

State Tax Policy and Entrepreneurial Activity

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Engaging in entrepreneurship and starting a small business can be made more or less difficult by the structure of income taxes. While federal income taxes are the single largest tax on small business, state and local taxes can also impact small firms. Recent studies have shown how federal income tax rates can affect decisions to engage in entrepreneurial activities; this study tests whether the same pattern holds for state tax policy. The paper examines the impact of both state tax rates and tax composition (i.e., which taxes are imposed and in what proportion) on entrepreneurship rates.

There is substantial variation in both the structure of taxes and tax rates across the 50 states. The paper identifies the effects of tax rates and tax composition on entrepreneurship. Using state-level data from 1989 through 2001 on taxes and entrepreneurship, the authors attempt to isolate the impact of tax policy by examining aggregate rates of entrepreneurship. Two entrepreneurship measures are employed: one is the number of filers of Schedule C on their federal income tax returns, and the second is the share of all non-farm employees who are sole proprietors. The paper examines not only the impact of tax policy on the number of entrepreneurs in the state using the two measures, but also on the state's share of all U.S. entrepreneurs. The effects of tax rates are estimated with top marginal tax rates for a number of different state taxes, including personal income tax, sales tax, corporate income tax, estate tax, inheritance tax, and gift tax. Other tax policy variables, such as combined reporting and throwback rules which affect where corporations must file taxes, and homestead rules which affect bankruptcy filings, are also examined.

Overall Findings

State tax policy, including both tax rates and the type of taxes in a state's portfolio, has only a modest effect on aggregate state entrepreneurship rates.

Highlights

- Higher top tax rates on individual income, higher sales tax rates, and the existence of state-level inheritance or gift taxes all tend to slightly reduce a state's share of the national entrepreneurial stock;
- Top marginal tax rates on individual and corporate income do not have statistically significant effects on state entrepreneurship rates, but states with higher sales tax rates tend to have higher entrepreneurship rates;
- States with combined reporting and throwback rules for corporate income taxes tend to have higher entrepreneurship rates;
- The composition of state tax portfolios (which taxes are imposed and what share of total taxes each imposes) is not a significant determinant of state entrepreneurship rates.

Scope and Methodology

The researchers use a panel of aggregated state-level tax data to estimate the effects of tax policy on entrepreneurship. These data include as explanatory variables state tax rates for personal income, sales, and corporate taxes; control variables for demographics and state fiscal policy; and state economic variables, such as employment and output measures. The primary dependent variables of interest are the number of entrepreneurs in the state, measured by either a

tax or employment proxy, and the state's share of national entrepreneurial stock, measured again by either the tax or employment proxy share of the relevant national stock.

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