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ANALYSIS OF THE SCALED-DOWN HIRING INCENTIVES TO RESTORE EMPLOYMENT (HIRE) ACT

Senate Majority Leader Harry Reid (D-NV) has scheduled Senate action on a scaled down version of the Hiring Incentives to Restore Employment (HIRE) Act. The bill takes a few small steps toward improving employment, but omits the major tax reforms that could really enhance the economic recovery and promote growth going forward. The offsets chosen to pay for the bill will discourage foreign investment in the United States and reduce the competitiveness of U.S.-based multinational businesses.

The trimmed version of the bill includes the Schumer-Hatch payroll tax exemption, and extension of Section 179 expensing for small businesses, an election to convert Tax Credit Bonds to Build America Bonds, and a transfer of funds to the highway trust fund to extend certain transportation programs. It would be paid for with "offsets" (tax increases or enhanced tax compliance provisions) relating to foreign investment accounts of American taxpayers and dividends paid to foreign investors, and a further delay in the reform of worldwide interest allocation rules.

A larger version of the Act had been readied for Finance Committee consideration by the Chairman and ranking member of the Senate Finance Committee Senators Max Baucus (D-MT) and Charles Grassley (R-IA). Dropped from the bill were the extension of certain expiring tax provisions (including the R&D Tax Credit), pension funding relief, active income treatment of financial services income, extension of two economic safety net provisions (emergency unemployment compensation and COBRA health insurance premium assistance extensions), several energy credits and health care provisions, and some associated revenue offsets. These dropped provisions will be taken up at a later date, although Senator Grassley may introduce them as an amendment to the Reid bill.

Analysis of jobs provisions

Downturns are due mainly to weak investment, and the current one is no exception. It was triggered by the banking collapse, but weak investment was in the cards anyway because the investment spurt and increase in the capital stock made possible by the 2003 tax cuts had run their course. What is needed for a strong recovery are further reductions in the tax barriers to investment and entrepreneurial risk taking. These would involve, at the very least, the permanent extension of the 15% tax rates on capital gains and dividends, and the 33% and 35% rates in the two top tax brackets (affecting many small business owners), plus some acceleration of depreciation for businesses of all sizes. Instead, the Administration and the Congress threaten to let the 2003 tax rate cuts expire at year end for people in the two top tax brackets (which would raise the rates to 36% and 39.6% and bring back the phase-outs of personal exemptions and itemizd deductions), and would boost the capital gains and dividend tax rates to at least 20%. The minor provisions of the HIRE Act will not offset the damage done by these tax hikes on investment and small business owners.

The Schumer-Hatch payroll tax exemption and hiring tax credit. This provision would waive the employer half (6.2%) of the retirement portion of the Social Security payroll tax for workers newly hired in 2010 who had been unemployed for at least 60 days. It would affect wages up to the payroll tax cap of $106,800. There would be an additional $1,000 credit for employers who retain the workers for 52 weeks, available on their 2011 income tax returns. Advantages: In theory, such a credit can cover some of the initial cost of training a new hire, thereby encouraging additional hiring. This credit is less complicated than earlier targeted tax jobs credits. Unlike earlier lump sum credits, it is an incentive "at the margin" for people to seek to earn wages up to the cap. Disadvantages: Targeted jobs credits have not worked well in the past. This credit would discriminate in favor of workers who have been unemployed over people who are newly entering the work force, such as recent graduates. There is no economic rational for favoring one job applicant over another.

Section 179 expensing. As of 2007, Section 179 expensing allowed businesses to write off immediately (expense) up to $125,000 of investment spending on equipment and certain structures, instead of depreciating it over time, subject to a phase-out once the investment spending reaches $500,000 (both numbers subject to indexing for inflation through 2010). These limits were raised temporarily for 2008 and 2009, allowing businesses to expense the first $250,000 of eligible investment, with the phase-out delayed until outlays reach $800,000. The provision in the HIRE Act would extend these higher limits through 2010. Advantages: The provision is a step toward expensing, which is the optimal unbiased tax treatment, and it allows the creation of a larger capital stock. Disadvantages: The provision is a temporary extension; it would create more jobs and more capital if it were permanent. Also, the expensing is not "at the margin" for businesses with larger investment outlays. Making the investment outlays by all businesses eligible for the expensing would lead to more investment and capital accumulation, and higher wages and levels of employment.

