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Cutting State Personal Income Taxes Won't Help Small Businesses Create Jobs and May Harm State Economies

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Cutting state personal income taxes not only won't promote small business growth and job creation, but it is also likely over time to threaten the success of entrepreneurs by taking resources away from critical services like education.

Until recently, most proposals to cut state taxes in the name of boosting economic growth and job creation focused on cutting *business* taxes like the state corporate tax. But in the past several years a growing number of elected officials and business organizations have called for cuts in state *personal* income taxes. They contend that because owners of most small businesses take advantage of provisions that allow them to pay personal income taxes on their profits — rather than corporate taxes — a personal income tax cut is required for small business to get the economic benefits of tax reduction. Supporters of such tax cuts argue that the level of state personal income taxes is a significant factor in small businesses' ability, and incentive, to create jobs despite the fact that there is virtually no evidence to support this claim.

Proposals include cutting state income tax rates across the board, reducing tax rates for the highest income brackets, cutting or eliminating state taxation of "small business" income, or entirely repealing the state income tax.

Regardless of the specific form they take, state personal income tax cuts will almost inevitably provide disproportionate tax savings to the most affluent households in a state. At the same time, cutting income taxes is a poor strategy for stoking small business growth and job creation.

- **The vast majority of those who would get a personal income tax cut are in no position to create small-business jobs**. Only 2.7 percent of all personal income taxpayers are owners of bona fide small businesses that have any employees other than the owner or owners. Most high-income households — the group that likely would get the most money back from a personal income tax cut — are not small business owners. And many who do have ownership interests receive only a small portion of their income from their business investments. Profits from the ownership of small businesses that have paid employees account for less than 4 percent of the income of households with incomes over $100,000.

If Tax Cuts Won't Create Small Business Jobs, Tax Increases Won't Eliminate Them

This paper argues that state personal income tax cuts won't help small businesses create jobs, and in fact could harm the ability of the small-business sector to contribute to economic growth. For all the reasons stated in this paper, the converse is also true: personal income tax increases, including those on the highest earners, won't harm small-business job creation. They could even contribute to a stronger business climate for entrepreneurs if the proceeds are invested wisely in better state schools and universities, roads and bridges, police and fire protection, and other critical services.

- **Most small businesses make too little money for tax cuts to produce enough income to pay new employees.** Only 13 percent of small businesses have $50,000 or more in taxable income in a given year. The rest make less than that or lose money. State income tax rates on income at this level already are so low, typically no more than 6 percent, or just a few thousand dollars for most of them, that even *eliminating* the personal income tax would generate negligible additional cash flow for the average small business — not nearly enough to pay one full-time worker's salary. 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.

- **Most small business owners are not significant "job creators" and have no plans to be.** Only 11 percent of taxpayers reporting business income own a bona fide small business with employees other than the owner(s). Even among recipients of business income who *are* true small business owners, most will not create jobs in response to a small increase in their after-tax incomes resulting from a state income tax cut. Most small business owners do not have the goal of expanding their business, according to a recent survey. This group includes self-employed skilled tradesmen, lawyers, accountants, real estate agents, consultants, and others with no need or desire to employ anyone else other than perhaps an office administrator. Many others are passive investors who do not have the authority to hire additional workers. Still others (like owners of restaurants, bars, and beauty shops) might have some employees, but the business serves a highly local market for an existing good or service; any job growth these firms experience is likely to come at the expense of jobs at competitor firms.

- **Small businesses hire employees based on product demand, not tax levels.** Big or small, businesses typically hire when demand for what they make or sell exceeds what the existing workforce can produce. Savings from a state income tax cut matters very little to hiring decisions — businesses are likely to hire when demand increases, and not hire when demand is flat or declining, regardless of tax rates. Employee wages are fully deductible in calculating state income tax liability, so the presence of taxes is not likely to discourage hiring.

- **Careful economic studies issued by organizations across the political spectrum show that there is just no relationship between state personal income tax levels and the decisions of people in a state to start a business and of would-be entrepreneurs to move to the state.** A rigorous 2012 study commissioned by the U.S. Small Business Administration found "no evidence of an economically significant effect of state tax portfolios on

entrepreneurial activity."[1] In fact, considerable research shows that many entrepreneurial firms spin off from or otherwise "cluster" in geographic areas where other firms in the industry have concentrated. It is highly unlikely that the meager tax savings arising from state personal income tax cuts would overcome the benefits of locating near other firms in the same industry.

There are better alternatives than tax cuts to help small businesses succeed, such as specially-tailored worker training, making it easier for entrepreneurs to turn the findings of state university research into commercially-viable goods and services, and providing strategic advice. These more direct approaches offer a much bigger "bang for the buck" than personal income tax cuts. States also can broadly promote long-term economic growth by investing in strong schools, cutting-edge research universities, modern transportation and broadband networks, efficient court systems, and other fundamental public services that reduce business expenses and improve the local quality of life. By reducing revenue, personal income tax cuts make it harder for states to invest in these and other public services that form the foundation of future economic growth. So personal income tax cuts not only don't help small businesses to grow but they can end up being counterproductive.

Few People Who Pay Income Taxes Own Small Businesses, and Few of Those Who Do Are Likely to Create Many Jobs

The first hole in the argument for creating small business jobs by cutting state personal income taxes has to do with who actually owns small businesses, what these business owners' goals are, and which small businesses actually have significant job creation potential. The facts are as follows:

- **Only a small fraction of taxpayers own small businesses**. Slightly less than one-fourth of the 143 million personal income tax returns Americans filed in 2007 reported any type of income from a business, according to a 2011 Treasury Department study. More importantly, only about one-seventh of all individual taxpayers were owners of *active, small* businesses.[2] (The Treasury study defines a bona fide small business as one with between $10,000 and $10 million in receipts and at least $5,000 in business-related deductions.)[3] Accordingly, under an *across-the-board* state income tax cut the vast majority of savings will flow to wage and salary earners and recipients of dividends, interest, and other types of income with no relationship to small business operations. Moreover, most of the tax savings will flow to the affluent. For example, 43 percent of the tax savings that would be provided by Ohio Governor Kasich's proposal to

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[1] Donald Bruce and John Deskins, "Can State Tax Policies Be Used to Promote Entrepreneurial Activity?," *Small Business Economics*, 2012.

