

# Personal Income Tax Cuts will Not Boost Small Business and Entrepreneurialism

State education funding has more to do with entrepreneurial vitality than tax policy. A recent study by Bruce, Liu and Murray<sup>1</sup> investigated whether state corporate or personal income tax rates, or the sales tax rate, affected the growth of entrepreneurial employment or income over the 31 years from 1978 to 2009. They summarize the results as follows:

[W]e find that state tax policies do not have quantitatively important effects on most of our entrepreneurial performance and productivity measures.... Our results suggest that **states that are interested in promoting entrepreneurial success should turn their focus away from ineffective tax policy options** [emphasis added]. Other policies might be pursued, including more general efforts to improve the business climate by reducing crime or unemployment rates, or increasing expenditures on public services including education, or targeted initiatives that seek to directly support entrepreneurs through business plan development and management training.

Prior research on the effects of state taxes on entrepreneurial activity had been largely inconclusive or contradictory,<sup>2</sup> but the recent study by Bruce et al. shows that some of these previous research findings relied on inferior statistical methods. They replicated those results in a simple model similar to the ones others have used, but the significance of the tax variables disappeared once the model was enhanced to account for “inertia” — the tendency of higher entrepreneurial activity in one period to lead to higher activity in the next.

Arthur Laffer and ALEC, in *Rich States, Poor States*, argue that personal income tax increases affect many small business owners because they are organized as proprietorships or pass-through entities (partnerships, S corporations, and LLCs) and therefore pay income taxes as persons, not corporations.<sup>3</sup> In fact, the personal income tax is friendlier to new businesses than the sales tax or the property tax. Income taxes are low or nonexistent in the early years of a business when the business is losing money, and they are payable only once a business has gotten off the ground and is generating a profit. Even then, income taxes will often remain low or nonexistent for years as the early losses are carried forward. In fact, **87 percent of small businesses have less than \$50,000 per year in taxable income.**<sup>4</sup> **State income taxes at that level of income are so small that even eliminating a state’s personal income tax would only be enough to finance a fraction of a new hire.**

As for the real entrepreneurs, such as those launching start-ups with real potential to create jobs, tax breaks don’t prompt faster growth. One research piece explains why:

For innovative start-up businesses that create a disproportionate share of jobs, tax

breaks are even less important. These operations account for 3 percent of all businesses and 20 percent of gross job creation. But they generally plow all their cash flow into new facilities, marketing, and R&D and have little taxable income.<sup>5</sup>

Finally, any argument about taxes and entrepreneurship must confront the issue of balanced budgets. **A recent study found that education levels more than anything else explain why some regions have higher rates of innovation than others.**<sup>6</sup> But education accounts for a major share of state and local budgets, and tax cuts, a poor tool to stimulate entrepreneurship to begin with, inevitably reduce the resources available for schools. States would be better served by focusing their efforts on supporting public education at all levels than cutting taxes for the sake of entrepreneurialism.

1. □ Donald Bruce, Xiaowen Liu, and Matthew N. Murray. "State Tax Policy and Entrepreneurship." *National Tax Journal* 68, 35 (Sept. 2015): 803-838.

2. □ For a summary, see Donald Bruce and John Deskins, "Can State Tax Policies Be Used to Promote Entrepreneurial Activity?" *Small Business Economics* vol. 38, 2012, pp. 375-397.

3. □ ALEC and Laffer claim that "eliminating the personal income tax is good for state growth." Laffer cites three academic studies in *Rich States, Poor States*, 5th edition, p. 24. One study (Stephen Mark, Therese McGuire, and Leslie Papke, "The Influence of Taxes on Employment and Population Growth: Evidence from the Washington, D.C. Metropolitan Area," *National Tax Journal*, v. 53, no. 1, March 2000, pp. 105-123) turns out not to be about state-level policy and growth as implied by Laffer but about local taxes and growth within a metropolitan area; furthermore, their research found no statistically significant relation between the personal income tax rate and population growth, and did not even consider the effect of the personal income tax on job growth or business location. The second, by Timothy Bartik, estimated the effect of the corporate income tax, not the personal income tax, on new plant locations. Thus, contrary to Laffer's claim, neither of these two articles provides any support for his proposed elimination of the personal income tax. The third article, by Poulson and Kaplan, was not published in a refereed academic journal but rather in the house organ of the conservative think tank, the Cato Institute; it did not include controls for any of the major non-tax factors influencing growth (such as wage rates or public expenditures) and cannot be considered a credible analysis of the independent effects of income tax rates.

4. □ Michael Mazerov. *Cutting State Personal Income Taxes Won't Help Small Businesses Create Jobs and May Harm State Economies*. Center on Budget and Policy Priorities, February 19, 2013.

5. □ Michael Mazerov. *Cutting State Personal Income Taxes Won't Help Small Businesses Create Jobs and May Harm State Economies*. Center on Budget and Policy Priorities, February 19, 2013.

6. □ Yasuyuki Motoyama and Jordan Bell-Masterson. "Beyond Metropolitan Startup Rates: Regional Factors Associated with Startup Growth." Ewing Marion Kauffman Foundation, January 2014.