POLICY *brief*

Goldwater Institute

No. 12-01 | February 29, 2012

Unlocking Entrepreneurial Forces: States Can Spark Business Creation, Attract Venture Capital Investment, and Increase Job Growth by Eliminating Taxation of Capital Gains

by Stephen Slivinski, Senior Economist of the Goldwater Institute

INTRODUCTION

This year, Arizona policymakers have a chance to do something that no other state with an income tax has done: eliminate the tax on capital gains.

Arizona, like most states with an income tax, treats capital gains as "ordinary" income and taxes it at the same rate as all other income. But eight states – Arkansas, Hawaii, New Mexico, North Dakota, Montana, South Carolina, Vermont, and Wisconsin – currently tax returns from investment at a lower rate than their standard income tax rates.

Taxation of capital gains is, among other things, a tax on entrepreneurship. Businesses – new businesses especially – need investment to flourish. States that have lowered their taxes on capital gains have seen an increase in investment which precipitated an increase in entrepreneurial activity and the job creation that accompanies it.

The Arizona legislature has before it a number of bills that would either phase-out or terminate next year the taxation of capital gains on assets purchased in 2012 and after. The governor has declared that she is interested in signing a bill that cuts taxes on capital gain income.

State policymakers can set the stage to make Arizona a national hub for new investment. The best way to do this is to immediately eliminate taxation of capital gains or phase it out as quickly as possible.

This memo outlines the case in favor or eliminating capital gains taxes and outlines how our neighbor, New Mexico, has experienced a venture capital investment boom as a result of cutting their capital gains tax. It also compares the economic impact of capital gains tax elimination to some tax reforms that have already been enacted in Arizona.

GOLDWATER INSTITUTE

Capital Gains Taxes Stifle Entrepreneurship, Business Start-ups, and Employment Growth

Investment is an important driver of economic growth. Without it, new businesses may never even see the light of day. Venture capital investment in start-ups, for instance, is one of the highest-profile sources of new business births. A number of studies have shown that taxes on capital gains – the return an entrepreneur or investor receives on their investment – impede entrepreneurship and the job growth it creates.

A 1998 study by Harvard University professors Paul Gompers and Josh Lerner concluded that entrepreneurial activity is sensitive to the taxation of capital gains. In particular, the authors found that states that lowered capital gains taxes saw an increase in venture capital funding.[1]

A 2010 study by William Gentry of Williams College came to the same conclusion. He noted that "capital gains taxes could distort a number of important decisions of entrepreneurs. These decisions include starting a new business, expanding the business, and obtaining outside financing; the capital gains tax can also affect whether and when an entrepreneur sells his or her business."[2]

Venture capital is especially sensitive to capital gains taxation. Dr. Gentry explained, "higher capital gains tax rates are associated with a reduction in state-level disbursements from venture capital funds." That has a dampening effect on business starts-ups. Gentry's analysis indicates that states with higher capital gains tax rates have fewer new businesses seeking venture capital funding.

Finally, capital gains taxation impedes job creation. A 2011 American Action Forum study found that states with higher capital gains taxes have lower employment growth.[3]

The Goldwater Institute's analysis of Census Bureau data comes to a similar conclusion.[4] Between 2000 and 2007, the eight states that tax capital gains at a lower rate have, on average, a 35 percent higher net job creation rate than those states that tax it fully as ordinary income.