[2] Matthew Knittel, Susan Nelson, Jason DeBacker, John Kitchen, James Pearce, and Richard Prisinzano, "Methodology to Identify Small Businesses and Their Owners," Office of Tax Analysis, U.S. Department of Treasury, August 2011, Table 14; http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2011-04-Small-Business-Methodology-Aug-8-2011.pdf. (Hereafter referred to as "Treasury study.") 24.3 percent of all individual returns reported some amount of small business income; this figure does not include dividends from investments in the stock of taxable corporations. 14.0 percent of all returns reported income from an active small business.

[3] The Treasury study used a variety of criteria to screen out from the count of small businesses those that consist of an individual providing employee-like services to a single company, people renting out a residence or farmland with no active management of the property, or business entities used to enable multiple individuals to pool their assets for passive investment in other companies. (The actual screening criteria used in the Treasury study are somewhat more detailed than just described.)

cut each of the state's current income tax rates by 20 percent would flow to the richest one percent of the state's taxpayers, while only 13 percent would flow to the bottom 60 percent of taxpayers.[4]

- **Most small businesses earn such modest profits that cutting state income taxes on those profits puts little additional cash in their coffers**. The taxable income of small businesses is $20,700 for the average sole proprietorship, $48,700 for the average S-corporation, and $74,800 for the average partnership/limited liability company (LLC), according to Treasury.[5] (See the Appendix for a brief description of the similarities and differences between these types of small businesses.) Just 13 percent of small businesses make $50,000 or more in a given year; the rest make less than that or lose money.[6] With state income tax rates in even the highest income brackets rarely exceeding 10 percent, and more typically around 4-6 percent for those with incomes of $50,000 or below, the owners of the average small business are paying relatively little state personal income tax on profits to begin with — at most a few thousand dollars per year. Accordingly, even *eliminating* state taxation of that income would generate very little additional cash flow for the average small business — certainly not anywhere enough to pay the salary of even one full-time worker.

- **Even state personal income tax cuts that were limited to small business owners would have little job creation "bang for the buck."** The Treasury study found that of taxpayers reporting any business income only 11 percent — or 2.7 percent of *all* income taxpayers — own a bona fide small business with any employees other than the owner(s).[7] Even this overstates the likelihood of small businesses having employees in a meaningful sense since the Treasury study deemed a small business to be an "employer" if it had just $10,000 in payroll expenses. In addition, a substantial share of this 2.7 percent represents passive investors in partnerships, LLCs, and S-corporations who have no authority to hire additional workers. Overall, fewer than one in four owners of partnerships, LLCs, and S-corporations own *small* businesses *with* employees *and* have an active role in managing the business.[8]

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[4] Analysis by the Institute for Taxation and Economic Policy for Policy Matters Ohio, "Kasich Tax Proposal Would Further Tilt Tax System in Favor of Ohio's Affluent," February 2013; http://www.policymattersohio.org/wp-content/uploads/2013/02/TaxCuts_Feb20132.pdf.

[5] Treasury study, Table 4.

[6] Treasury study, Table 6.

[7] Treasury study, Table 15.

[8] Treasury study, Table 13. Many partners, stockholders in S-corporations, and members of LLCs either: a) own businesses that do not engage in sufficient activity to be considered a bona fide business; b) own large businesses, not small businesses; b) own businesses that do not employ anyone other than themselves; c) are owners of businesses that are entirely engaged in passive investing in other businesses; or d) are themselves mere passive investors in the businesses they own with no operational role and no authority to hire people, i.e., "create jobs." According to the Treasury study, 78 percent of taxpayers reporting partnership, LLC, or S-corporation income fall into one of these four categories, meaning that only 22 percent potentially have any hiring authority in small businesses that currently have (non-owner) employees.

Table 1			
Income from Ownership of Small Businesses with Employees Is a Small Share of Total Income Even in the Highest Income Brackets			
Adjusted Gross Income Class	**Total AGI**	**Total Income from Small Businesses with Employees**	**Income from Small Businesses with Employees as Share of Total AGI**
$0-$50,000	$1.9 trillion	$7 billion	0.4%
$50,000-$100,000	$2.2 trillion	$17 billion	0.8%
$100,000-$200,000	$1.8 trillion	$37 billion	2.1%
$200,000-$500,000	$1.0 trillion	$68 billion	6.8%
$500,000-$1 million	$0.4 trillion	$37 billion	8.4%
Over $1 million	$1.4 trillion	$35 billion	2.5%
All AGI classes combined	$8.7 trillion	$201 billion	2.3%
All AGI classes above $100,000 combined	$4.6 trillion	$177 billion	3.8%

Source: Treasury study, Tables 14 and 15

- **State personal income tax cuts for the highest tax brackets are poorly targeted to "job creators."** Some proponents of economic development-oriented tax cuts propose limiting them to taxpayers in the highest tax bracket(s) on the theory that this is where the "job creators" can be found. While small business income accounts for a slightly large share of total income in higher income brackets than it does in lower income brackets, it is still quite modest even in the highest brackets. Table 1 shows that even for taxpayers with federal Adjusted Gross Income (AGI) between $500,000 and $1 million, profit attributable to ownership of small businesses that employ people other than the owners is just 8.4 percent of total AGI. For taxpayers with AGI in excess of $1 million, it drops sharply to just 2.5 percent of AGI (capital gains, dividends, and interest are much more important sources of income for people in this income range). A Congressional Research Service study further points out that "there is no evidence that businesses owned by high-income [taxpayers] have more employees than those owned by lower income [taxpayers]."[9]

  In half the states with personal income taxes, the top tax rate is reached at taxable income levels below $50,000.[10] In such a state, cuts in the top rate are an even more inefficient way to provide tax reductions to small business owners that employ people. Nationally, small business income from employer firms represents just 3.8 percent of total AGI for taxpayers with AGI above $100,000 (which should roughly correspond to taxable income above $50,000, once deductions and exemptions are factored in). (See Table 1.)

