

Tax policy and entrepreneurship

Kate Smith (joint work with Helen Miller)

Small businesses are widely perceived to be engines of growth and employment

Many governments give preferential tax rates to business owners to promote entrepreneurship and risk taking

- BUT no economic reasons to promote this *per se*

Policy interventions should be justified by *market failures*

- e.g. spillovers, incomplete insurance, financing constraints
- but these are not present for all businesses

Policies to promote ‘entrepreneurship’ can be poorly targeted

- can lead to a misallocation of people and capital, and costly tax avoidance

How do UK company owner-managers respond to the tax system?

- Their taxable income is highly responsive to changes in marginal tax rates;
 - but what explains this responsiveness?

To what extent do different aspects of the taxation of businesses and owners impact business start-up and subsequent investment & growth?

- New project in early stages
- Interested in the wide variation of closely held business owner population
- Potential to be informative about impact of various policy reforms

How do company owner-managers respond to the tax system?

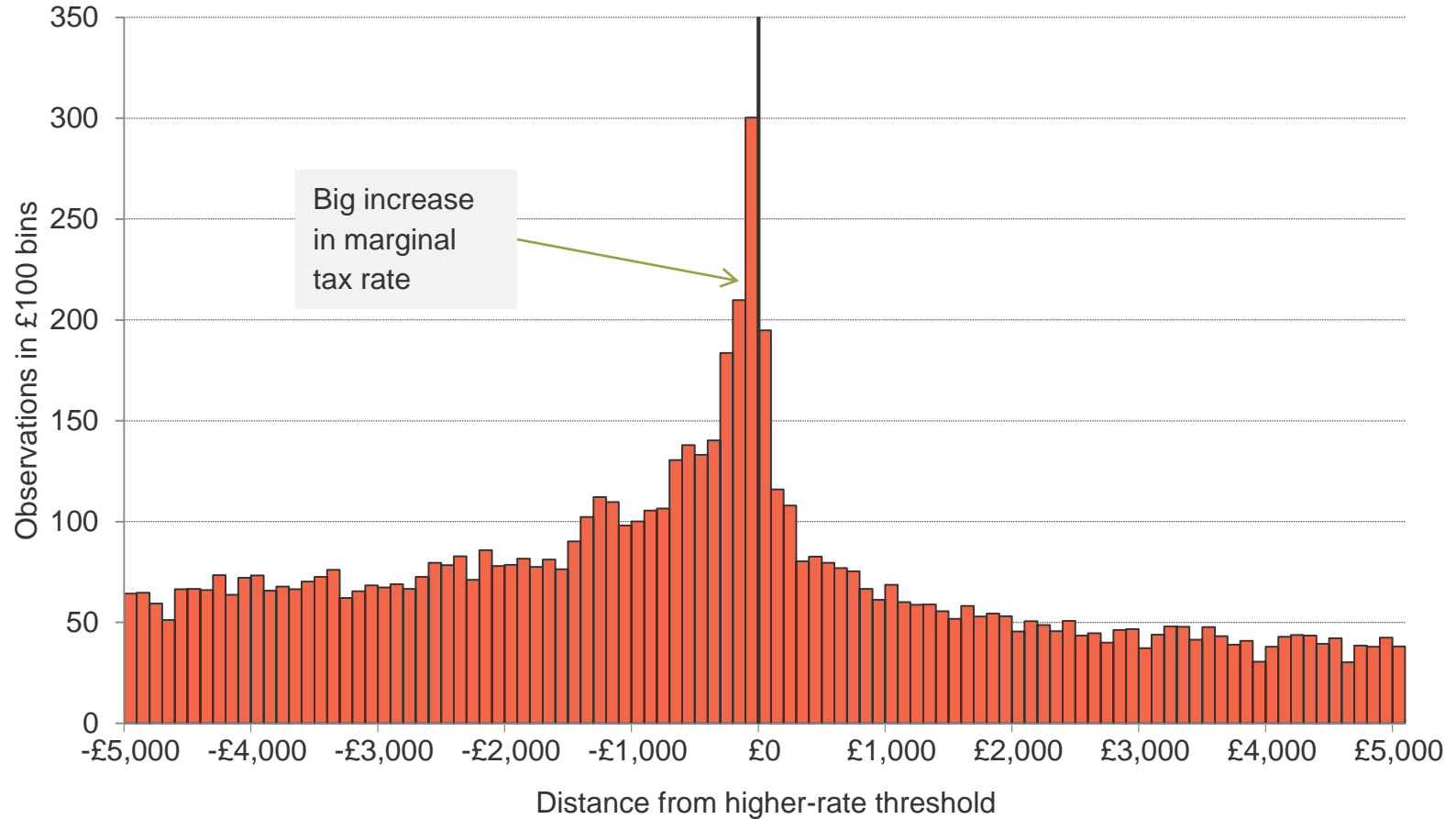
Company owner-managers run closely held incorporated businesses

