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Tax and entrepreneurship

How the tax system impedes the creation of new firms and decreases employment

Dr. Jonathan M. Scott and Matthew Sinclair

With a Foreword by Julie Meyer

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About the authors

Dr. Jonathan M. Scott is a Teaching Fellow at Queen's University Belfast. His research focuses on entrepreneurship and small firms; international trade and networks; advice; finance; and ethnic minority and women-owned firms. An underpinning theme throughout most of his research is the role of inter-firm social networks and trust in enhancing business performance. He has published papers in a number of academic journals and has contributed to over 20 policy-related research projects for a range of public sector clients.

Matthew Sinclair is the Research Director at the TaxPayers' Alliance. Since joining the TPA in May 2007, he has produced major reports on government capital procurement, environmental policy, NHS performance, the dynamic effects of corporate tax cuts, the economic and social burden of crime and the effects of aid policy, among others. He frequently represents the TaxPayers' Alliance on the television and radio, particularly in response to the economic crisis.

Julie Meyer, author of the foreword, is one of the leading champions for entrepreneurship in Europe. With over 20 years investment and advisory experience helping start-up businesses, she is the well known **founder & CEO of Ariadne Capital, founder of Entrepreneur Country, co-founder of First Tuesday, dragon on BBC's Online Dragons Den** and weekly **columnist in London's City AM**.

Through these intertwining roles of entrepreneur, advisor, investor and industry commentator, Julie has set her mission to build a growth story for the UK and Europe. This passion and entrepreneurial flair is what has earned her awards as Ernst & Young Entrepreneur of the Year, World Economic Forum Global Leader of Tomorrow and in the Wall Street Journal's Top 30 Most Influential Women in Europe.

American by birth and European in spirit, Julie has added a flourishing media career to her business commitments, recently joining BBC's **Online Dragon's Den** http://www.bbc.co.uk/dragonsden/thedragons/julie.shtml. In addition to her weekly column for London's **City A.M.** http://www.cityam.com/ and regular contributions to Business Week, Computing, FT Digital Business, Spectator Business, Julie is also a regular industry commentator on the BBC and CNBC.

She is Chief Executive of **Ariadne Capital**, the investment and advisory firm she founded in August 2000. Ariadne backs entrepreneurs in the media (music, broadcast, publishing, advertising, gaming), mobile internet and communications, and internet sectors.

Most recently Julie founded **Entrepreneur Country**. Managed by Ariadne Capital, Entrepreneur Country is a dedicated community for leading and emerging entrepreneurs, investors, the media and corporate partners who service the start-up industry across the UK and Europe (www.entrepreneurcountry.net).

From 1998 to 1999, Julie was part of the team at NewMedia Investors, which became early stage investment firm Spark Ventures in October 1999. During this time she took her first steps in the entrepreneurial arena founding **First Tuesday**, the largest global network of entrepreneurs, which many credit for igniting the Internet generation in Europe. It was sold for $50million in cash in and shares in July 2000.

As a personal project, Julie is also currently setting up an association for teenage girls to help them find their unique contribution to the world and create a virtuous circle of investment in women.

Foreword

Growing up in the household of an entrepreneur, and through my 12 years in the UK working with some of the best entrepreneurs of this country, I've seen the application of entrepreneurial talents to some of the most thorny problems in the business world as well as the social landscape. Entrepreneurs who are successful tend to be some of the most generous people in the world as they have been helped along the way. As a result, they want to "send the lift down" to help the next batch of super motivated entrepreneurs with their visions.

We are fortunate that there exists that class of people - who have been there throughout history – the Michaelangelos, the Gutenbergs, the Christopher Columbuses – who are the artists, adventurers, architects, inventors and business people of their day - who are prepared to live abnormal lives in the bringing to life of their vision of the world, their products and services. Greatness drove them, not work life balance. They sought excellence, profits and transparency, and made the impossible inevitable.