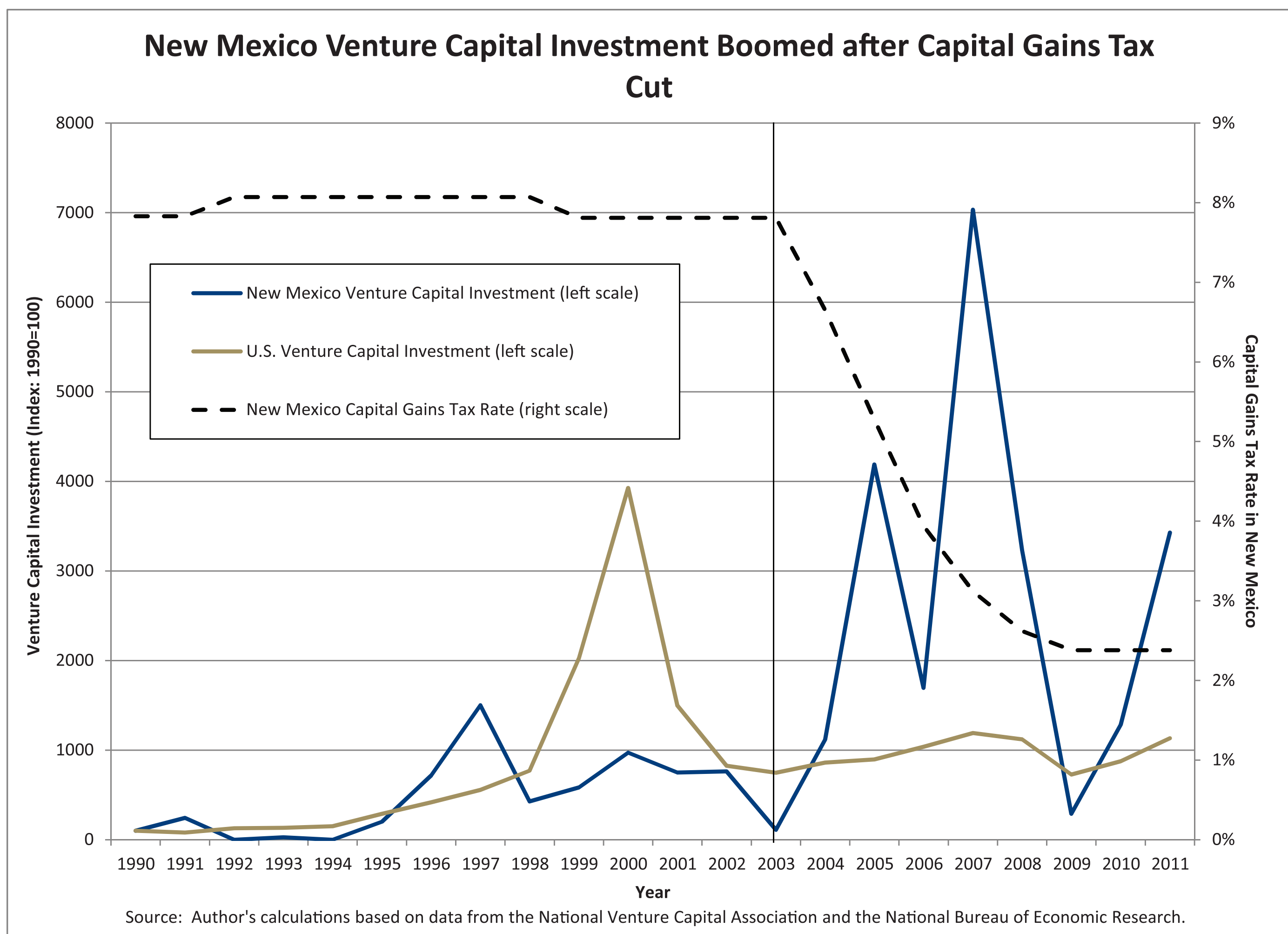
The New Mexico Venture Capital Boom

In 2003, the state of New Mexico enacted a capital gains tax cut alongside across-the-board income tax cuts. That tax reform allowed a 50 percent deduction of net capital gains from taxable personal income. The deduction was phased in over five years, from 2003 to 2007. It was the equivalent of a 50 percent cut in the tax rate on capital gains relative to other sorts of income.

This natural experiment helps us see what effects this action had on investment in the state. Data from the National Venture Capital Association show that New Mexico saw large increases of venture capital investment after capital gains taxes were cut.[5] The level of venture capital in a state is an especially relevant variable to consider since these sorts of investors in these new businesses are often part owners or majority shareholders in the company and the return on their investment can be substantial, as can their risk exposure. An increase in venture capital investment in a state indicates that, all other things being equal, the after-tax return for an investor is better there than in a competing state.

Chart 1 plots the growth of venture capital investment in New Mexico and the U.S. from 1990 to 2011. Creating an index using 1990 as the base year allows a comparison of how fast investment grew or declined relative to prior years. The right axis shows the effective rate of capital gains taxation in New Mexico. The vertical line indicates the year in which the state's capital gains tax cut was enacted.

Chart 1



As you can see, New Mexico benefited briefly from the cut in capital gains taxation that was enacted at the federal level in 1997 before returning to the trend. The spike for the U.S. as a whole in 2000 is explained by the spurt in investment in dot-com companies. That burst of investment activity didn't really trickle down to New Mexico, however.

Venture capital investment really picked up in New Mexico after 2003 when the capital gains tax cut began to kick in. Even the temporary decline in 2006 dipped to a level that was more than twice what it was prior to the tax cuts.

The decline in 2008 and 2009 was likely due to the recession that hit all states. Yet the uptick in investment in 2010 and the preliminary data available for 2011 indicate that venture capital investment in New Mexico is on-track for a strong recovery.