Election to convert "Tax Credit Bonds" to "Build America Bonds". "Tax Credit Bonds" are available for certain school and energy projects. They give the buyer of the bond a federal tax credit in lieu of interest, saving the interest cost for the issuers. "Build America Bonds" provide a direct federal payment to the issuer to cover a portion of the interest paid on bonds for public works projects. The provision would allow issuers of tax credit bonds the option of using the Build America structure for new issues. These tax breaks for bonds targeted to investment in school and "green" energy projects distort the allocation of investment dollars, diverting them from private sector projects that are of more value. Instead of enhancing the programs by making it easier to shift from one to another, they should both be canceled.

Extension of highway and mass transit programs. This provision would extend highway and transit programs through calendar 2010, and transfer money from the general fund to the highway trust fund. Highway spending is too slow a vehicle for counter-cyclical job creation. Besides, because it must be paid for by taxing or borrowing which crowd out private activity, its counter-cyclical credentials are questionable even if the projects are ready to go. Highway and transit projects should be done if and only if they can pass a cost-benefit test, regardless of the state of the business cycle. We should not throw money at infrastructure that is not of value just because of a recession. Some projects have strong cost benefit ratios, but some are bridges to nowhere or high-cost, low-ridership mass transit systems that cannot pay their own way.

Analysis of offsets

Foreign account tax compliance. The bill includes measures to reduce unreported earnings from foreign investments by giving the IRS stronger enforcement tools. It would allow the IRS to impose

30% withholding on U.S. source payments to foreign institutions that do not disclose the identities of their U.S. account holders to the IRS. It would require U.S. taxpayers to disclose their foreign accounts on their U.S. tax returns. It would clarify when a foreign trust is considered to have a U.S. beneficiary. It would treat certain substitute dividend and dividend equivalent payments as dividends for withholding purposes.

These provisions will raise only a fraction of the anticipated revenue, and might slow the recovery by discouraging foreign financial institutions from investing in the United States. The reporting requirements may be in violation of foreign bank secrecy laws, and lead to more disputes akin to those currently involving Switzerland. In an ideal tax system, such as a consumed-income tax, saving sent abroad would be taxed on exiting this country, and the subsequent foreign earnings would be exempt from U.S. tax, as in a Roth IRA. Then none of these foreign account issues would exist.

Further delay interest allocation rules. Senator Reid has included a further delay, from 2018 to 2020, in the effective date of the pending worldwide interest allocation reforms. They have been delayed before as offsets to earlier tax and spending changes. This is a shame, as the reforms are sound tax policy and correct a serious inequity afflicting U.S. based multinational businesses. If a U.S. parent business borrows money, it is required to allocate part of its interest deduction against the income of its foreign affiliates. This can reduce its eligibility for a foreign tax credit on earnings from high tax countries, and therefore indirectly reduce the value of the interest deduction. However, if the business borrows abroad through one of its foreign subsidiaries, it is not allowed a corresponding allocation of part of its foreign operations' interest deduction against its U.S. income, which would thereby increase its eligibility for the foreign tax credit. The current rules are an asymmetrical, unfair, "heads I win, tails you lose" feature of the U.S. tax code that reduces the competitiveness of U.S. businesses in the global economy. The worldwide interest allocation reforms would correct this asymmetry.

Conclusion

This is a weak jobs bill. It would be better to put the money toward extending the 2003 tax cuts for dividends, capital gains, and the tax rates in all brackets, and to enhance expensing of investment for all businesses. The added growth from those particular tax changes would obviate the need for these offensive offsets.

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.