[9] Jane G. Gravelle and Sean Lowery, "Small Business and the Expiration of the 2001 Tax Rate Reductions: Economic Issues," August 1, 2012, p. 7.

[10] Table of state personal income tax rates compiled by the Federation of Tax Administrators; available at http://www.taxadmin.org/fta/rate/ind_inc.pdf.

- **Most small business owners are not looking to expand**. A recent survey of small business owners found:

> [T]he vast majority of small business owners do not expect to grow, report not wanting to grow, never expect to innovate . . . and report not wanting to innovate . . . . [T]he most common response for why individuals were starting their business was the existence of non pecuniary benefits. Individuals reported that they liked being their own boss and like the flexibility that small business ownership provided.[11]

  This finding is consistent with the Treasury study cited above. Many small business owners are self-employed skilled tradespersons, lawyers, accountants, real estate agents, consultants, and others with no need or desire to employ anyone else other than perhaps an office administrator.[12] Other small businesses (like restaurants, bars, and beauty shops) may have some employees, but they are principally involved in serving a local market for an existing good or service, not attempting to innovate.[13] Even if the owners of such a business should decide to expand and succeed in doing so, the business likely will only displace less-efficient local competitors, resulting in no net job creation.

- **While innovative start-up firms account for most small business job creation, personal income tax cuts are unlikely to benefit many of them**. The focus on providing personal income tax cuts to small business owners to encourage job creation is based on a longstanding belief that small businesses are responsible for all or nearly all net job creation in the U.S. economy. But a recent study by economists from the U.S. Census Bureau and the University of Maryland convincingly refutes that proposition.[14] It found that a minority of start-up businesses, which almost by definition have relatively few employees at inception, break out of the pack with an innovative new service or product and grow very rapidly with respect to both sales and employees. Such startups account for only 3 percent of employment but almost 20 percent of gross job creation, the report found. But, it added, "Our findings suggest that policies targeting firms based on size without taking account of the role of firm age are unlikely to have the desired impact on overall job creation." State personal income tax cuts are unlikely

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[11] Erik Hurst and Benjamin Wild Pugsley (University of Chicago), "What Do Small Businesses Do?" August 2011.

[12] To be sure, self-employed workers are an important part of the U.S. economy. According to the Treasury study (Table 8), in 2007 there were 19 million bona fide small businesses that were such "non-employer" firms.

Nonetheless, state tax bases are finite and are called on to finance a wide array of critical services. Hard questions need to be asked about whether states should devote the limited resources they have available for economic development to encouraging the creation of businesses that are unlikely ever to employ anyone other than one or two owners — particularly when the mechanism is as poorly targeted as state income tax cuts are. In any case, those who propose state personal income tax cuts in the name of job creation do not profess that their goal is the creation of a lot of small "mom and pop" businesses. To the contrary, they give every indication of being focused on attracting or incentivizing the creation of the next Facebook or Amazon, that is, firms that develop an innovative product, service, or business model, grow rapidly, and create a large number of jobs.

[13] "Only 10 percent of all new businesses reported that they plan to develop proprietary technology, processes, or procedures in the future." "Nearly 80 percent of all new businesses report that they have no plans for research and development to be a majority priority for the business when they are establishing the business." "What Do Small Businesses Do?" p. 25.

[14] John Haltiwanger, Ron S. Jarmin, and Javier Miranda, "Who Creates Jobs? Small vs. Large vs. Young," August 2011; http://econweb.umd.edu/~haltiwan/size_age_paper_R%26R_Aug_16_2011.pdf.

to help many of the rapidly-growing start-up firms most likely to quickly create large number of jobs because these firms spend so heavily on new equipment, product development, and marketing that they have relatively little taxable profit in their early years.[15] (As discussed below, however, there are a number of targeted steps states can take to help these businesses.)

Claims Often Rely on Flawed Economic Analysis

As discussed above, state income tax cuts for high-income people, even if limited to recipients of "small business income," for the most part won't wind up in the pockets of those small businesses most likely to create jobs. But leaving that aside, the claim that cutting income taxes for small business owners will encourage them to expand and hire additional employees often relies on flawed economic analysis and a misunderstanding of the major growth barriers confronting small businesses. There are a number of reasons *not* to expect state personal income tax cuts to stimulate significant small business job creation:

- **Demand for a business' products — not taxes — is the primary driver of hiring.** As the non-partisan Congressional Budget Office has observed with respect to *federal* tax cuts for businesses: "[I]ncreasing the after-tax income of businesses typically does not create much incentive for them to hire more workers in order to produce more, because production depends principally on their ability to sell their products."[16]

- **The cash-flow effects of business tax cuts cannot create *net new* jobs.** Proponents of state personal income tax cuts often argue that doing so will create jobs simply because it leaves more money in the hands of small business owners they can use to hire additional employees or "put back into the economy" through purchases that enable their *suppliers* to hire more workers.[17]

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[15] A recent study found that start-up firms receiving venture capital investments are likely to grow much more rapidly and ultimately create a much larger number of jobs than similar firms not obtaining venture capital. The study found that fully 47 percent of firms receiving such investments had no *revenue* in their first year of operation, let alone any *profit*. Moreover, for the firms that were profitable, the profitability dropped sharply after the venture capital investment as the firms use the money to hire more higher salary employees and to grow rapidly. It took an average of nine years for the rate of profit of venture-capital financed startups to equal the rate of profit of start-ups that did not obtain venture capital investments. Manju Puri and Rebecca Zarutskie, "On the Lifecycle Dynamics of Venture-Capital- and Non-Venture-Capital-Financed Firms," National Bureau of Economic Research Working Paper 14250, August 2008.