That is the human spirit, and it drives every entrepreneur. It is the celebration of the new, the wonderful, and yes, ego drives a lot of it, but all of society benefits.

Many of us wouldn't claim to call ourselves entrepreneurs, but we are part of a trend of what I call, "Individual Capitalism" – where the unit of business has shifted to the individual away from company man. No one under 30 that I know wants to work for anyone anymore. Part of the reason is that the large corporate has been neutered, but more importantly, the internet brings the power of distribution and communication to the individual as never before. We are all slowly becoming Individual Capitalists. Not only can the government not shoulder the burden of the bloated welfare state which it has created. The balance sheet creaks enough already. But far more importantly, we - the little guys of the world - know what to do with our lives.

We don't need government intervention and quangos; we need more of our own money to build our own lives, businesses, and communities. Governments don't tend to downsize, and therein lies the heart of the problem.

Personally, I've always wanted to be the architect of my own life. I have accepted the starting point that was given to me, and I've internalised both the good and bad decisions that I've taken which lead me – for better or worse – where I am today. Society benefits when the outcomes of people's decisions are borne by them. So, if people in their effort to improve their lives and those of their children, live lives of sacrifice, honest hard work, and investment into the future, they should reap the rewards of those efforts. Discipline, risk, commitment should be rewarded with the multiplied fruits of their efforts.

The trouble in the UK is – and I can say this as an American who loves this country, and plans to become a British citizen – that effortlessness is considered a virtue. No one likes to talk about how hard they have worked. I first realised this at INSEAD, where I went to business school, where without exception, all of my British classmates suggested that they hadn't prepared for the entrance exam at all.

So British society doesn't educate itself about the work that went behind the fortunes as the whole goal is to make it look easy. Back at home in California, people love to talk about endless work and the near death experiences. That's not British. This may change.

Entrepreneurs instinctively shrug their shoulders when it comes to matters of government bureaucracy and tax. Frankly, they don't have time to try to throw off the unhelpful laws which eat at their drive. But Scott and Sinclair's report gets at the heart of how damaging the tie is between the current tax system and entrepreneurship. Lower employment than what we should have is the result.

The United Kingdom is good at building frameworks for the next paradigm shift. Witness the on-going role of the Royal Society, or Tim Berners Lee's role with the world wide web, Jonathan Ive's iPod, Robin Saxby's breakthrough with the ARM microchip, Dr Wolfram's Wolfram Alpha, Charles Dunstone's empire in mobile phones, or game-changers in the financial services sector like Travelez, Zopa, Egg, Monitise and Wonga.

Part of the reason that the average 28 year old who is setting out to build his new venture thinks big is that he or she knows that Britain can do big. Indeed, it has been "doing big" throughout its history. We owe it to those creators of the next big thing to suspend disbelief and negativity, to find our optimism every morning, and to don the cloak of 'early believer' and facilitator of their success in every way that we can.

Our response to their drive and hard work should be an embrace and a recognition that while they conduct the orchestra, we play the flute, horn and keyboards. So I say it's actually very simple – Follow the Entrepreneur. He or she has the market insight, is the creator of value, is the Hero. Let's not saddle him or her with a tax burden before, during and after their contribution to society, but recognise that without them, all of society would slow to a crawl.

Read Tax and Entrepreneurship, and let the implications run through you of how big the UK's contribution to the world could be if its entrepreneurs were empowered through smart tax policy.

Julie Meyer, Chief Executive, Ariadne Capital Ltd

Executive Summary

There is rightly **increasing political and popular concern about unemployment**. In response, parties are putting in place or proposing new schemes to provide specific incentives for employers to take people off the unemployment register or take on new interns and apprentices.

These policies do little to encourage the new firms that create the vast majority of new jobs. Policy should instead be focussed on encouraging entrepreneurship. Despite a notional commitment to 'enterprise for all' and significant public expenditure on business support services to encourage entrepreneurship, there has been little progress on that measure in recent years with just a 0.3 per cent increase in new business registrations between 1997 and 2006.

