A recurring theme of this year's presidential campaign is the need to encourage the formation of new businesses. Republicans in general, and Mitt Romney in particular, have stressed that the best way to stimulate such startups is via low tax rates on high-income earners.

Romney wants to cut top rates by 20 percent, maintain the favorable treatment given to capital gains and dividends, and completely eliminate the estate tax, which currently only kicks in on estates in excess of $5 million for an individual or $10 million for a (heterosexual) married couple.

In other words, this is a strategy that emphasizes maximizing the after-tax returns if and when you hit it big. Yet if you think about the way most new businesses are started, it should be clear that these tax incentives have very little to do with the decisions facing most new entrepreneurs.

The typical business startup (think Joe the Plumber) begins with an initial stake that has been saved or borrowed, and 97 percent of small-business owners make less than
$250,000 a year. It is a good bet that when Bill Gates, Steve Jobs and Larry Page were creating their new businesses in their proverbial garages, they weren’t giving much thought to the tax rate they would have to pay if they struck it rich. Rather, they were hoping their startups would survive, something that less than half of new businesses succeed in doing.

**Loss Aversion**

Research in *behavioral economics* shows that when people consider risky propositions, they are especially concerned about the downside. Roughly speaking, people weigh losses about twice as heavily as gains, a phenomenon called “loss aversion.”

So if we really want to encourage risk takers and job creators, we should concentrate on what will happen to them in the all-too-likely event that their brilliant idea doesn’t pan out and the new venture flops.

One might think that Romney, an expert on new businesses, would be particularly insightful on this topic. But it turns out that the most sensible thoughts I have heard on this issue were not from him, another business executive, or an economist for that matter. They *were from Jon Stewart* on “The Daily Show.” Here is a portion of what Stewart said (profanity deleted) in a recent interview with my University of Chicago colleague Austan Goolsbee:

“What we need to do in this country is make it a softer cushion for failure. Because what they say is the job creators need more tax cuts and they need a bigger payoff on the risk that they take. … But what about the risk of, you’re afraid to leave your job and be an entrepreneur because that’s where your health insurance is? … Why aren’t we able to sell this idea that you don’t have to amplify the payoff of risk to gain success in this country, you need to soften the damage of risk?”

This is exactly right. Someone who leaves a big company to start her own business is bearing not only the risk of losing all of her investment, but also her health insurance. One benefit of health-care reform is that people will still be able to get insurance while they are starting their new business, or after it fails, even if they have a pre-existing condition.

The essence of Stewart’s idea goes to the heart of why our economy is largely organized around limited-liability public corporations. When successful entrepreneurs decide to take their businesses public, they are selling some of the upside to other shareholders in return for making sure that they can’t lose all their wealth if something at the company goes wrong.
So-Called Reform

What about smaller startups that don’t begin their lives as corporations? One thing that would help stimulate this sort of business creation is making sure that a business bankruptcy is not ruinous to the entrepreneur’s family. But the Republican-sponsored bankruptcy “reform” law of 2005 changed the rules in the opposite direction. For someone who uses a credit card to help open a bakery or landscaping business, this law raised the cost of failure. Maybe this is what people mean by the phrase “job-killing” legislation.

A more generous safety net, not just the continued access to health insurance but also downside protections such as unemployment insurance, can stimulate job creation in another way. The owners of many successful small businesses treat their employees as if they were family members, and some actually are. Such owners may be more reluctant to hire new employees if these safety nets are not in place.

This brings us back to Jon Stewart’s point. Cutting taxes on high-income earners is unlikely to be the most cost-effective way of stimulating new business startups. If entrepreneurs who hit it big have to pay the same tax rate on their capital gains as on their ordinary income, they are unlikely to give up on their dreams. When people are contemplating starting a new enterprise, the last thing they are worried about is the tax rate their heirs might have to pay if they die as billionaires. But if they aren’t sure they can provide health insurance and a home to live in for their family should they fail, they may play it safe.

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