A second study found that "while investing in the development of intellectual property (specifically, patents) in young ventures allows them to grow their *sales*, this growth is *not profitable* (at least in the short run)." Maija Renko, "Innovations and the Performance of New Ventures: Evidence from the Kauffman Firm Survey," unpublished, 2011; http://www.icsb.org/assets/icsbgw_renko_fullpaper.pdf. Emphasis added.

[16] Douglas Elmendorf, Director, Congressional Budget Office, "Policies for Increasing Economic Growth and Employment in 2012, and 2013," Testimony to the Senate Budget Committee, November 15, 2011; http://www.cbo.gov/sites/default/files/cbofiles/attachments/11-15-Outlook_Stimulus_Testimony.pdf.

[17] This same argument is made to justify cuts in state *corporate* income taxes, and it is wrong for the same reason discussed here. See: Michael Mazerov, "Cutting State Corporate Income Taxes Is Unlikely to Create Many Jobs," Center on Budget and Policy Priorities, September 14, 2010; http://www.cbpp.org/files/9-14-10sfp.pdf.

This is wrong, because it ignores the fact that states must balance their budgets by law. Accordingly, every dollar states lose in revenue by cutting income taxes for small businesses is a dollar less that someone else has in *their* pockets. That "someone else" is one of three types of people. It is another taxpayer whose taxes had to go up to offset the tax cut for the small business. Or it is the recipient of a payment from the state that had to be reduced or eliminated because the state had less money to spend, such as someone who works for a private company that builds roads for the state under contract. Or it is a state employee whose wages, benefits, or hours were reduced for the same reason.

Tax revenue does not sit in government coffers. It is spent, and that spending creates jobs — in both the public and private sectors. States can alter the balance between public sector and private sector job creation by cutting taxes, but merely altering who receives the money cannot by itself create additional jobs.

- **Increasing small business cash flow through tax cuts does not stimulate significant small business hiring.** Leaving aside the fact that the cash-flow effects of income tax cuts for small businesses cannot create *net new* jobs because of state balanced-budget requirements, such tax cuts are unlikely to promote the creation of new private sector jobs by small businesses, either. First, as noted above, the average small business has relatively little profit and pays relatively little state income tax on it, so even eliminating the tax generates only a modest amount of additional cash.[18] Second, and conversely, small businesses do not need to rely on internal cash flow to finance expansion. Although they do face greater barriers than large businesses do in obtaining loans, if they can demonstrate that expansion will be profitable, they can obtain funds from banks (perhaps with a Small Business Administration loan guarantee), credit unions, city-run revolving loan funds, and other types of community development financial institutions. Indeed, there is strong evidence that few small businesses actually grow enough to generate a significant amount of new employment if they do not receive outside financing, especially equity financing from venture capital investors.[19]

- **State personal income taxes are not a bar to hiring because employee wages are already fully deductible.**[20] Business decisions as to whether to hire additional workers only depend on

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[18] Moreover, any state tax savings resulting from a cut in the state personal income tax rate(s) applicable to small business profits is likely to be significantly offset by higher taxation of the same profit by the federal government and other states.

First, since state personal income taxes are deductible in calculating federal income tax liability, lower state tax liability results in higher federal liability. This effect can eliminate up to one-third of any tax savings a cut in the state rate would otherwise provide to a small business.

Second, if a state exempts or cuts the tax rate on small business income, much of the intended tax savings will result in higher tax liability in *other* states. Any income of a pass-through business that is received by out-of-state owners is also potentially taxable by the states in which *they* reside. Such states give a dollar-for-dollar credit against their taxes for any income taxes imposed by the state in which the business operates. But if that state exempts or cuts taxes on that income, other state(s) in which the owners reside will grant smaller credits and thus tax more of the income themselves. Once again, cutting or eliminating state personal income taxes on small business owners proves itself to be an extremely inefficient means of assisting them.

[19] Manju Puri and Rebecca Zarutskie, "On the Lifecycle Dynamics of Venture-Capital- and Non-Venture-Capital-Financed Firms," National Bureau of Economic Research Working Paper 14250, August 2008, Figure 2a.

[20] "[T]here is no direct effect on the incentive to hire workers from changes in the owner's tax rate . . ." "Because the costs of labor are deductible, tax rates would matter only if the employer expanded the scope of *his* efforts or investment

whether the value of the additional output the workers produce exceeds the cost of employing them, that is, whether hiring them is profitable. There is no additional income tax liability for the owner associated with hiring additional employees.

- **Lower income taxes are not an effective work incentive for small business owners; they are just as likely to lead small business owners themselves to work *fewer* hours as they are to encourage longer hours, with no clear effect on job creation.** Most small business owners work in their businesses in addition to investing capital in them. Reducing state income taxes might induce some owners to work more hours, and if they do, they may need to hire additional employees to help. But economists have long understood that cuts in income tax rates can just as easily lead business owners to work *less*, because with the lower tax rates it takes fewer hours of work to achieve a desired standard of living.[21] In fact, considerable research shows that income tax cuts only encourage additional work hours to a very limit degree, with the effect *decreasing* steadily as income rises and becoming negligible at the highest income levels.[22] Accordingly, state personal income tax cuts for small business owners are unlikely to stimulate the creation of many additional jobs for employees.

- **Cutting state income taxes will not stimulate significant additional small business investment, but even if it did that wouldn't necessarily create jobs**. The claim that cutting income taxes will inevitably stimulate small business investment is as flawed as the argument that it will necessarily increase the owner's work hours. An owner might just as easily choose to spend the tax savings on personal consumption as plow it back into the business. Moreover, more investment does not necessarily mean more jobs; it could result in substituting computers and machinery for workers. Finally, it is worth noting that the federal government and most states *already* provide a very strong tax incentive for small business investments in new equipment by conforming to Section 179 of the federal Internal Revenue Code. Section 179 allows small businesses to deduct the entire cost of up to $125,000 in equipment in the year in which it is purchased rather than deducting it gradually ("depreciating" it) over the useful life of the investment. Given the major tax savings on both federal and state tax returns that Section 179 provides to small businesses investing in capital equipment, it is unlikely that cuts in state personal income tax rates would give much of an additional boost.