Existing academic evidence suggests that a series of different pressures affect the decision to become an entrepreneur:

- People may become "necessity" entrepreneurs because of economic need or unemployment.
- They may have non-economic reasons to become, or not become, an entrepreneur. For example, they may start a new business to be their own boss or not start one because of the social stigma attached to failing.
- Entrepreneurs are often stymied by a shortage of capital. Most small businesses are established not with bank loans but with the entrepreneur's own money or support from their family.
- They may wish to make a lot of money. This potential reward is likely to be offset, though, by increased risk.

The tax system affects the decision over whether to become an entrepreneur in two key ways:

- It may reduce the amount of capital they can access from their own wealth or their family. In particular, existing research suggests that receiving an inheritance leads to higher levels of self-employment. **Inheritance Tax, in particular, may reduce the extent that entrepreneurs can obtain finance without the risks that come with a bank loan.**
- The tax system undermines the large rewards that justify the risks attached to starting a new business.

When entrepreneurs earn a large amount of money they will often earn substantial amounts above the various tax thresholds, save and invest that money then eventually pass it on to their children. That money is therefore taxed repeatedly before it is spent and winds up facing a very high marginal rate:

- Under the present tax system that rate is around **90 per cent**.

- With the proposed 50 per cent top tax rate, the marginal rate facing successful entrepreneurs could rise to **92 per cent**. That means this measure has taken 20 per cent of the money entrepreneurs are left under the present 40 per cent top tax rate.

- Even if entrepreneurs take their initial reward as capital gains and benefit from the Entrepreneurs' Relief, they will still face a marginal rate of **86 per cent**.

1. Introduction

With unemployment rising, political attention is rightly turning to how that increase can be limited and, eventually, reversed. Proposed measures have included specific tax incentives for employers who take people off the unemployment registers and new schemes to increase the numbers of apprentices and interns. Unfortunately, these schemes are focussed on intervening in the economy to affect the hiring and firing decisions of existing business, distorting the economy in the process, instead of encouraging the formation of new businesses that might increase employment.

David Birch demonstrated in the US,[1] and more recently Trends Business Research[2] showed in the UK, how new firms create the vast majority of the new jobs. Indeed, high-growth "gazelles" were found to be responsible for creating the vast majority of new jobs.[3]

Entrepreneurship has been very much perceived in the UK, since Margaret Thatcher's "enterprise culture" in the 1980s, as a means to create businesses and jobs to offset the impact of industrial decline. Indeed, a similar agenda has been articulated since New Labour came to power in 1997. Gordon Brown, in particular, has argued for two pillars of economic growth – enterprise for all (i.e. business start up leading to self-employment of the entrepreneurs and job creation for others) and productivity – of which there are five drivers of productivity – Enterprise, Investment, Innovation, Competition and Skills.[4]

Policy initiatives, including fiscal incentives, have flowed from these statements of priorities – for example, an exemption from stamp duty in Enterprise Areas (the most deprived wards) in order to encourage higher rates of business start ups in such areas. Furthermore, the link between enterprise and social exclusion has been recognised by the Government.[5] In other words, becoming an entrepreneur can be a route out of social exclusion and, therefore, a lever for social mobility – just as a good education can be.

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[1] Birch, D. *'Job Creation in America: How Our Smallest Companies Put The Most People to Work'*, Old Tappan, NJ: Free Press, 1987
[2] Trends Business Research *'Job Creation by New and Small Firms, 1995-1999'*, Newcastle upon Tyne: Trends Business Research, 2001
[3] Birch, *op. cit.*
[4] SBS/HM Treasury *'Enterprise Britain: Supporting Small Business, Entrepreneurship and Innovation'*, SBS/HM Treasury: London, 2002; HM Treasury *'Productivity in the UK: The Evidence and the Government's Approach'*, HM Treasury: London, 2001
[5] HM Treasury *'Enterprise and Social Exclusion, National Strategy for Neighbourhood Renewal: Policy Action Team 3'*, HM Treasury: London, 1999

