.

The policy is based on the tenuous assumption that putting income into someone's pocket guarantees that they will spend that money immediately. Empirical research and well-known economic theory, however, show that this is not the case.

The Permanent Income Hypothesis tells us that individuals take the future into account when they decide how to consume or spend.[5] This theory suggests that if a consumer perceives a change in income to be temporary, the increased amount of money in their pocket will not lead to a change in spending behavior. In other words, people are not likely to purchase a big-ticket item or make a long-term commitment because of a one-time cash windfall.

Empirical research following two direct tax rebates and one payroll withholding reduction—both intended to increase demand—shows that these programs provided little stimulative effect on the economy.

In 2001, many U.S. households received an advanced payment in the form of a $300 or $600 check for the newly constructed 10 percent tax bracket. During and after the disbursement of these rebates, Matthew D. Schapiro and Joel Slemrod conducted a study to determine what, if any, effects these direct payments had on spending. They concluded that the rebates were, contrary to expectations, very ineffective at increasing demand. Only 25 percent of recipients said they had spent the money or intended to do so. The rest of the group included in the study decided to save the money or pay off debt.[6] In other words, every dollar of tax rebates given out by the government resulted in just 25 cents of consumer spending.

Schapiro and Slemrod conducted another survey-driven study after the tax rebates of 2008. Only 20 percent of the respondents said the rebates would lead them to increase spending, and the study found that economic growth was actually weaker than it would have been absent the rebates. The authors concluded that, "Because of the low spending propensity, the rebates in 2008 provided low 'bang for the buck' as economic stimulus."[7]

In 2009, a withholding reduction similar to what is included in the American Jobs Act was included in the Making Work Pay credit. As the AJA payroll tax cut is intended to do, the 2009 withholding reduction increased disposable income by a small fixed amount on each paycheck. However, out of all of the households that benefitted from the 2009 withholding reduction, only 13 percent said it would induce them to mostly increase their spending.[8] A recurring

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[5] Fumio Hayashi, "The Permanent Income Hypothesis: Estimation and Testing by Instrumental Variables," *Journal of Political Economy*," Vol. 90, No. 5. 1982.

[6] Matthew D. Schapiro and Joel Slemrod, "Consumer Response to Tax Rebates," University of Michigan and NBER. November 2001.

[7] Matthew D. Schapiro and Joel Slemrod, "Did the 2008 Tax Rebates Stimulate Spending?" University of Michigan and NBER, January 2009.

[8] Claudia R. Sahm, Matthew D. Schapiro, and Joel Slemrod, "Check in the Mail or More in the Paycheck: Does the Effectiveness of Fiscal Stimulus Depend on How It Is Delivered?" Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, D.C. 2010.

theme is that, regardless of how the "new income" is delivered, the effort is economically inefficient and does little to significantly increase demand.

Business Expensing: A Good Idea if Made Permanent

Another element of the December 2010 tax compromise was a provision to allow firms to immediately expense a major purchase made in 2011 rather than amortize the cost of that item over the normal depreciation period. The AJA would extend this temporary measure for one additional year.

Economically, allowing a business to expense 100 percent of certain investments is good policy. In general, economists favor full expensing over depreciation, especially since depreciation rules are often arbitrary and have little relationship to the economic life of the investment. However, full expensing loses its economic effectiveness if it is temporary.

A study conducted by Christopher L. House and Matthew D. Schapiro examined the effects of legislation which enacted temporary bonus depreciation in 2002 and expanded it in 2003. The results suggest that such temporary expensing provisions do little to increase employment or output. The study authors find that: "While the policy noticeably increased investment in types of capital that benefited substantially from bonus depreciation, the aggregate effects of the policy were modest. The analysis suggests that the policy may have increased output by roughly 0.1 percent to 0.2 percent and increased employment by roughly 100,000 to 200,000 jobs."[9] If replicated, this would result in lowering unemployment by 0.7 percent to 1.4 percent.

At the margin, however, it is likely that this proposal will encourage some firms to purchase new plant and equipment in 2012 that they might not have purchased otherwise or which they may have put off for future years. Making expensing permanent policy would greatly enhance its effectiveness and be a step toward broader business tax reform.

Permanent Tax Hikes

While it is likely that the tax incentive portion of Pres. Obama's plan would deliver few jobs and little economic growth, the permanent tax increases that "pay for" the tax cuts can do permanent harm to the economy.