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to increase the size of the firm." [Emphasis added.] Jane G. Gravelle and Sean Lowry, "Small Business and the Expiration of the 2001 Tax Rate Reductions: Economic Issues," Congressional Research Service, August 1, 2012, pp. 13-14. These quotes are taken from an analysis of the implications of *federal* personal income taxes for small business hiring decisions, but they apply equally to *state* personal income taxes.

[21] This research is summarized in Chye-Ching Huang, "Recent Studies Find Raising Taxes on High-Income Households Would Not Harm the Economy," Center on Budget and Policy Priorities, April 24, 2012, p. 7 (and associated endnotes); http://www.cbpp.org/files/4-24-12tax.pdf.

[22] CBO reports the total wage elasticity assumed for various income classes, with total wage elasticity being the percentage change in hours worked that would result from a 1 percent increase in both after-tax income and the after-tax wage rate. The total wage elasticities decline steadily as income increases: for the lowest decile, 0.168; for the second decile, 0.126; for the third and fourth deciles, 0.084; for the fifth and sixth deciles, 0.063; and for the top four deciles 0.028. (The study on which these estimates are based does not disaggregate the elasticities for the top four deciles.) "The Effect of Tax Changes on Labor Supply in CBO's Microsimulation Tax Model," Congressional Research Service Background Paper, April 2007, http://www.cbo.gov/ftpdocs/79xx/doc7996/04-12-LaborSupply.pdf.

State Personal Income Taxes Have Almost No Relationship to Small Business Growth, Studies Show

The preceding sections have laid out a number of reasons why one would not expect to see much impact on small business job creation from cuts in state personal income taxes. This conclusion is reinforced by empirical research on the correlation between differences in personal income tax levels from state to state and the growth of small businesses.

U.S. Small Business Administration, 2012: States with High Personal Income Taxes Create Just as Many Small Businesses as Other States

The major study on the relationship between state personal income tax policy and entrepreneurship was commissioned by the U.S. Small Business Administration and published in final form in early 2012.[23] Economists Donald Bruce of the University of Tennessee and John Deskins of Creighton University examined four measures of the states' relative success in giving birth to and sustaining small businesses: the share of all federal tax returns filed in each state that reported any income from a sole proprietorship, each state's share of the national total of such tax returns, the share of workers in each state employed as sole proprietors or active owners of a partnership (as estimated by the Commerce Department), and each state's share of the national total of proprietors/partners. They examined the correlations between these measurements and state personal and corporate income tax policies for all 50 states between 1989 and 2002.

The study found that:

- Higher top personal income tax rates in a state had no statistically-significant impact on the share of all taxpayers in the state that were employed in a small business they owned.

- To the extent that higher top personal income tax rates could be said to reduce an individual state's share of the total number of U.S. taxpayers engaged in their own small business, the magnitude of the impact was exceedingly small: a one-percentage point increase in the top personal income tax rate in a state, with all other states' tax rates remaining unchanged, would reduce a state's share of national small business self-employment by *less than two one-hundredths of a percentage point*.

- Having a progressive state personal income tax rate structure in which the tax rates rises as income rises, did not reduce the share of taxpayers engaged in a small business. Indeed, it had a small positive impact. Nor did such a tax structure have a statistically-significant impact on an individual state's share of total U.S. self-employment in a small business.

- The share of total state tax collections provided by the personal income tax did not have a statistically-significant effect on three of the four measures of small business self-employment, and was of very small magnitude and borderline statistical significance for the fourth. Effective state personal income tax rates did not have a statistically-significant effect either under standard tests.

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[23] Donald Bruce and John Deskins, "Can State Tax Policies Be Used to Promote Entrepreneurial Activity?" *Small Business Economics*, 2012.

In summarizing their findings, the economists stated: "We find no evidence of an economically significant effect of state tax [policy] portfolios on entrepreneurial activity. . ."

Kauffman Foundation, 2012: State Personal Income Taxes Don't Predict Where Fast-growing Startups Are Located

A September 2012 study by scholars at the Ewing Marion Kauffman Foundation — the leading think tank conducting research on entrepreneurship — found that the number of *Inc.* [magazine] *500* firms based in the state per one million state residents did not have a statistically significant correlation with the state's ranking in the Tax Foundation's "State Business Tax Climate Index," which includes a number of measures of state personal income tax levels and progressivity (along with other business tax liability measures, such as state corporate income tax rates).

The authors observed: "While a number of organizations claim that lower taxes are better for new firm creation and innovation, we do not see any connections between *Inc.* firms and scores provided by the Tax Foundation."[24] The study examined the correlation between a variety of state characteristics and policy choices and the state's success in playing host to the fastest growing start-up businesses listed in the *Inc. 500*.

Garrett/Wall, 2006: Personal Income Tax Rates Don't Affect States' Rates of Self-employment

A 2006 study published in the journal of the libertarian Cato Institute reached the same conclusion as the Bruce/Deskins paper. It did not find a statistically significant correlation between top personal income tax rates (state and federal combined) and the share of state residents employed in their own businesses (sole proprietorships and partnerships). The authors also noted:

> [E]ven if these effects . . . [had been] statistically significant, they would have had very little economic significance. The highest and lowest rates of entrepreneurship along the curve differ by only about 0.08 percentage points. This failure to find a relationship between the rate of personal income tax and state-level entrepreneurship is consistent with Bruce, Deskins, and Mohsin (2004).[25] [The latter paper is a preliminary draft of the Bruce/Deskins paper discussed above.]

Bartik, 1989: High Personal Income Tax Rates Don't Affect Manufacturing Start-ups

Finally, a much earlier study by economist Timothy Bartik found that interstate differences in combined state/federal personal income tax levels did not have a statistically-significant impact on start-up rates of small manufacturing businesses in the late 1970s and early 1980s. [26]

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[24] Yasuyuki Motoyama and Brian Danley, "An Analysis of the Geography of Entrepreneurship: Understanding the Geographic Trends of Inc. 500 Companies Over Thirty Years at the State and Metropolitan Levels," Ewing Marion Kauffman Foundation, September 2012, p. 22; http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID2145480_code861608.pdf?abstractid=2145480&mirid=1.

