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Let's Talk Taxes
By R. Glenn Hubbard
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In this election year, with domestic discussion centered on taxes and jobs, it's useful to take stock of what we know about taxes and hours worked, entrepreneurship and jobs. The robust employment growth in August and the gain of 1.5 million jobs so far this year show a strengthening job market. But, if John Kerry rolled back President George W. Bush's tax cuts, as he has promised, would more jobs be created?

The president's tax cuts can, in theory at least, affect the economy through both the demand side and the supply side. There is now mounting evidence that the demand-side effects significantly shortened the recession. Individuals received tax refunds in the mail, and spent them when times were tough. Combined with aggressive monetary policy, the recent fiscal policy blunted the recession's impact on incomes and production. Economy.com recently stated in a review of policy developments that, "If monetary and fiscal policy had remained unchanged during the Bush presidency, the recession that began in early 2001 and ended later in the year, would have likely instead lasted through much of 2003. The economy would still be shedding jobs."

So on the demand side, one would have to conclude that the Kerry tax hikes would harm job creation.

On the supply side, economists have for many years argued that high marginal tax rates discourage both work and effort. A potent illustration of this effect can be seen in the large differences between labor supply in Europe and the United States. It is well known that Europeans work far less than Americans. According to the work of economist Edward Prescott, this was not always true. In the early 1970s, when European and U.S. tax rates on work were comparable, European and U.S. hours worked per employee were also comparable. Since that time, Mr. Prescott finds that virtually all of the large difference between U.S. labor supply and labor supply in France and Germany is due to differences in tax systems.

This suggests that individuals really do adjust their work effort in response to high tax rates. The first-round effect of Mr. Bush's tax cuts raised disposable income and household spending. The second-round effect was likely a healthy supply-side boost to labor, investment, and production.

That boost may not be just to the labor supply of affected individuals. Quantifying the supply-side effect requires that we also pay attention to the link between tax policy and entrepreneurship. Entrepreneurs create jobs for new employees as well.

Tax policy can play a significant role in encouraging -- or discouraging -- entrepreneurial risk-taking. It is startling how many entrepreneurs starting a business are subject to the individual income tax (as sole proprietorships, partnerships, or S corporations). Because entrepreneurship is a risky undertaking, prospective entrants evaluate possible after-tax returns from success and failure in deciding whether to start a business. The income tax weighs in because the government is not an equal partner in success and failure. While the government does not grant a complete offset for business losses, the progressive income tax imposes a "success tax" on a good outcome. If this success tax is high enough, a prospective entrepreneur may forego a risky venture to continue working for someone else.

How important is this effect. Using data on U.S. households, William Gentry and I found that the "success tax" has a potent negative effect on entry into entrepreneurship. We estimated that President

Clinton's 1993 tax increase, which raised substantially the top individual income-tax rate, reduced the probability of entry for upper-middle- income households by as much as 20%. Should Mr. Kerry reverse the president's tax cuts, that estimate suggests an important hit to new entrepreneurial activity.

President Bush's tax cuts reduced marginal tax rates on both work and entrepreneurship. In related research, Mr. Gentry and I estimated that cuts in marginal tax rates also increased the likelihood that employees change jobs to improve their well-being.

How many new jobs do entrepreneurs create for others? Because, again, the individual income tax applies to many starting business owners, changes in tax rates affect the cost of hiring additional employees. In an important paper, Robert Carroll (now deputy assistant secretary of the Treasury), Douglas Holtz-Eakin (now the director of the Congressional Budget Office), Mark Rider (now with Georgia State University, formerly with Treasury's Office of Tax Analysis), and Harvey Rosen (now a member of the White House Council of Economic Advisers) found that higher taxes on business owners lower the probability that their firms will hire workers. Tax increases also cause those entrepreneurs to decrease their wage payments to workers.

Describing cuts in marginal tax rates for high-income taxpayers as a giveaway to the rich completely misses the importance of entrepreneurs in this group and the potent effect of tax cuts on the willingness to assume the risk of a new venture and to hire additional workers.

Mr. Kerry likes to claim that his tax hikes are costless because they fall mostly on the rich. But a recent study by the nonpartisan Tax Foundation reported that 74% of the wealthiest 1% of taxpayers report income from business activity.

And, available economic evidence suggests that the proposal by Mr. Kerry to raise income-tax rates substantially on higher-income individuals would throw the job machine into reverse, with adverse implications for business formation and employment. That's something to think about looking forward to Nov. 2.

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