Reportedly, the tax increase measures total roughly $460 billion over ten years. They include:

- **Section 401:** Limits the ability of high-income taxpayers to take deductions, by reducing their value to a maximum of 28 percent. (If a high-income taxpayer is in the 35 percent bracket, they can currently deduct charitable contributions, for example, at the 35 percent rate. This measure would reduce that deduction to 28 percent.)
- **Section 411-412:** Taxes certain partnership income (known as "carried interest") as ordinary income at a top rate of 35 percent instead of as a capital gain at 15 percent.[10]
- **Section 421:** Repeals the bonus depreciation deduction to those purchasing corporate jets, a provision enacted as part of the 2009 stimulus law.
- **Section 431-442:** Disallows a number of deductions for the oil and gas industry.

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[9] Christopher L. House and Matthew D. Shapiro, "Temporary Investment Tax Incentives: Theory with Evidence from Bonus Depreciation," *American Economic Review*, American Economic Association, Vol. 98(3), 737-68, June 2008. http://www.nber.org/papers/w12514

[10] Tax Foundation staff, "Q&A on the Carried Interest Debate," Tax Foundation Fiscal Fact No. 101, September 2007. http://www.taxfoundation.org/news/show/22590.html

By and large, these measures are not motivated by sound tax policy, but rather as a means of punishing politically unpopular groups such as the "rich," hedge fund managers, and oil companies.

While limiting tax deductions for high-income taxpayers is certainly less harmful economically than raising their marginal tax rates, the provision would still mean a substantial tax increase for America's most successful private business owners. For example, more than 60 percent of taxpayers in the 33 percent tax bracket have business income while more than 82 percent of those in the top 35 percent bracket have business income.[11] While they may be few in number, high-income taxpayers earn the vast majority of all private business income. It's hard to imagine that these business owners would increase hiring in the short term in the face of a *permanent* tax hike.

The ostensible purpose of the "carried interest" provision is to raise taxes on hedge fund managers, who many feel have structured their business arrangements to avoid paying the top marginal income tax rate. Indeed, there is a strong case to be made that the work that many hedge fund managers do "for a piece of the capital gain" in an investment deal looks a lot like the same work that is done by salaried employees in large investment banks. However, carried-interest – or sweat equity – arrangements have long been a standard practice in the oil drilling field as well as in real estate, and these partnership arrangements could become casualties of the President's tax plan.

The various provisions to "eliminate tax breaks" for the oil and gas industry are also a blatant attempt to punish an unpopular industry and not grounded in good tax policy. For example, the Obama plan would deny oil companies the ability to expense their intangible drilling costs, which is similar to the R&D tax provisions available to other industries.

Another provision of the Obama plan would expose oil companies to double taxation on their foreign earnings. One of the inviolate principles of sound tax policy is that a dollar of income should not be taxed twice by two different governments. In keeping with this principle, the U.S. tax code affords multinational firms a credit for income taxes paid to other governments on their foreign earnings. Oil companies are frequently subject to extra layers of taxation in countries such as Norway (the total income tax for oil companies is 78 percent) and Saudi Arabia (the total tax for oil firms is 85 percent) so the tax code allows these "dual capacity" taxpayers to deduct more than the base rate of tax. Pres. Obama would eliminate this well-established (and well-litigated) provision, subjecting these companies to U.S. tax on income that was already highly taxed abroad.

Lastly, Pres. Obama's plan to deny the Manufacturing Activities Deduction (known as the Section 199 deduction) to oil and gas companies would set a very bad precedent on many levels. First, it would deny the deduction for the oil companies but keep the deduction for all the industries that use petroleum products, such as the automakers, asphalt layers, tire companies, rubber toy manufacturers, or makers of synthetic clothing. Secondly, once the precedent is set to punitively deny a tax provision to some industries over others, there is no reason to think that lawmakers would not use the same tactic against other disfavored products such as fatty foods, sugary drinks or alcoholic beverages.

Conclusion

The American Jobs Act is intended to be an ambitious proposal to spur new hiring and generate economic growth. But the economic research suggests that its core tax incentives will have little, if any, impact on either job creation or improved GDP growth. Moreover, whatever meager benefits come from these temporary provisions will be swamped by the long-term impact of the permanent tax increases that are nearly twice the size of the tax cuts.

[11] Tax Policy Center, Distribution of Tax Units with Business Income, by Statutory Marginal Tax Rate, 2011,Table 11-0150. http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=3031&DocTypeID=7

Lawmakers should stop trying to jump-start the economy in the short run and begin crafting policies that set the country on a long-term growth path. The economic evidence suggests that cutting our corporate and personal income tax rates while broadening the tax base would greatly improve the nation's prospects for long-term GDP growth while helping to restore Washington's fiscal health. More importantly, these measures will lead to higher wages and better living standards for American citizens. And that should be the number one priority of any tax policy.

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