- Most tax-advantaged legal form in the UK
- Taxed at corporate and personal level:
 - Corporate tax: paid as income flows into the company
 - Personal tax: paid as income is taken out of the company (either as wages, dividends or capital gains)

Have a lot of flexibility over when to take income out the company and therefore when to pay personal tax on it

- Entrepreneurs' Relief provides an incentive for higher income owner-managers to retain profits in the company until they liquidate it

Owner managers bunch at kinks in the tax schedule



Notes: Distance from higher-rate threshold measured in 2007–08 prices. Distribution shown for company owner-managers, 2003-4 to 2007-8.

New linked tax records crucial to get fuller picture of owner-managers' behaviour

New link between personal tax records of the owner-manager and the corporate tax records of the company

- Observe: company profit (total income), and timing and size of taxable income withdrawals by owner-manager

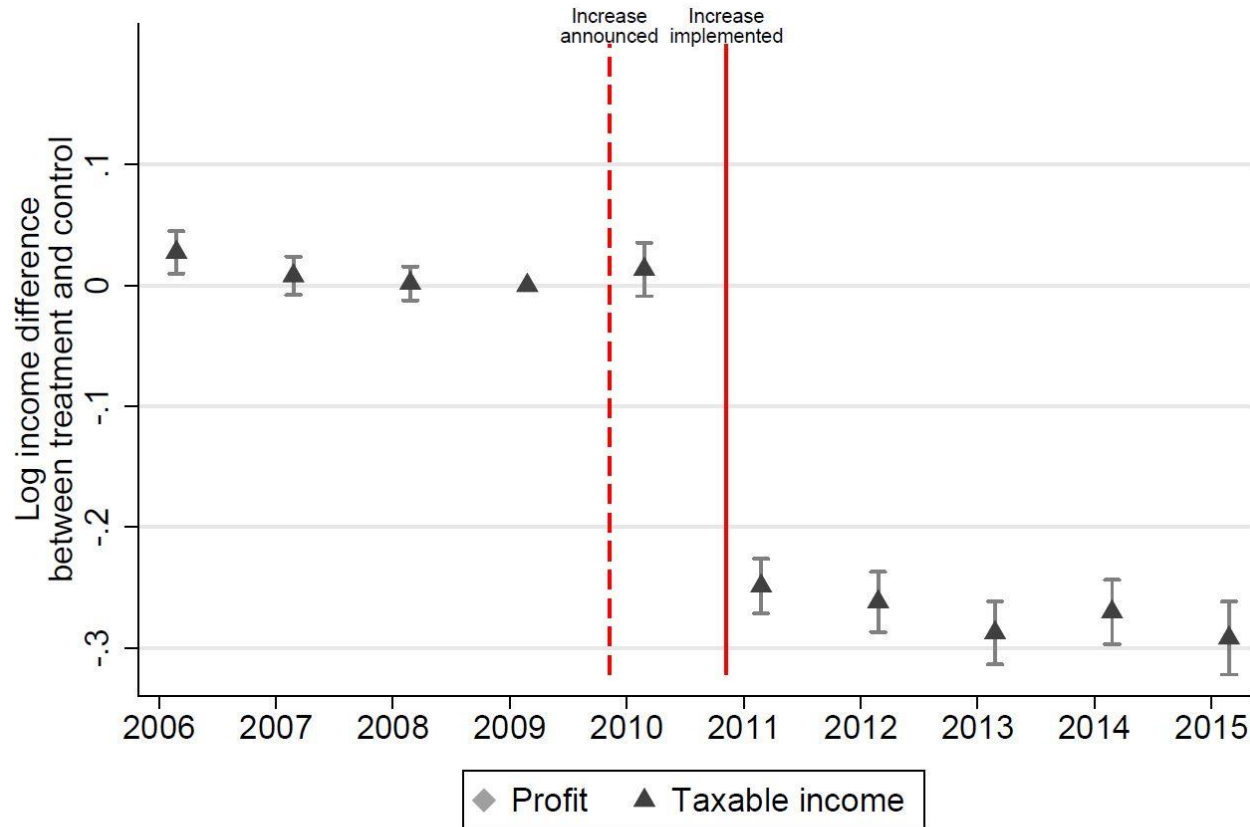
Allows us to understand how much of responsiveness is driven by income shifting or adjustments to 'real business activity'