However, whilst there has been a strong rhetorical commitment to encourage entrepreneurship from the Government, it is far from clear whether these policies have been effective.[6]

The conventional indicator of business creation and closure, VAT registration and deregistration,[7] suggests there has been little progress in improving the rate of new business creation. With 181,530 businesses registering for VAT in 1997 and 182,055 businesses registering in 2006, there has been a 0.3 per cent increase,[8] significantly less than population growth over that period. This suggests that a decade of efforts to encourage people to start businesses has not had the desired result. This report will investigate whether the increasing tax burden is the reason why.

With unemployment rising in the present recession, the key to limiting the problem now and ensuring a swift recovery in the future is encouraging entrepreneurship. New, high-growth firms are a better long term bet to increase employment than propping up uncompetitive industries or employing complicated tax reliefs to encourage existing firms to keep extra workers on at the margin. This paper will examine how tax cuts might help that.

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[6] Serious flaws have been identified by: Bennett, R.J. 'SME Policy Support in Britain Since the 1990s: What Have We Learnt?', *Environment and Planning C: Government and Policy*, 26, 2008, pp. 375 – 397; Richard, D. '*Small Business and Government: the Richard Report*',Conservative Party, London, 2008

[7] From the end of 2008 the Office for National Statistics (ONS) and the Department for Business, Enterprise, and Regulatory Reform (BERR) launched a new methodology for measuring the creation and closure of UK businesses: 'births' and 'deaths'. This measure captures those businesses which do not register for VAT, enabling in the future a more accurate analysis of those enterprises opening and closing over a year. However, the data series is potentially misleading. 2007 is the first year in which data was systematically collected for this new method, and totals for previous years were done retrospectively, potentially overstating the rate in 2007 relative to earlier years.

[8] BERR *'Guide to Business Start-ups and Closures'*, 2008, Table 1a & Table 1b

2. Factors driving the decision to become an entrepreneur

The creation of a new venture, or firm, is often referred to as entrepreneurship. Although we recognise that academics are still arguing over a precise definition of entrepreneurship, in this report we define entrepreneurship as the process of new venture creation through bearing risks[9] by discovering and exploiting opportunities,[10] and often causing creative destruction.[11]

Entrepreneurs assess the risks associated with starting a business. He or she may be in employment or may be unemployed, so must make a rational economic decision about whether the risk of moving into self-employment is worth taking.

The individual may be a "necessity" entrepreneur who starts a business because of economic need or unemployment[12] or a Kirznerian opportunity entrepreneur who moves from employment to self-employment to exploit an opportunity that he or she has discovered.[13] Indeed, Shane identifies that those who are unemployed have "less to lose by becoming entrepreneurs",[14] i.e. "a lower opportunity cost on their time" and he goes as far as saying that "If a place wants more of its population to start businesses, it needs to have more of its population out of work".[15] With rising unemployment in the UK, many people who are made redundant will inevitably be 'pushed' towards entrepreneurship which may increase the effectiveness of policies designed to encourage entrepreneurship.

[9] Knight, F. H. *'Risk, Uncertainty and Profit'*, Houghton Mifflin: New York, 1921
[10] Kirzner, I. 'Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach', *Journal of Economic Literature*, 35, 1997, pp. 60-85
[11] Schumpeter, J. A. *'The Theory of Economic Development'*, Harvard University Press: Cambridge MA. 1934
[12] Bögenhold, D. *'Der Gründerboom: Realität und Mythos der neuen Selbständigkeit [The Founder's Boom: Reality and Myth of the New Independence]'*, Campus: Frankfurt am Main/New York, 1987
[13] Kirzner, I. 'Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach', *Journal of Economic Literature*, 35, 1997, pp. 60-85
[14] Shane, S. A. *'The Illusions of Entrepreneurship: The Costly Myths That Entrepreneurs, Investors and Policy Makers Live By'*, Yale University Press: New Haven, CT., 2008, pg. 25
[15] Ibid, pg. 24

There are non-economic reasons why people start a business. It may be that the individual would rather be independent or be his or her own boss,[16] or as Shane delightfully puts it, "most people start businesses simply because they just don't like working for someone else."[17]

There are also non-economic factors that might put people off starting a business. These will include the potential stigma of failure, i.e. many simply do not become an entrepreneur because they think they could fail and are not prepared to risk having the social disgrace of failing.

