JOB CREATIONISM

*Victor Fleischer**

> [I]t is the most pro growth tax plan that I can imagine because it doesn't tax investments at all. You know why? Because the more you tax something, the less of it you get.
>
> -Sen. Marco Rubio, Republican Presidential Debate, Oct. 28, 2015[1]

Does a low tax rate on entrepreneurial income create jobs? Tax scholars view this question as empirical in nature. But for many policymakers, voters, and even some academics, the relationship between taxes and entrepreneurship is a matter of faith. If there is a question, it is one of ideological commitment, not evidence and reason.

Consider the ease with which politicians claim that tax cuts for entrepreneurs and investors create jobs and fuel economic growth. This claim would appear to be a falsifiable claim subject to empirical observation and testing. But evidence in support of the claim is, in fact, hard to come by. The evidence instead suggests that at moderate tax rates (below, say, 50 percent), tax policy has little effect on the marginal rate of entrepreneurial entry or the marginal growth rate of new firms. Singling out entrepreneurs and their investors for tax breaks is not a policy of job creation. It is job creationism.

This Article considers four ways of interpreting the phenomenon of job creationism: (1) as a cynical ploy to shovel tax benefits to the rich; (2) as an exercise in hero worship; (3) as an ideological claim properly beyond the scope of scientific inquiry; or (4) as a legitimate empirical comparison of our system of entrepreneurial capitalism to other capitalist systems.

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1. *Transcript: Republican Presidential Debate*, N.Y. TIMES (Oct. 28, 2015), http://www.nytimes.com/2015/10/29/us/politics/transcript-republican-presidential-debate.html?smid=pl-share&_r=0 [https://perma.cc/VK6C-JYSH].

INTRODUCTION

Does a low tax rate on entrepreneurial income create jobs?

To an academic ear, that question sounds like an empirical question. But the empirical evidence in support of the claim is scant. For many people the question is not empirical but rhetorical. The relationship between taxes and job creation is a question of faith and ideology rather than an opportunity for evidence-based analysis and argument.

Consider the ease with which many politicians claim that tax cuts for entrepreneurs and investors spur useful investment, create jobs, and drive economic growth. There is, in fact, little empirical evidence to support the claim. For example, many people have suggested that the increase of venture capital investing in the 1980s was attributable to the reduction of the capital gains tax rate from 35 percent in the 1970s to 20 percent in the early 1980s. James Poterba investigated the question in a seminal 1989 study.[2] Poterba found no evidence that changes in the capital gains tax rate affected the supply of venture capital.[3] Most of the capital, he pointed out, was provided by tax-exempt investors.[4] More recent studies have confirmed what most tax academics now believe: there is little evidence to support a claim that U.S. tax policy materially affects the rate of entrepreneurial entry or the growth rate of new firms.[5]

The persistence of the claim of job creation is understandable. Many economists predict a causal relationship between tax rates and entrepreneurial job creation because the theoretical basis for the claim is simple, clear, and obvious: tax rates *should* directly affect the decision, on

2. *See* James M. Poterba, *Capital Gains Tax Policy Toward Entrepreneurship*, 42 NAT'L TAX J. 375 (1989).

3. *Id.* at 384 ("It is simply not credible to argue that a substantial fraction of the growth in organized venture capital markets since the late 1970s is the result of lower capital gains tax rates on investors, since most of the funds have come from investors who do not face the personal capital gains tax. Across-the-board reductions in individual capital gains tax rates would have a small effect on the total tax burden on venture capital financiers, while conveying large benefits on many assets other than venture capital investments."); *see also id.* at 375 (explaining that "more than three quarters of the funds that are invested in start-up firms are provided by investors *who are not subject to the individual capital gains tax*"); *id.* at 384 ("[T]here is very limited evidence on the extent to which the supply of entrepreneurial activity responds to the relative tax burdens on capital gains and labor income.").

4. *See supra* note 3.