[25] Thomas A Garrett and Howard J. Wall, "Creating a Policy Environment for Entrepreneurs," *Cato Journal*, Fall 2006; http://www.cato.org/sites/cato.org/files/serials/files/cato-journal/2006/11/cj26n3-7.pdf.

[26] Timothy J. Bartik, "Small Business Start-Ups in the United States: Estimated of the Effects of Characteristics of States," *Southern Economic Journal*, April 1989. Consistent with the discussion below of the importance to entrepreneurial

Research Shows That State Income Tax Cuts Are Unlikely to Attract Entrepreneurs from Other States

It is clear that state income tax cuts will not provide significant incentives for existing small businesses to hire additional employees or for people to start businesses they wouldn't otherwise start. But could such cuts attract from *other* states existing small businesses or entrepreneurs seriously contemplating new ventures?

The research strongly shows that nascent entrepreneurs are not particularly mobile. Rather, they tend to create their businesses where they *are*; where they are familiar with local market conditions and have ties to local sources of finance, key employees, and other essential business inputs.[27] Given this reality, cutting state personal income taxes is unlikely to be an effective way to attract entrepreneurial businesses with rapid growth potential to a state.

The following is a summary of the relevant research:

- A 2007 study by economists Claudio Michelacci and Olmo Silva noted that "Entrepreneurship can be either nurtured locally or attracted. . . and, in principal, both sources of entrepreneurial activity can contribute to. . . growth. . . . [W]e show that new businesses are mainly created by local entrepreneurs. . . ." The study examined data on the location of entrepreneurs in both the United States and Italy and found that in both countries "the fraction of entrepreneurs who start up businesses in the region where they were born is significantly higher than the corresponding fraction for dependent workers [that is, employees]."[28] Data for the United States indicated that "entrepreneurs are about 4.5% less mobile than dependent workers." The authors concluded that "Overall, our analysis suggests that entrepreneurship can hardly be regarded as a mobile factor of production. . ." Michelacci/Silva "found that firms created by locals are, on average, more valuable and bigger (in terms of capital and employment), operate with more capital-intensive technologies, and are able to obtain greater [outside] financing per unit of capital invested than firms created by nonlocals. . . . Local individuals have privileged access to financing in the region where they were born."

- A 2008 study by economist Jerry Parwada examined the business location choices of 358 business executives who left existing U.S. mutual fund firms between 1988 and 2003 in order to

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businesses of high-quality public services, this study found a positive relationship between manufacturing start-ups and both state per-pupil spending on K-12 education and the density of state highway networks.

[27] As economists Michael S. Dahl and Olav Sorenson observe:

> "[E]ntrepreneurs cannot easily transplant their social capital. The relationships that can help them to spot opportunities and to assemble the resources necessary for an organization to exploit those opportunities are concentrated in the regions in which they have lived and worked. . . . the potential financiers and employees they might know also tend to reside in those same regions. . . As a result, entrepreneurs should benefit from locating their businesses in the (home) regions in which they have deep social roots, and therefore should tend to open operations in these locations."

Michael S. Dahl and Olav Sorenson, "Home Sweet Home: Entrepreneurs' Location Choices and the Performance of Their Ventures," *Management Science*, June 2012.

[28] Claudio Michelacci and Olmo Silva, "Why So Many Local Entrepreneurs?" *Review of Economics and Statistics*, November 2007.

start their own investment funds. He found that 68 percent of these managers located their new firms in the same county as their old employer and fully 56 percent located the business within one mile of the old firm. He observed: "These statistics suggest that most entrepreneurial fund managers are constrained to their original location by such considerations as the need to perpetuate professional, social, and family networks, and relocation costs. . . . I confirm that the area of origin indeed heavily conditions where founders locate."[29]

- A 2009 Kauffman Foundation study of 25,800 active companies founded by graduates of the Massachusetts Institute of Technology found that although less than 10 percent of MIT graduates grew up in Massachusetts, fully 31 percent of the companies they founded are headquartered there.[30]

- A 2011 study of the Pennsylvania businesses that grew fastest in the 2004-2009 period found that the number that were founded in Pennsylvania during that period was more than 20 times larger than the number that moved into the state (680 versus 28).[31]

- A 2005 study looked at the location decisions of 282 entrepreneurs who had been professors or researchers at U.S. universities or research institutes and left them to start biotechnology companies. It found that almost two-thirds of them started the companies in the same state in which they had previously worked. The share was even higher — 82 percent — in the relatively high-tax state of California. Moreover, nearly half of the people who did change states before starting their companies moved *into* California.[32]

Geographic Clustering Drives Entrepreneurs' Location Decisions

Any claim that nascent entrepreneurs are likely to be attracted to a state because it cuts its personal income tax not only is not supported by the existing research on the mobility of entrepreneurs themselves, but it flies in the face of an enormous body of research highlighting the emergence of geographic "clusters" of start-up businesses in places like Silicon Valley and the Research Triangle area of North Carolina. As a recent Harvard Business School analysis points out:

> [S]ince most entrepreneurs leave existing businesses to start new firms, often in industries where they have developed expertise, clusters tend to persist around already-strong

[29] Jerry T. Parwada, "The Genesis of Home Bias? The Location and Portfolio Choices of Investment Company Start-Ups," *Journal of Financial and Quantitative Analysis*, March 2008.

[30] Edward B. Roberts and Charles Eesley, "Entrepreneurial Impact: The Role of MIT," Ewing Marion Kauffman Foundation, February 2009; cited in Erin Sparks and Mary Jo Waits, "Growing State Economies: Twelve Actions," National Governors Association Center for Best Practices, 2012; http://www.nga.org/files/live/sites/NGA/files/pdf/11HEINEMAN12ACTIONS.PDF.

[31] Gary Kunkle, "Pennsylvania's High-Growth Companies, 2004-2009," Team Pennsylvania Foundation, May 2011; http://teampa.com/wp-content/uploads/2011/06/Team-PA-Higro-Research-Update.pdf.