Summary of findings

Responsiveness of owner-managers' taxable income to changes in tax rates is due to shifting income across time, not reducing real activity

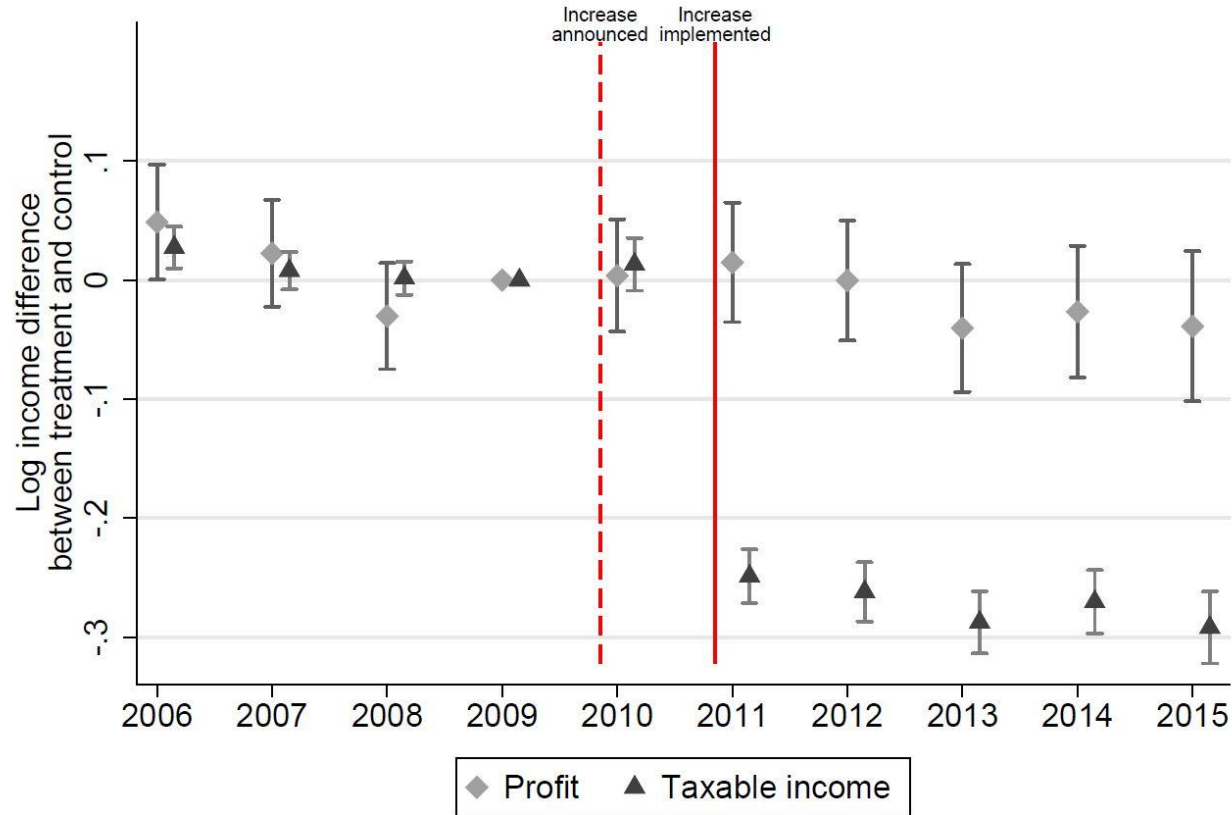
- Allows smoothing of volatility in incomes that fluctuate around a kink
- And to take advantage of lower future rates (e.g. Entrepreneur's Relief)

Introduction of 50p rate and withdrawal of personal allowance led to large reduction in taxable income of higher income owner-managers



Treatment definition: taxable income between 95000 and 200000.
Control definition: taxable income between 50000 and 95000.