While these non-economic factors may be significant, they are predicated on the perceived chances that a venture will be economically successful. An entrepreneur will not achieve financial independence if their firm is a failure or its success is insufficient to pay them enough that they can maintain their lifestyle. Equally, the social disgrace of failing is tied up in the ability to make a sufficient return from a new venture. Economic factors are also likely to be important in themselves.

Blanchflower and Oswald[18] used surveys to examine the choice between employment and self-employment and concluded that:

- There is a clear preference towards self-employment which leads to higher levels of satisfaction.
- Potential entrepreneurs are often stymied by a "shortage of capital and money" and "most small businesses were begun not with bank loans but with own or family money […] and that the single biggest concern to potentials was with where to obtain capital". As a result, receiving an inheritance or a gift led to higher levels of self-employment.[19]

There is a wide range of literature which draws similar conclusions about the impact of finance constraints upon entrepreneurship, which are widely thought to be a major barrier to starting up a business.

The relative importance of potential financial rewards in encouraging entrepreneurship is contested within the existing academic literature.

[16] Burke, A. E., Fitzroy, F. R. & Nolan, M. A. 'Self-employment wealth and job creation: The role of gender, non-pecuniary motivation and entrepreneurial ability', *Small Business Economics*, 19 (3), 2002, pp. 255-270; Shane, S. A. '*The Illusions of Entrepreneurship: The Costly Myths That Entrepreneurs, Investors and Policy Makers Live By*', Yale University Press: New Haven, CT., 2008
[17] Shane, S. A. '*The Illusions of Entrepreneurship: The Costly Myths That Entrepreneurs, Investors and Policy Makers Live By*', Yale University Press: New Haven, CT., 2008, pg. 43
[18] Blanchflower, D. & Oswald, A. J. 'What makes an entrepreneur?', *Journal of Labour Economics*, 16(1), 1998, pp. 26-60
[19] Ibid. pg. 50

Douglas and Shepherd found that: "the intention to be an entrepreneur is stronger for those with more positive attitudes to risk and independence. That is, the higher the tolerance for risk, and the more-positive the attitude to decision-making autonomy, the stronger is the stated intention to be an entrepreneur. Note that income was not a significant determinant of entrepreneurial intention — people do not appear to start their own businesses to get rich, or to get any richer than they expect to get as employees."[20]

However, other studies suggest that potential financial rewards are important:

- Cassar found that a key motivation for becoming an entrepreneur was potential financial success.[21]
- Henderson and Robertson interviewed students and found that "being one's own boss" and "to make money" were the primary motivations for choosing to start a new business.[22]
- Evans and Jovanovic found that "he will choose to start a business if and only if his expected net income from doing so exceeds that from waged work".[23]

That controversy extends to the question of whether high tax rates will encourage or discourage entrepreneurship. Some authors suggest that higher income tax levels can increase entrepreneurship. This can happen because entrepreneurs are given particular reliefs or because "high marginal tax rates on unincorporated businesses serve as an insurance policy against business failure because they allow businesses to write off business losses against personal income in the event that they fail." There is some empirical support for these arguments.[24]

However, a number of other empirical studies suggest that taxes impede entrepreneurship:

- Folster draws upon data on OECD countries and particularly in Sweden, and found that "there is a strong negative correlation between the tax burden and the share of self-employment", and that "reducing the tax burden by 10