[32] Junfu Zhang and Nikesth Patel, "The Dynamics of California's Biotechnology Industry," Public Policy Institute of California, 2005, pp. 69-71; http://www.ppic.org/content/pubs/report/R_405JZR.pdf.

> industrial bases. In fact, existing industry composition and city population can account for over 80% of the geographic variation in start-up activity across a country.[33]

The report describes the critical importance of start-up businesses being able to access a broad pool of specialized labor force skills, business infrastructure (such as law firms with expertise in the legal issues confronting particular industries), and venture capital in an existing industry cluster location. These benefits are potentially so valuable to the start-up that it is highly unlikely an entrepreneur would forgo them to take advantage of lower state personal income taxes elsewhere — especially when the likelihood of making enough profit to owe significant taxes is far off. This point is well-illustrated by the location in relatively high-tax California of Google and Facebook, two of the fastest-growing start-ups of the past two decades.

State Income Tax Cuts Risk Erosion of Public Services Important to Small Businesses

As compelling as the arguments are that show why state personal tax cuts will not promote small business growth, there is an equally strong argument that what little growth conceivably might be attributed to tax cuts would come at an unacceptably high cost.

States have to balance their budgets from year to year. When they cut taxes — especially given that such tax cuts do not create jobs and spur new tax revenue — the money has to come from someplace. That "someplace" — unless other taxes are raised — is likely to be state support in areas crucial to businesses, particularly K-12 schools and higher education.

As a recent report by the National Governors Association observed:

> States that have a higher average level of education tend to have greater levels of economic success. . . Highly educated persons are disproportionately likely to start successful high-growth firms and to develop new ideas that are economically valuable. . . Science and technology firms are even more likely to be started by well-educated founders. . .[34]

In addition, high-quality services are important to making a state a place where highly-skilled people want to live. A growing body of research finds that young professionals and other members of what has become known as the "creative class" increasingly choose where to live based on lifestyle considerations like the availability of cultural amenities, good schools for their children, efficient transportation networks that minimize commuting times, and up-to-date recreational facilities.[35] Not only are members of this group responsible for starting many fast-growing, entrepreneurial businesses, but businesses in more traditional industries are being attracted to cities

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[33] William R. Kerr and Ramana Nanda, "Location Choice for New Ventures: Cities," Harvard Business School case 9-811-106, revised February 23, 2012.

[34] Joe Cortright and Mary Jo Waits, "Growing State Economies: A Policy Framework," National Governors Association, July 2012, pp. 12-13; http://www.nga.org/files/live/sites/NGA/files/pdf/11HEINEMANFRAMEWORK.PDF.

[35] See, for example, Richard Florida, *The Rise of the Creative Class* (2002); Timothy R. Wojan and David A. McGranahan, "Ambient Returns: Creative Capital's Contribution to Local Manufacturing Competitiveness," *Agricultural and Resource Economics Review*, April 2007.

where a younger, highly-educated workforce is increasingly choosing to live. As one recent review of factors contributing to local economic growth observed:

> With human capital becoming an increasingly strong determinant of economic competitiveness, those areas that have or are better able to attract a more highly educated and trained labor force may have a competitive advantage for economic activities requiring more highly skilled labor. Amenities and quality of life are important because there is increasing evidence that highly educated people who are residentially mobile and have a variety of job options favor areas with a high quality of life. In short, the conventional assumption that people follow jobs may in some cases be turned around. For certain kinds of jobs that require high levels of education and for which there is a national demand, jobs may follow people; firms may locate disproportionately in areas where desired amenities are present to gain access to the educated labor force that has chosen to locate there.[36]

Making up on average more than one third of all state tax collections, personal income taxes play a critical rule in financing education, public safety, parks, road maintenance, and other services and facilities that both benefit businesses directly and contribute to a high quality of life that attracts well-educated employees. Deep cuts in personal income taxes threaten states' ability to finance these services, which would in turn likely be counterproductive to economic development and job creation.

While it could be argued that many *large* corporations can overcome the erosion of state support in important areas — for example, hiring private security forces to offset cuts in police protection — *small* businesses lack the resources or scale to do so.

How States Can Help Small Businesses Emerge, Thrive and Create Jobs

"First, do no harm" is a preeminent principle of medicine, and it arguably should apply as well to any action aimed at solving a perceived problem. If the potential benefits of a proposed intervention appear to be small or highly uncertain, and if there is a significant risk of making the problem worse, then the action should not be taken.

Substantial evidence shows that cutting state personal income taxes is not the solution to what is viewed as insufficient job creation by small businesses. Further, the lost revenue from such tax cuts is likely to result in deterioration of public services and infrastructure that are crucial to the success of large and small businesses alike. In short, cutting state income taxes in the name of boosting small business job creation and entrepreneurship represents a quintessential violation of the "first, do no harm" principle.

That does not mean state policymakers are powerless to help small businesses emerge, thrive, and create jobs, however. The most important contribution they can make to achieving these objectives

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[36] Hal Woman, Alice Levy, Garry Young, and Pamela Blumenthal (George Washington University), "Economic Competitiveness and the Determinants of Sub-National Area Economic Growth," report for the Office of Revenue Analysis, District of Columbia Office of the Chief Financial Officer, September 30, 2008, p. 41; http://www.gwu.edu/~gwipp/Competitiveness%20lit%20rev%20final%20word.pdf.

is doing the best job possible of providing state and local government services that have a significant impact on the vitality of small businesses. This includes high-quality education at all levels, reliable physical infrastructure like roads, bridges, public transit and water and sewer systems, effective police and fire protection, and rational land use planning, zoning, construction permitting, and occupational licensing. Even services that might not at first appear to affect businesses directly, such as parks and public sponsorship of cultural events, can greatly affect how attractive a location is to the people small businesses need as employees and customers.