... but no reduction in the total income created by their companies



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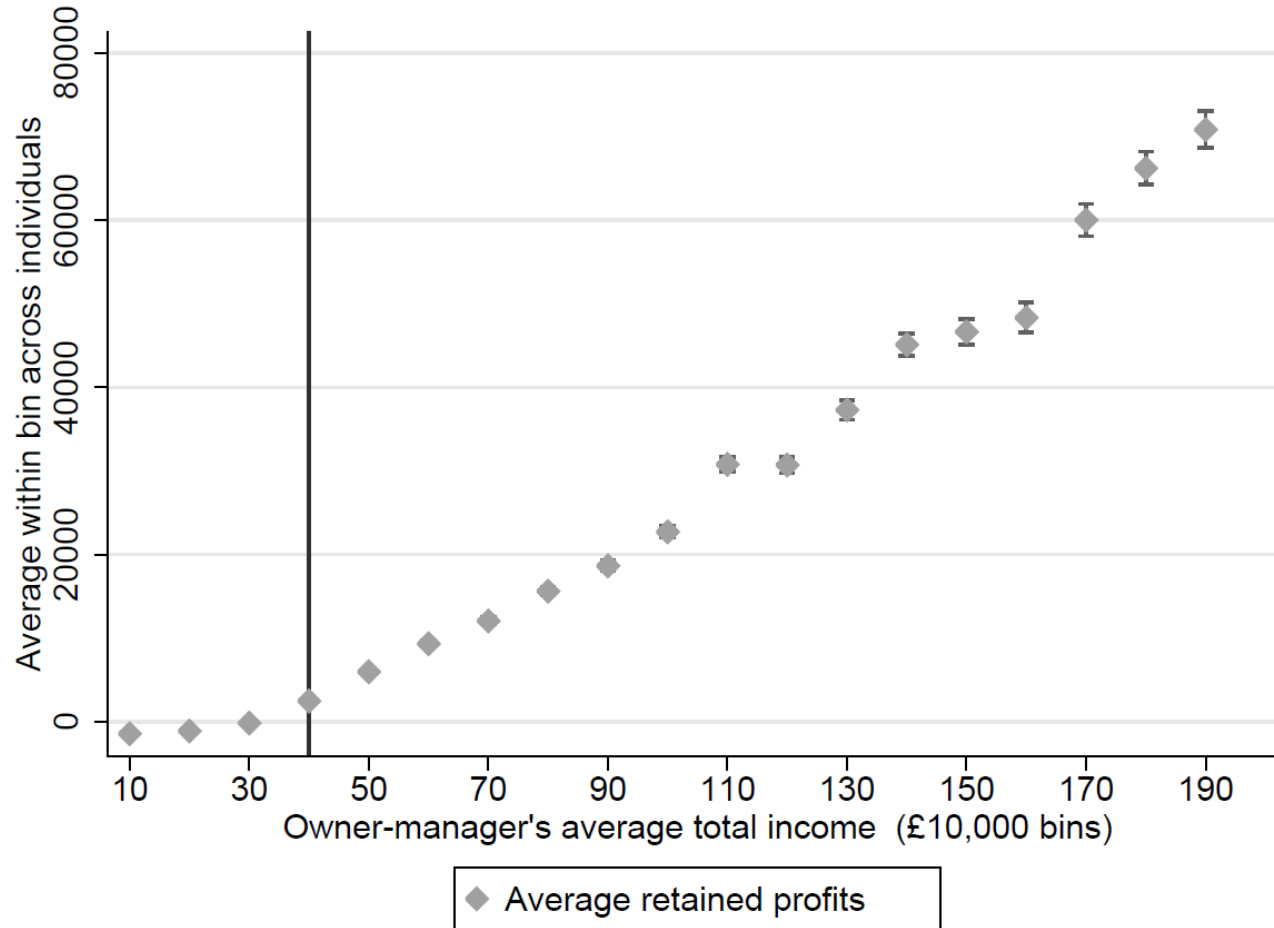
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Systematic retention of income within closely held companies is large

Higher income owner-managers are retaining large sums in their companies



Notes: Average retained profits constructed across years observed for each owner-manager.