Overall, average venture capital investment almost quadrupled in New Mexico after the capital gains tax cut: it went from an average of $13 million over the seven years before the tax cut was enacted to $48 million in the seven years after the tax cut was enacted.

To look at it another way, consider the fact that in 2003, the year the capital gains tax cuts were enacted, New Mexico was ranked 40th in the nation in per capita venture capital investment. In 2007, the year in which the capital gains tax cut was fully implemented, the state leaped all the way to 13th in the nation, ahead of investment hubs like Texas and New York.

Arizona vs. New Mexico

Now let's consider how Arizona fared during that period with a tax rate on capital gains about twice as high as the rate in New Mexico. Arizona was ranked 26th in the nation in terms of venture capital investment in 2002. That's higher than New Mexico that year at 40th place. But by 2007, Arizona had only risen to 20th place while New Mexico had jumped to 13th place. New Mexico was able to quickly leapfrog Arizona in terms of per capita venture capital investment by cutting taxes on capital gains.

Table 1 compares Arizona and New Mexico in terms of average per capita venture capital investment between 1997 (when the federal government cut the capital gains tax) and 2011. It's broken into two periods – before and after the New Mexico capital gains tax cut. Both periods contain one economic downturn and together they represent a period in which national venture capital markets were maturing and growing.

As you can see, New Mexico was able to catch up with Arizona during the period in which their capital gains tax was cut. Part of that is because Arizona's per capita rate of venture capital investment dropped in 2003 and stayed roughly constant until 2006, at which point it edged upward again – although not as high

Table 1: **Average Venture Capital Investment per Capita**

	1997-2003	2004-2011
Arizona	$49.03	$26.22
New Mexico	$7.25	$25.13

Source: Author's calculations based on National Venture Capital Association data.

as it had been earlier in the decade. The main reason for the New Mexico's "catch-up," however, is that a great deal of new investment was attracted to that state.

It's also worth noting that in 2009 and 2010, when investment in both states dropped, Arizona venture capital investment ended up around the level it was at in 2003. New Mexico investment dropped, too, but to a level that was much higher than 2003.

The Economic Impact of Cutting Capital Gains Taxes in Arizona

We can make some general estimates about the economic impacts we might expect from an elimination of the capital gains tax in Arizona. The Joint Legislative Budget Committee (JLBC) analysis of the capital gains bills introduced in the Arizona legislature can be used in conjunction with the STAMP tax modeling program developed by the Beacon Hill Institute at Suffolk University to generate job growth and investment estimates. This model is "dynamic" in the sense that it can (within some limits) generate estimates that include assumptions about economic activity that would not have occurred except for a cut in taxes.

Job growth from eliminating capital gains taxes

If the capital gains tax were terminated this year – meaning, a 100 percent deduction was allowed for capital gains on assets purchased in 2012 and later – at least 2,500 new jobs would be created within 18 months of the policy change.[6]

Note that the model assumes investments that would have occurred under the old tax law would still occur under the new law. But investors are forward looking, after all. So, by that logic, there is plenty of reason to believe that this job creation estimate is quite conservative. Seeing that the capital gains tax will be gone for the foreseeable future, investments that might not have been made otherwise would appear, just as the New Mexico example suggests, or those investments that might have occurred later occur more quickly. Our dynamic model tries to capture this phenomenon, but there's only so much any model can do to predict this sort of thing. As such, the model likely underestimates this activity in the near term.

When the capital gains tax is phased-out over time, the job growth estimate is smaller, but still above the baseline. A four-year phase down brings the employment growth potential to at least 3,000 jobs by 2016. However, this is still very conservative considering that investors intending to hold onto their stake in a business over a five-year period would invest today knowing that at the end of the five-year period their capital gain would not be taxed. So, it's very likely that job growth would materialize much sooner than the model predicts.

Investment growth from eliminating capital gains taxes

The boost in investment will be significant. If the tax on capital gains were eliminated immediately, within 18 months the state would likely see at least $32 million in new investment. The phase-down would generate a similar amount of investment but over a longer time frame. As noted earlier, this is likely a conservative estimate since forward-looking investors who plan to purchase and hold an asset or invest in a business for a period of more than four or five years would do so shortly after enactment of the capital gains tax reduction, whereas they may not have under the old higher capital gains tax rate.

Revenue estimates

The revenue loss to state coffers that is assumed on paper in a "static" sense does not take into account the higher revenues that come from increased economic activity resulting from terminating the capital gains tax. Our dynamic model suggests that there would be a roughly 20-30 percent "feedback" effect on state revenue. In other words, the revenue loss would only be about 70-80 percent of what would be predicted in the static calculations produced by the JLBC because of increased revenue generated by other taxes, particularly the sales tax.