[20] Douglas, E. J. & Shepherd, D. A. 'Self-employment as a career choice: attitudes, entrepreneurial intentions and utility maximization' in *Entrepreneurship: Theory and Practice*, 2002, pg. 88
[21] Cassar, G. 'Money, money, money? A longitudinal investigation of entrepreneur career reasons, growth preferences and achieved growth', *Entrepreneurship & Regional Development*, 19(1), 2007, pp. 89-107
[22] Henderson, R. & Robertson, M. 'Who wants to be an entrepreneur? Young adult attitudes to entrepreneurship as a career', *Career Development International*, 5(5), 2000, pp. 279-287
[23] Evans, D. S. & Jovanovic, B. 'An estimated model of entrepreneurial choice under liquidity constraints', *Journal of Political Economy*, 97(4), 1989, pp. 814-815
[24] Schuetze, H. J. & Bruce, D. *'Tax Policy and Entrepreneurship'*, 2004, http://web.uvic.ca/~hschuetz/setax.final.pdf, Table 1

percentage points (of GDP) increases the share of self-employed by about 3 per cent of total employment."[25]

- The World Bank's "Doing Business" study found that a "10 percentage point increase in the 1st year effective corporate tax rate reduces business density by 1.9 firms per 100 people (average is 5), and the average entry rate by 1.4 percentage points (average is 8)".[26]

- Blau found that "self-employment rates fall when tax rates rise for low income groups."[27]

- Bögenhöld and Stabler and Meager have found that countries with 'high welfare payments' such as Denmark and Sweden have miniscule levels of self-employment as a result.[28]

To narrow this general literature down, it is necessary to consider how the British tax system might affect the incentives facing entrepreneurs.

[25] Folster, S. 'Do Lower Taxes Stimulate Self Employment?', *Small Business Economics*, 19, 2002, pp. 135-145
[26] Djankov, S., Ganser, T., McLiesh, C., Ramalho R. & Shleifer, A. *'The effect of corporate taxes on investment and entrepreneurship'*, World Bank: Doing Business, May 2008
[27] Blau, D. M. 'A time series analysis of self-employment in the United States', *Journal of Political Economy*, 95(3), pp. 445-446, 1987
[28] Bögenhöld, D. and Stabler, U. *'Self employment and the institutional-political framework'*, Mimeo, 1992. Cited in Storey, D.J. *Understanding the Small Business Sector*, Routledge: London., 1994; Meager, N. 'The characteristics of the self employed: Some Anglo-German comparisons', in P. Leighton and A. Felstead eds. *The New Entrepreneurs: Self Employment in Small Businesses in Europe*, Kogan Page: London, 1992. Cited in Storey, 1994

3. The effect of taxes on incentives to entrepreneurship

It is well understood that taxes can have a number of effects on the incentives that shape people's behaviour:

- High corporate taxes may encourage firms to move abroad.
- High motoring taxes are put in place partially to encourage people to drive less, reducing greenhouse gas emissions.
- High taxes may shift the balance of rewards between work and leisure, leading people to work less.

They can also affect the choice between becoming an entrepreneur and remaining in employment. This can happen in two ways:

- The tax system undermines the key means by which new businesses are financed.
- The high rewards that justify the risks associated with becoming an entrepreneur.

Making it harder to finance a new business

As has been noted in the previous chapter, most small businesses are founded not with bank loans but with people's own or family money. Receiving an inheritance or gift led to higher-levels of self-employment.

While the tax system can affect the availability of informal sources of finance in a number of ways, inheritances are particularly singled out. Anyone who receives a share of an estate after a death or a gift from someone who died within seven years of making that gift will have to pay inheritance tax on any amounts above a threshold, £312,000 in 2008-09. As many estates will exhaust that threshold with the transfer of a family home the amounts left to help finance a new business could be significantly reduced. In 2008-09, Inheritance Tax raised £3.9 billion. That element of the tax burden is levied upon funds particularly critical to entrepreneurs hoping to finance new businesses without the risks attached to formal external finance.