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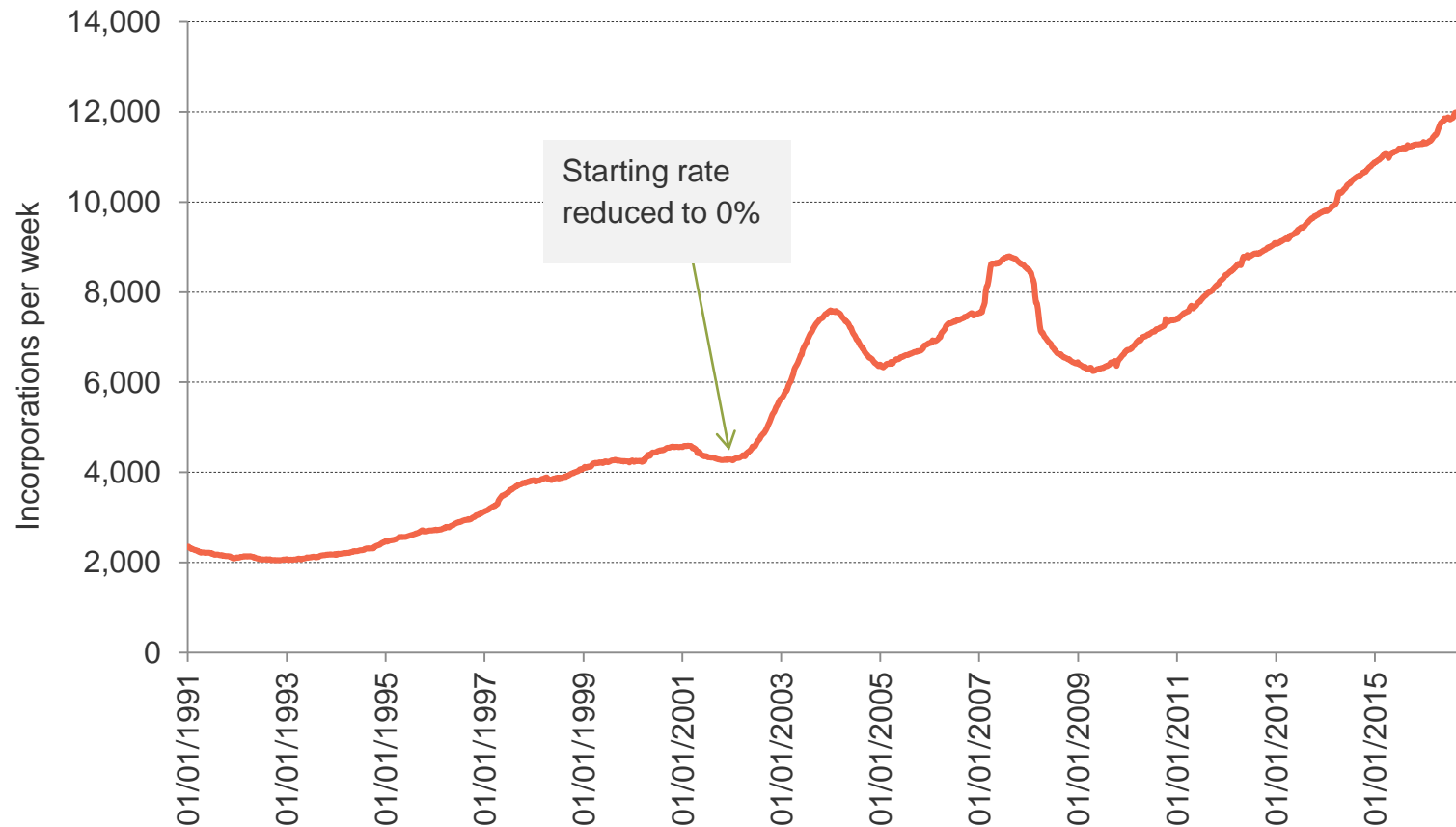
- No evidence that tax-induced retention leads to higher investment in business capital
 - Retained profits are held as current assets (i.e. cash and equivalents)
 - No change in investment around the introduction of the additional rate or withdrawal of personal allowance

Next stages

Our research so far has cast light on how owner-managers respond to the tax system

- Plan to incorporate these findings into a study of how the tax system affects business start-up, and subsequent investment and growth

Rise in incorporations following the 0% starting rate of corporation tax



Source: Figure 7.6 in Chapter 7 “Tax, legal form and the gig economy”, *The IFS Green Budget*, February 2017 .

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Aim to use rich administration data + econometric methods to study:

- The decision to start a business
- Whether to incorporate (owner-manager) or not (self-employed)
- Decisions over investment in business capital
- Income growth
- Business failure and exit

What we will do that is new

Account for the richness of the tax system

- Move beyond differences in average tax rates to look at the progressivity of the system, loss offsets, avoidance opportunities

Combine newly available panel micro data with policy reforms

- The UK's institutional setting provides large and salient differences across legal forms (e.g self-employed versus owner-manager)
- As well as a large number of policy changes

Develop a modelling framework that accounts for dynamics in decision making

- Allows us to study the impact of *counterfactual* policy reforms
- e.g. if we removed Entrepreneur's Relief, what would be the effects on business start-up, growth and tax avoidance?

Tax & entrepreneurship: lessons for policy

Not all small or closely held businesses are doing innovative or entrepreneurial activities

- Even those that are should not necessarily be helped by government

Policy should focus on correcting market failures that lead to levels of business activity that are inefficiently low

- e.g. when people cannot raise financing to fund investments, or innovation generates positive spillovers to society

Across-the-board tax breaks are not necessarily the best way to do this

- Lead to costly tax avoidance, and can also create misallocation of capital
- Limits the ability to redistribute from rich to poor
- Creates unfair differences across people doing very similar types of work