

The Growth Penalty

By Robert King

Only growth companies create jobs. In the great debate on how to create jobs this simple fact has been largely ignored. Trying to get our economy going again with broad based stimulus or tax incentives has continually produced disappointing results because it doesn't address the problem. It's not that we are taxed too high or too low; the way we tax is wrong. If our tax system was retargeted so the job creating sector was not overwhelmingly burdened, we could significantly lower overall tax rates and keep collections the same, while reinvigorating the economic engine that drove innovation and unstoppable job creation for much of our history.

Our economy is based on the legacy of tens of thousands of entrepreneurs who build new innovative businesses and industries which made ours the strongest, richest economy in history. According to a 2010 Kauffman Foundation study based on Bureau of Labor Statistics data on start-ups and established firms, on average, existing firms are net job destroyers – slashing 1 million jobs net combined per year. In contrast, in their first year of business, start-ups add an average of 3 million jobs net combined per year¹.

One only needs to look at the census data on new business formation to understand why our economic growth cannot create the jobs we need and why we are falling behind global competitors in industry after industry. According to data released in November 2011 by the US Census Bureau the per capita rate of employer firm formation for 2009 was less than half the 1977 rate when the Census Bureau first began collecting this data.² In fact, we have seen steep reductions in new business formation in each decade since.

What has happened to these American entrepreneurs and their businesses that drove growth and employment? New businesses need cash to survive and grow; without it, innovation is just a dream. They need cash to pay for inventory, equipment, research, and new employees before they can even think of going public or borrowing from a bank (even then, they will need cash to service the loan and keep growing).

The unique and flawed way our tax system calculates taxable profits is starving growth companies of cash. This system has had a devastating effect on new business formation over the last 40 years. This same system minimizes the tax burden on declining companies. As tax rates have risen over the years, this effect has become a far greater barrier to new business formation. Instead of nurturing growth companies and helping them retain cash, we have been doing the opposite. While taxing declining companies that are shedding jobs at a minimal rate relative to cash flow.

The IRS's system of calculating profits³, based on accrual accounting, works well for low growth companies but results in wild differences between cash verse accrual profit when revenue growth or decline is involved. Accrual income doesn't recognize a number of large uses of cash. Inventory is not deductible for American businesses therefore the cash used to purchase it is taxed. Equipment that might be used to improve productivity or enter new markets must be



deducted over several years. Receivables – cash that has not yet been received -- are taxed. So the faster a company grows the higher its effective tax rate (rate based on cash profits or what cash is left over at year end). This could be stated another way: the more jobs a company creates the higher its effective tax rate!

This isn't a matter of a few percentage points. If a company is growing at 25% (adding jobs) and its rate for federal, state and local taxes is 44%, it typically pays an incredible 138% of its cash profits in tax. A similar company with zero growth (not adding jobs) pays 44% of cash profits – the same as its accrual rate. A company shrinking at a 25% rate (and shedding jobs) would only pay 15%. I call this the growth penalty.

Nothing could be more destructive to job creation and long term economic strength. It starves growth companies of cash, to the extreme where many higher growth companies have to borrow money annually just to pay their taxes. This puts the brakes on growth for the majority of growth companies. But it also ensures that the entrepreneur has a relatively low income level until he or she is able to "cash out" sometime in the future. This powerful disincentive is keeping our brightest and most ambitious young people out of the start-up business and into low risk high reward jobs in law and finance⁴.

If a young entrepreneur ignores higher return career paths and is smart, hard working, and lucky enough to scrape together enough cash to create a successful growth company, his luck will undoubtedly run out (literally and fiscally) when it is time to pass his or her company on to the next generation. On top of paying effective tax rates that can easily exceed 100% of annual cash profits, he or she will now have to pay between 35% and 55% of the total value of the company as estate tax. Again the faster a company grows – and the more jobs it creates – the higher the tax, because the higher its growth rate, the higher its value will be as it will have a higher multiple of accrual earnings. This can be 10 or even 20 times earnings for a growth company; but only a fraction of that for a slow growth or declining company. If our devastating growth tax penalty hasn't yet shut a company's growth down, the estate tax almost certainly will. Usually a company will be forced to sell or borrow. If the company is sold the buyer will more typically add debt to the new acquired firm to fund the purchase so either way the company will add significant putting the brakes on growth and job creation as well as increasing the risk of bankruptcy at a later date. To remedy this, the United States could look to countries like Germany, which allow companies to be passed to the next generation of a family without additional taxes⁵, thus preserving this critical job creation sector of the economy.

Interestingly – and fortunately – not all growth companies are affected the same way⁶. Internet companies, service organizations, and law firms often have no inventory or receivables and little or no capital equipment. The tax system works for them and they have thrived. But service companies and Internet companies alone cannot drive GDP growth and provide full employment to a nation of over 300 million people.

We can restore America's job creation machine and preserve America's position as the world's leading economy well into the 21st century by replacing our job-destroying tax policy with a job creating policy. If a company has a growth rate of 20%, makes \$100, and the tax rate is 50%, they should have to pay \$50 in tax on that \$100, not an unfair and growth-stifling \$138. The faster a company grows, the more cash it needs to continue that growth. Ultimately pegging corporate tax rates to growth rates would be a powerful economic force. Unfortunately lowering tax rates for corporations, even job creating corporations, will always be politically difficult. A first step which would have tremendous impact would be to simply allow growth companies (or all companies) the option to pay taxes on a cash rather than accrual basis. A policy like this would not only create jobs in the immediate future, but also dramatically change the direction of our country's long-term economic success.



Sources:

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