Weakening the rewards attached to successful entrepreneurship

While there will be a host of non-economic factors, differences in how risk averse potential entrepreneurs are and other complications, it is possible to understand the financial incentives facing an entrepreneur in terms of their potential reward, chances of success and the earnings they will receive if they remain in their current employment.

Many new businesses fail. Research in the United States suggests that 66 per cent of new establishments are still in existence 2 years after their birth and 44 per cent are still in existence 4 years later.[29] Another study, looking at the venture capital backed businesses, that are the best candidates to become high-growth 'gazelles', suggests that first-time entrepreneurs have a 'success rate' (managing to go public) of 17.7 per cent. Even serial entrepreneurs with successful track records only have a 29.6 per cent success rate.[30] When businesses fail, the entrepreneur can often lose substantial amounts or their home and risk bankruptcy.

For simplicity, it is possible to think of the earnings for an entrepreneur from a failed business as zero. Leaving aside other factors, this would mean an individual would become an entrepreneur if the following held true:

$$Ee \times Pe > Ec \qquad (1)$$

Where,

Ee is the expected return as a successful entrepreneur,
Pe is the probability that the entrepreneur will be a success,
Ec is the expected return the potential entrepreneur would make if they decided not to start a new business.

In this simplified model, if a new business has a one-third chance of being a success then the rewards will need to be three times as large if it does succeed as the entrepreneur could obtain by staying in their existing, secure, employment.

The tax system complicates this, as the decision will be made on the basis of post-tax returns to entrepreneurship or remaining in existing employment.

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29 Knaup, A. E. 'Survival and longevity in the Business Employment Dynamics data', Bureau of Labour Statistics, *Monthly Labour Review*, May 2005, pg. 51
30 Gompers, P. et. al. *'Skill vs. Luck in Entrepreneurship and Venture Capital: Evidence from Serial Entrepreneurs'*, July 2006

James Manzi recently summarised this in the City Journal:[31]

> *"Some people start companies because they're driven by a dream that transcends rational economic calculation. But most successful entrepreneurs are pretty serious about comparing risks with opportunities. Higher tax burdens raise the price of entrepreneurship. When you raise the price of something, then, all else held equal, you usually get less of it."*

The following will need to be true for entrepreneurship to be worthwhile:

$$T(E_e) \times P_e > T(E_c) \qquad (2)$$

The tax system is not neutral with respect to the choice between entrepreneurship and remaining in existing employment. Successful entrepreneurs are likely to face a greater tax burden as their earnings will be higher, which will make it less likely those earnings will be sufficient to outweigh the risk of failure. While relatively low rates of capital gains tax are available to entrepreneurs, the total tax burden on high earnings that are often the reward for entrepreneurial success can be formidable.

This is particularly the case because the high earnings may well be more than the entrepreneur needs to satisfy their own, personal needs. It is no accident that the BBC television programme Dragons Den features a successful entrepreneur who refers to his personal wealth as his children's inheritance.

The high marginal rates that can affect these kinds of earnings can be understood by looking at the marginal tax rate on income that is earned, saved and invested in a company and then passed on as an inheritance at the top rates and above the various thresholds (the Inheritance Tax threshold is the largest but will often be consumed by the family home). The same assumptions and calculations have been used by N. Gregory Mankiw to examine policies put forward by US presidential candidates at the last election.[32]

If t_1 is the income tax rate, t_2 is the corporate tax rate and t_3 is the capital gains tax rate and t_4 is the inheritance tax rate and r is the pre-tax return on an investment in a company. One pound earned before tax will yield:

$$(1-t_1)\{[1+r(1-t_2)(1-t_3)]\hat{}T\}(1-t_4) \qquad (3)$$

[31] Manzi, J. 'The Innovation Squelch', *City Journal*, 3 March 2009
[32] Mankiw, N. G. *'My Personal Work Incentives'*, 26 October 2008

Assume that the entrepreneur lives 35 years from receiving such a return on his or her enterprise and that r is 10 per cent. Without any taxes an investment of £1 would yield £28.10 thanks to compound interest over the 35 years. This is a substantial return but, equally, it is a long time to leave money invested.

