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Testimony to House Finance and Appropriations Committee On HB 59 Income Tax Plan

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Good afternoon, Chairman Amstutz, Ranking Member Sykes, and members of the committee. My name is Michael Mazerov, and I am a Senior Fellow with the Center on Budget and Policy Priorities in Washington, DC. The Center is a non-partisan, non-profit research institute that analyzes federal and state budgets, tax policies, and programs, with a particular focus on how they affect low- and moderate-income families and individuals. Thank you for the opportunity to testify today regarding House Bill 59. I will limit my comments to the portions of the budget bill implementing Governor Kasich's proposal to reduce personal income tax rates and exclude from income taxation 50 percent of the first $750,000 of income from so-called passthrough businesses – sole proprietorships, subchapter S corporations, partnerships, and limited liability companies. In particular, I will focus on the question of the extent to which the proposal is likely to help small businesses grow and create jobs.

We at the Center on Budget and Policy Priorities wanted to answer a question that's on our minds and yours: what's the impact on job creation and entrepreneurship of state income taxation of small businesses? Relying on some very compelling academic and government studies on small businesses and small business taxation published in just the past 2 or 3 years, a report I recently wrote concluded that cutting state income taxes is not an effective way either to encourage job creation by existing small businesses or to stimulate the birth of new businesses.

Point number one. If you want to help small businesses that have a real potential to create a significant number of jobs, cutting income taxes across the board, or even eliminating taxes on the profits of passthrough businesses, are not your answer. They're wasteful, costly, and unfocused policies. A U.S. Treasury Department study from 2011 showed that less than three percent of all taxpayers in the United States own a real, functioning small business with even a single paid employee. And, many of the people in that tiny group of business owners are just passive investors in a business. They aren't involved at all in hiring. The vast majority of people reporting income from a passthrough business on their personal income tax returns are people who might earn a small amount of income from self employment on the side. Or they're passive investors in investment partnerships that themselves are passive investors in other businesses, again, with no authority over job-creation decisions by those businesses. Or they're owners of real businesses, but they're entirely self-employed as plumbers, lawyers, and so on and have no intention, need, or desire to hire anyone else.

Further, even for those small passthrough businesses that do have some employees, only a tiny proportion of them have significant job creation potential. That's because most of them serve an entirely local market for a good or a service and plan to keep it that way. Only a tiny share of new businesses are seeking to develop a new product, service, technology or business model that has the potential to be the next Google, Facebook, or Amazon. So tax cuts for everyone is a very expensive way to try to help the very few that are even in a position to create a meaningful number of jobs.

Second, even if you somehow could limit tax cuts to those kinds of businesses, you wouldn't be doing them much good anyway. Why? Because they have so little taxable profit to begin with. Just 13 percent of bona fide small businesses make more than $50,000 per year in profits; the rest make less than that or lose money. Even at the current top income tax rate in Ohio of 5.925 percent, a business with $200,000 in profit – a much, much greater amount than that of the average small business—will save approximately $7,100 from Governor Kasich's proposal. That is not enough additional cash flow to hire even one full time worker at minimum wage.

Well, you might ask, what about the small business startups engaged in real innovation that have the potential to grow quickly and generate a large number of jobs? In fact, they're likely to have even less profit than the average small business. They're plowing all their cash flow into R&D, marketing, and hiring new employees. A 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. But the study also found that almost half of firms receiving such investments had no revenue in their first year of operation, let alone any profit. And, for the firms that were profitable, the profitability dropped sharply after the venture capital investment as the firms used the money to hire more higher-salary employees and to grow rapidly. So, here again, personal income tax cuts are just not an effective way to help the so-called "gazelle" firms.

Third, economic theory also strongly suggests that cutting income taxes is not likely to be an effective way to boost business start-ups or the rate of job creation by existing small firms. Businesses expand when they foresee increased demand for what they sell, not just because they have more cash in their bank accounts. On the flip side, if they have identified a good investment opportunity, they don't need to finance it out of their own cash flow; they quite properly borrow the money or bring in new investors. And remember, wages and salaries of employees are fully deductible in calculating taxable profit, so the tax system in no way discourages hiring additional workers. It's often argued that cutting marginal tax rates will encourage business owner-operators to work longer hours, but most entrepreneurs will tell you they're already working as many hours as there are in a day. Finally, although in theory lower income tax rates should stimulate additional capital investment by businesses, the federal government already highly subsidizes capital investment through the tax code. It's very unlikely that additional tax cuts at the state level would have much bang for the buck in encouraging additional capital investment either.

Fourth, some serious research looking directly at the effect of state income tax policy on self-employment, small businesses, and entrepreneurship finds no significant impact. The most thorough such study was commissioned by the U.S. Small Business Administration and published last year. After an exhaustive analysis of various measures of entrepreneurship and self employment, the academic authors concluded, "We find no evidence of an economically significant effect of state tax portfolios on entrepreneurial activity." Another study, by the libertarian Cato Institute, found no meaningful correlation between top personal income tax rates -- state and federal combined -- and the share of state residents employed in their own businesses. The authors observed: "Even if these effects . . . [had been] statistically significant, they would have had very little economic significance." Then there's the study last year from the Kauffman Foundation, the leading research institute on entrepreneurship in the country. It looked at the location of the 500 fastest-growing businesses identified each year by Inc. magazine. It found that the number of Inc. 500 firms based in a state had no relevant correlation with the state's ranking in the Tax Foundation's "State Business Tax Climate Index." 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."

My fifth point responds to the argument made by some that even if income tax cuts don't stimulate the creation of businesses that wouldn't otherwise be created, they could still attract to a state entrepreneurs on the cusp of starting a new business that otherwise wouldn't choose to locate there. Research on the location decisions of entrepreneurs finds that not many of them are likely to be drawn to a state by something as minor to their operations as a cut in the state income tax rate. Entrepreneurs start businesses where they already live, where they know the market and have personal relationships with potential bankers and investors, and people who could become their partners or employees. Considerable research backs this up. For example:

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

- A study made public just last week found that fully 45 percent of the almost 40,000 existing companies founded by graduates of California's Stanford University remain headquartered in that state, which imposes some of the highest income taxes in the country. If state income tax policy really had a significant impact on where entrepreneurs choose to locate, would Silicon Valley be in California?

So, to summarize, and the evidence comes down squarely on this, cutting state income taxes will not have any significant impact on Ohio's ability to stimulate job creation by existing small businesses or to attract or give birth to new entrepreneurial firms that have rapid growth potential.

Cutting income taxes further not only won't fix Ohio's economy, it is likely to prove harmful. A study we will release later this week finds that Ohio has already cut state per pupil aid in higher education by 29 percent in real terms over the past five years, that is, after adjusting for inflation. Almost three-fourths of the states have a higher proportion of their adult population with at least a bachelor's degree. As a recent National Governors' Association report titled "Growing State Economies" 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. . .

Additional income tax cuts will eventually force the state to cut back further on investments in education, infrastructure, and other areas that over the course of history have proven to be the best ways to create jobs and promote prosperity. So the question before Ohio policymakers – as it is for those in other states – is, simply, "Will you risk squandering your economic potential?" I hope you will answer that question with an emphatic no.

Thank you again for allowing me to testify today, and I would be happy to answer any questions you may have.