5. *See generally* Donald Bruce & Beth Glenn, *Does the Tax System Measure and Encourage the Right Kind of Entrepreneurial Activity? An Updated Look at the Time Series Data*, TAX L. REV. (forthcoming); David Clingingsmith & Scott Shane, *How Individual Income Tax Policy Affects Entrepreneurship*, 84 FORDHAM L. REV. 2495 (2016).

the margin, of whether to become an entrepreneur. If one models an entrepreneur as a rational actor deciding whether to continue to work as an employee or to start a business, tax ought to be part of the entrepreneur's decision. Wages are taxed at ordinary income rates, but entrepreneurial income is often taxed at capital gains rates.[6] An entrepreneur rationally should assess the odds of success, assess the risk-adjusted *after-tax* payoff, and make a decision. If Congress reduces the capital gains rate by some amount, entrepreneurial entry ought to increase as more people are enticed by larger after-tax returns to starting a business.

Indeed, it is obvious that at the extreme—say, a capital gains tax rate of 80 or 90 percent—high taxes would dampen entrepreneurship significantly. But capital gains rates have never exceeded 35 percent in the United States.[7] In the range of tax rates one can observe and reasonably discuss as a policy matter, tax is rarely a first order consideration for most entrepreneurs. We should not be so surprised that there is little empirical evidence to support a claim that taxes have a significant effect on entrepreneurship.

The available empirical evidence offers few lessons. Even the direction of the tax effect is unclear. As taxes on ordinary income rise, for example, new Subchapter S Corporations are organized, largely to avoid payroll taxes. Some scholars interpret this transformation of labor income into business income as evidence of an increase in entrepreneurship.[8] More likely, choice-of-entity effects are evidence of how economic activity is reported, not the amount or nature of the underlying economic activity. After all, if one is foolish enough to look at the creation of a legal entity as a proxy for entrepreneurship, the city of George Town in the Cayman Islands, population 27,704, is the most entrepreneurial city in the history of the world, far surpassing today's Palo Alto, eighteenth-century Birmingham, or thirteenth-century Venice.

6. *See generally* Victor Fleischer, *Taxing Alpha: Labor Is the New Capital*, TAX L. REV. (forthcoming 2016).

7. *2012 CCH Whole Ball of Tax*, WOLTERS KLUWER CCH, http://www.cch.com/wbot2012/029CapitalGains.asp (last visited Apr. 29, 2016) [https://perma.cc/N2RD-Y238].

8. Julie Berry Cullen & Roger Gordon, *Taxes and Entrepreneurial Risk-Taking: Theory and Evidence for the U.S.*, 91 J. PUB. ECON. 1479, 1480 (2007).

Figure 1:
Hotbeds of Entrepreneurship Source: World Bank[9]

Economy	Year	New Business Density	Number of New Limited Liability Companies
Virgin Islands, British	2009	2,604.76	47,477
Isle of Man	2012	45.27	2,287
Guernsey	2014	39.74	1,767
Jersey	2009	37.57	2,329
Hong Kong SAR, China	2014	31.30	167,280

They say it takes a theory to beat a theory, and my theory is this: tax is not a first-order consideration for most entrepreneurs. Entrepreneurship has long odds; a 1 percentage point increase in the likelihood of success matters far more than a 1 percentage point increase in the size of the reward.[10] Moreover, if an entrepreneur believes that her marginal utility curve declines as income rises, it may not matter much whether her gains total $100 million or $200 million at the end of the day in the somewhat unlikely event that everything works out. In other words, tax breaks for entrepreneurs are mostly inframarginal. Instead of inducing salaried workers to become entrepreneurs, tax breaks mostly reward entrepreneurs for activity they would have engaged in anyway.

Even the idea that entrepreneurs make rational present value calculations is a bit suspect. What entrepreneurs take on is not risk but uncertainty. Knightian uncertainty cannot be translated to a net present value calculation, and without such a calculation, the impact of taxes is hard to assess.

As for investors, tax often is irrelevant for a different reason: most of the capital for entrepreneurial ventures comes from tax-exempt investors like pension funds and university endowments.[11] Taxable investors, even the

9. *Entrepreneurship*, WORLD BANK GRP., http://www.doingbusiness.org/data/exploretopics/entrepreneurship (last visited Apr. 29, 2016) [https://perma.cc/NC9T-RXPR].