Under the present tax system $t_1 = 0.40$, $t_2 = 0.28$, $t_3 = 0.18$ and $t_4 = 0.4$. Based on equation 3 above, this implies that the return will fall from the pre-tax level of £28.10 to £2.68. That implies that the top marginal tax rate, even before the money has been spent and leaving out national insurance contributions, is over 90 per cent.

The Government's policies may push the rate even higher. As part of the package of measures intended to restore the public finances to health, they plan to put in place a new 50 per cent top rate of tax. This will push that marginal rate up further, to over 92 per cent. In other words, twenty per cent of the amount left under the existing system will be taken by this change.

Of course, some of an entrepreneur's earnings may come in the form of capital gains, subject to a flat 18 per cent tax rate from 2008-09. In that case, the final marginal rate – after investing, saving and leaving the income as an estate – is around 87 per cent. The capital gains tax rate may be reduced further by Entrepreneurs' Relief on the first £1 million of gains, which will reduce the final rate to around 86 per cent. These sources of tax relief will generally only benefit those who sell all or part of their companies, though.

High marginal rates at the top end on income earned, saved, invested and passed on can clearly have a devastating effect on incentives to start a business as it will make it more difficult for potential returns to outweigh the financial risks that come with becoming an entrepreneur, shown in equation 2.

Conclusions

With the recession leading to almost daily announcements of huge job cuts, politicians are rightly concerned with trying to limit the numbers facing unemployment. Unfortunately, they have mostly focussed on complicated new tax reliefs and business support schemes.

Earlier TaxPayers' Alliance reports *The Case for Abolishing Regional Development Agencies* and *An affordable voice for business: Reforming the Department for Business, Enterprise and Regulatory Reform* have established that Government business support spending is generally ineffective.[33] Despite the best of intentions, Government attempts to manage business into success tend to fail. That means taxpayers' money is wasted and there are fewer jobs than there could be if better policies were put in place.

The priority instead should be to boost the economy through tax cuts. Earlier TaxPayers' Alliance work, such as the *Dynamic Model of the UK Economy* produced for the TPA by the Centre for Economics and Business Research, has shown how making the UK a more attractive destination for footloose international capital can build prosperity, while high corporate tax rates force companies like Shire Pharmaceuticals and Hiscox to move abroad.

This report sets out why pursuing lower taxes is so vital to maintaining employment. As well as attracting international capital, we need to make it worthwhile for British entrepreneurs to set up the high growth firms that play such a vital role in creating new jobs as older industries shed workers. While a range of factors including access to capital, regulations and entrepreneurs' 'animal spirits' can affect the likelihood a new firm will be created, the tax system plays a critical role in whether someone will have the capital to set up a new firm and whether it will be worth their while to do so.

While everyone has to be completely aware of the dire state of the public finances, the answer can't be pushing up taxes and making an even worse mess of our economy. Existing research suggests the returns to a new top rate will be minimal, or that the tax hike might even lose money,[34] but the unintended consequences could be dire if that new tax discourages wealth, and job, creation.

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[33] Significant problems with Government business advice has also been identified in: Scott, J.M. and Irwin, D. 'Discouraged Advisees? The Influence of Gender, Ethnicity, and Education in the Use of Advice and Finance by UK SMEs', *Environment and Planning C: Government and Policy*, 2009, forthcoming

[34] CEBR 'Would a 45% tax on incomes over £150,000 raise any revenue at all?', *The Forecasting Eye*, 24 November 2008; CEBR 'Government will lose £800 million from tax hikes on the rich', *The Forecasting Eye*, 22 April 2009