In addition, two recent reports set forth some promising options for more direct ways that state and local government can promote the birth and growth of innovative, start-up businesses:

- A 2012 report by the National Governors Association, "Growing State Economies: Twelve Actions," discusses what the authors view as successful models for academic education in entrepreneurship, state promotion of industrial clusters, identification of small- and medium-sized businesses with high growth potential, facilitating commercialization of state university research, and programs to match entrepreneurs with mentors.[37]

- A January 2012 report from the Ewing Marion Kauffman Foundation, "Startup Act for the States," is more focused on steps states can take to create a more conducive overall environment for entrepreneurship.[38] It includes encouraging state universities to develop simple, standardizing licensing agreements for university-developed technologies, creating health insurance plans tailored to the needs of entrepreneurial businesses under the state insurance exchanges to be set up under the Affordable Care Act, and working with local governments to relax zoning restrictions on home-based businesses.

It is worth noting that neither report advocates state personal income tax cuts as an entrepreneurship-promotion policy.[39] Moreover, these kinds of targeted programs and reforms can be implemented at a fraction of the cost of broad personal income tax cuts and scaled up as state financial resources permit.

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[37] Erin Sparks and Mary Jo Waits, "Growing State Economies: Twelve Actions," National Governors Association Center for Best Practices, July 2012; http://www.nga.org/files/live/sites/NGA/files/pdf/11HEINEMAN12ACTIONS.PDF.

[38] Dane Stangler, Robert Litan, and Yasuyuki Motoyama, "Startup Act for the States," Ewing Marion Kauffman Foundation, January 2012; http://www.kauffman.org/uploadedfiles/soe_address_2012.pdf .

[39] The NGA study unfortunately begins with a rather boilerplate assertion that "Competitive tax rates, including income, sales, property, and other business taxes do make a difference. Each state needs to assess its overall tax climate and work to improve its competitiveness structure." However, the paper does not cite a single study to back up that assertion, makes no attempt to describe what it means by a competitive tax structure, and makes no further tax policy-related recommendations. The only tax-related recommendation that the Kauffman study authors make is that states simplify their corporate income tax structures, by which they appear to mean primarily scrubbing them of the wide array of specific tax incentives that have been added over the years: "What a state must avoid are taxes and regulations that distort business activity by favoring one sector over another. Tax credits and incentive programs do just this, distorting the environment not only for new and young firms but for all other companies in the state as well. . ."

Conclusion

There is almost nothing in economic theory or empirical research to support an assertion that cutting state personal income taxes will have a significant impact on the emergence, success, or job-creation performance of small businesses. The vast majority of any revenue forgone from such tax cuts will flow to people who don't own businesses, and of the limited tax savings that does happen to flow to business owners, the vast majority will be received by people with no intent or authority to hire additional people. State personal income tax cuts do not increase the cash flow of most small businesses sufficiently to finance the creation of new jobs, and, conversely, small businesses with good growth prospects do not need to rely on their own cash flow to finance expansion.

Neither economic theory nor empirical research support the assertion that personal income tax cuts inherently encourage increased work-effort on the part of small business owners that could generate additional hiring as a side-effect. Nor is there any evidence that entrepreneurs on the cusp of starting their ventures are likely to be attracted to a state merely because it cuts its personal income taxes. Perhaps most importantly, a very detailed and careful empirical study commissioned by the U.S. Small Business Administration concluded, in the words of the authors, that there is "no evidence of an economically significant effect of state tax [policy] portfolios on entrepreneurial activity. . . ."

While there is no compelling evidence that the large state income tax cuts promoted by a number of governors would be a cost-effective means of encouraging entrepreneurship, there is a significant risk that the cuts would seriously impair the ability of these states to fund infrastructure, education, public safety, and other services that are a critical underpinning of a healthy state economy. Policymakers should therefore reject proposals for state personal income tax cuts as a means of encouraging the birth and growth of small businesses and focus instead on more targeted approaches to assisting these firms.

Appendix: How Small Businesses Are Structured Affects How Profits Are Taxed

There are numerous ways a small business owner can choose to structure his or her firm from a legal standpoint, and this affects how its profits are taxed.

The vast majority of small businesses are structured as "pass-through entities" (sometimes called "flow-through entities"). This means that any profits they earn after subtracting allowable business expenses from business receipts are passed through from the business to the owner and reported on *individual* income tax returns. There are four principal types of pass-through entities:

- **Sole proprietorships** are owned by a single individual. All of their profits are reported on a single federal (and usually a single state) income tax return. These businesses do not actually exist as separate legal entities apart from the owner.

- **Partnerships** are business entities that have at least two owners. At least one owner will be a "general partner" directly legally liable for the debts of the partnership should the business's assets be insufficient to cover those debts. That means that the general partner could have to cover any debts out of personal assets. Some partnerships have "limited partners" who are passive investors not engaged in managing the business and not personally responsible for the business's debts.

- **S-corporations** are regular corporations but are small enough to be able to elect to be treated as pass-through entities under Subchapter S of the federal tax code. This means that they are exempt from the federal corporate income tax and that their profits are reported on the personal income tax returns of their owner(s) in the year in which the profits are earned. As with all corporations, none of the owners of an S-corporation is personally liable for the business's debts. Some S-corporation owners may be passive investors not engaged in management of the business. Corporations with more than 100 stockholders cannot make a Subchapter S election.

- **Limited Liability Companies** (LLCs) are similar to S-corporations in that none of the owners is personally liable for the debts of the business and the business is exempt from the corporate income tax. (LLC owners are referred to as "members.") LLCs do not have to meet all the strictures that apply to S-corporations, but there are other features of both their tax treatment and their legal structures that make S-corporation status preferable for some businesses.

Finally, some small businesses are legally structured as so-called C-corporations that either do not qualify for or do not elect S-corporation status. C corporations are *not* pass-through entities; their profits *are* subject to federal (and state) corporate income taxes, but the owners are only subject to individual income tax on the business's profits if and when those are distributed to them as dividends. Accordingly, the minority of small businesses organized as C-corporations are largely irrelevant to the subject of this report since it focuses on the potential impact of state *individual* income taxes on small business job creation decisions.