10. *See generally* Susan C. Morse & Eric J. Allen, *Innovation and Taxation at Startup Firms*, 68 TAX L. REV. (forthcoming 2016).

11. *See* Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 18 (2008).

most sophisticated ones, are sometimes unaware of how their investments will be taxed.[12] Venture capitalists do pay taxes, occasionally, and the tax rate on carried interest is common knowledge. But unless you believe the United States suffers from an undersupply of aspiring venture capitalists, the case for a tax break is weak.

This Article explores the meaning of this gap between job creation claims and the empirical evidence. One possibility, of course, is that those who support tax cuts are misreading the evidence. In the same way that ideology can distort the way we interpret evidence about climate change, minimum wage laws, or other politically charged topics, we tend to view empirical evidence about entrepreneurship through the bias of our ideologically driven priors. There are some highly respected economists who take the view that tax cuts fuel entrepreneurship;[13] perhaps my own analysis of the evidence is distorted by my own cognitive proclivities, motivated reasoning, and academic skepticism. When entering a crowded bar, after all, it is natural to seek out one's friends. The reader can judge the empirical evidence for herself.

It is not my goal in this Article to blow the whistle on the biased and selective use of evidence. Policymakers ignore academic studies all the time. Instead, I want to consider why, for purposes of public policy, empirical evidence seems to be entirely beside the point.

This Article considers four ways of interpreting the phenomenon of job creationism: (1) as a cynical ploy to shovel tax benefits to the rich; (2) as an exercise in hero worship; (3) as an ideological claim properly beyond the scope of scientific inquiry; or (4) as a legitimate comparison of our system of entrepreneurial capitalism to other capitalist systems.

There is some evidence to support each of these explanations. But in the spirit of reading generously, I find the last of these explanations the most productive in terms of future research.

I. THE EVIDENCE

Consider the various ways in which the tax code favors entrepreneurial income. These preferences take the form of (1) generally applicable departures from an ideal income tax that benefit entrepreneurial income; (2) specially targeted expenditures; and (3) gaps in the tax base for entrepreneurial income. By contrast, there are few special burdens on entrepreneurial income.

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12. *See* Fred Wilson, *Qualified Small Business Stock*, AVC (July 28, 2013), http://avc.com/2013/07/qualified-small-business-stock/ ("For the past twenty years, the US federal tax code has included provisions that allow startup investors to get favorable tax treatment on the capital gains they earn on early stage investments. These provisions are in [s]ections 1202 and [s]ections 1045 of the tax code. I have been in the startup investing business for the entire time that these provisions have been in the tax code and to my knowledge, I have never taken advantage of them. So that tells you something, [either] about me or the provisions, or both.") [https://perma.cc/EW8B-XS3J].

13. Cullen & Gordon, *supra* note 8, at 1501–02 (concluding that combining high personal tax rates with low capital gains rates create a strong incentive to start a business).

Preference	Primary Implied Empirical Claim	Empirical Evidence
Generally Applicable Departures		
Capital gains preference	A low capital gains rate creates jobs.	*Scant*
Carried interest	The preferential treatment of carried interest creates jobs.	*None*
Founders' stock	The preferential treatment of founders' stock creates jobs.	*None*
Deferral	Mark-to-market or retrospective capital gains taxation would be too difficult to implement.	*Mixed*
Step up in basis at death	The income from appreciated property already has been taxed by the estate tax.	*Mixed*
Targeted Tax Breaks		
Exclusion of gains from qualified small business stock	Eliminating the capital gains tax up to $10 million reduces the cost of capital for new start-ups organized as C Corporations.	*Scant*
Rollover of gains from qualified small business stock	Deferring capital gains reduces the cost of capital for new start-ups organized as C Corporations.	*None*
Ordinary deduction for loss investments	Allowing an ordinary deduction reduces the cost of capital for start-ups.	*Scant*
Amortization of start-up expenses	Avoiding the normal capitalization rules increases the success rate of start-ups, which in turn creates jobs.	*Scant*
Gaps in the Tax Base		
S Corporation avoidance of payroll taxes	S Corporation owners pay themselves a reasonable salary subject to payroll taxes.	*None*
Special Burdens on Entrepreneurial Income		
Loss limitations	Loss limitations discourage investment in risky activities.	*Scant*
Corporate tax	Entrepreneurs bear the incidence of the corporate tax, which discourages entrepreneurial entry.	*None*