Eliminating Capital Gains Tax vs. Already-enacted Tax Cuts

Last year, the legislature passed a "jobs bill" (HB 2001) that included a number of tax cuts. Among them were a corporate income tax rate cut and a capital gains tax cut for gains derived from investments in small businesses.

Both of these reductions are important for Arizona's economic recovery and future growth. However, compared to the job-creation potential of eliminating the capital gains tax, they are somewhat marginal.

For instance, take the proposal to exempt taxation of gains in small businesses with up to $10 million in assets. According to data from the Internal Revenue Service, 58 percent of all capital gains come from investment in businesses. However, last year's jobs bill proposal cut taxes on less than 5 percent of that amount – about 2 percent of all capital gains in Arizona.[7] The proposal to eliminate taxation of capital gains, on the other hand, would eliminate taxation of all new investment in businesses.

Also, if policymakers moved forward the effective dates of the corporate income tax rate cut by starting the phase-down this year, the corporate income tax rate would be 4.9 percent in 2015 instead of 2017 and we could expect additional job growth above the baseline over the next 18 months. But eliminating the capital gains tax would generate over 10 times more job growth than moving up the effective date of the corporate tax rate cut.

Conclusion

Policymakers have a historic opportunity to make Arizona the first state with an income tax to eliminate the tax on capital gains. It could make Arizona a hub for new investment and venture capital activity. It would make the state more competitive, particularly with respect to New Mexico, which currently has the lowest effective capital gains tax rate in the nation among states that have an income tax. In addition, this policy would generate job growth well above that expected for policies already enacted but that have yet to kick in. For a state hoping to set itself up for strong economic growth, taking the burden of taxation off of new investment and unleashing entrepreneurial forces in the state is a necessary step forward.

ENDNOTES

1 Paul A. Gompers and Paul Lerner. "What Drives Venture Capital Fundraising?" National Bureau of Economic Research Working Paper no. 6906, January 1999. A draft version is available at: http://www1.hbs.edu/research/facpubs/workingpapers/papers2/9899/99-079.pdf

2 William Gentry. "Capital Gains Taxation and Entrepreneurship." American Council on Capital Formation, November 2010. Available here: http://www.accf.org/publications/142/capital-gains-taxation-and-entrepreneurship

3 Ike Brannon, William Melick, and Eric Andersen. "Employment Effects of Reducing Capital Gains Tax Rates in Ohio." American Action Forum, June 2011. Available here: http://americanactionforum.org/sites/default/files/capgainstaxoh-draft%20to%20post.pdf

4 Census Bureau Business Dynamics Statistics, available here: http://www.census.gov/ces/index.html A description of the data set and the methodology used to derive the statistics appears on the Ewing Marion Kauffman Foundation website: http://www.kauffman.org/research-and-policy/business-dynamics-statistics.aspx

5 Data on venture capital investment by state appears in the *National Venture Capital Association Yearbook 2011*, published in March 2011. Available here: http://www.nvca.org/index.php?option=com_docman&task=doc_download&gid=710&Itemid=317

6 These estimates of job growth are based on a projected baseline. Therefore, saying at least 2,500 jobs will be created means that the baseline shifts upward by 2,500 jobs in that specific year. Or, to put it another way, the baseline would be 2,500 jobs lower if not for the tax policy change.

7 See JLBC "Fiscal Note" for HB 2001 (2nd Special Session, 2011), available at: http://www.azleg.gov/legtext/50leg/2s/fiscal/hb2001.doc.pdf

The Goldwater Institute

The Goldwater Institute was established in 1988 as an independent, non-partisan public policy research organization. Through policy studies and community outreach, the Goldwater Institute broadens public policy discussions to allow consideration of policies consistent with the founding principles Senator Barry Goldwater championed—limited government, economic freedom, and individual responsibility. Consistent with a belief in limited government, the Goldwater Institute is supported entirely by the generosity of its members.

Guaranteed Research

The Goldwater Institute is committed to accurate research. The Institute guarantees that all original factual data are true and correct to the best of our knowledge and that information attributed to other sources is accurately represented. If the accuracy of any material fact or reference to an independent source is questioned and brought to the Institute's attention with supporting evidence, the Institute will respond in writing. If an error exists, it will be noted on the Goldwater Institute website and in all subsequent distribution of the publication, which constitutes the complete and final remedy under this guarantee.

GOLDWATER
INSTITUTE

Where freedom wins.

500 East Coronado Rd., Phoenix, AZ 85004 | Phone (602) 462-5000 | Fax (602) 256-7045 | www.goldwaterinstitute.org