Given the array of tax breaks for entrepreneurial activity, one would hope for an equally powerful array of empirical evidence. Empirical evidence is, of course, always incomplete. But it would be hard to defend even a modest empirical claim that low capital gains tax rates significantly increase the rate of entrepreneurial entry based on the evidence we have in the United States.[14]

Donald Bruce and Beth Glenn's recent article explores the empirical relationships between major features of U.S. federal tax policy and entrepreneurial activity.[15] Because entrepreneurship is not easily captured in a single economic variable, Bruce and Glenn use a wide array of proxies to measure entrepreneurial activity, such as the number of new firms, the amount of income earned by such firms, and the number of jobs created by such firms.[16] Their article includes proxies on the extensive margin (the rate at which new firms organize) and intensive margin (measures of success such as income or employment).[17] Using a time series regression framework, they fail to find significance for most relationships.[18] They find some variables of significance on the extensive margin—such as the rate of entrepreneurial entry—but they explain that the findings likely relate to changes in legal form rather than new economic activity.[19] When they find significance on the intensive margin—such as entrepreneurial success—the data points in both positive and negative directions.[20] In sum, tax does not seem to have much effect on entrepreneurial activity. The main effect is that when the tax rate on ordinary income rises, contractors and other self-employed people form business entities to shelter income. This is evidence of tax planning, not entrepreneurship.

David Clingingsmith and Scott Shane review the empirical literature on tax policy and entrepreneurship.[21] They find that most of the empirical studies to date rely on measures of self-employment or Schedule C income as a proxy for entrepreneurship.[22] The problem with this approach is that it systematically excludes venture-backed start-ups, which is the sector that is said to drive job creation. Many studies, moreover, rely on regression models to suggest causation without adequately addressing omitted variable bias. Even apart from these methodological issues, the theme is that the effect of tax on entrepreneurship is small, unreliable, and inconclusive.

Even if one were to assume a causal link between taxes and entrepreneurial activity, the case for job creationism is questionable. Tax subsidies normally are justified in terms of externalities—that is, social

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14. *But see generally* WILLIAM M. GENTRY, CAPITAL GAINS TAXATION AND ENTREPRENEURSHIP, AMERICAN COUNCIL FOR CAPITAL FORMATION (2010), http://www.accf.org/wp-content/uploads/2012/02/capGainsTaxation.pdf [https://perma.cc/U25X-87QS]. Gentry's empirical case focuses on lock-in as a potential deterrent to entrepreneurship and, importantly, as an inefficiency in and of itself, rather than as evidence of tax-deterring entrepreneurship. *See id.* at 26–29.

15. Bruce & Glenn, *supra* note 5.

16. *See id.* at 5–11.

17. *See id.* at 3.

18. *See id.* at 3, 17.

19. *See id.* at 9–10, 14–15, 17–18.

20. *See id.* at 3, 18.

21. Clingingsmith & Shane, *supra* note 5.

22. *See id.*

benefits that are not captured privately.[23] Just as we might impose a Pigovian tax to curb behavior that causes externalized social costs, we often use tax expenditures to subsidize behavior that we think is socially beneficial.

Most of the gains from entrepreneurship are private gains—entrepreneurial or quasi-monopoly rents—captured by the entrepreneurs and investors in the business.[24] There is a case to be made that, broadly speaking, innovation creates knowledge spillovers. But it is not clear that the knowledge spillovers from innovation in start-ups are more socially beneficial than the knowledge spillovers from innovation and research conducted by large corporations.

Similarly, consumers may benefit from innovative products, but typically pay a market price for the privilege. To the extent there is a consumer surplus above and beyond the market price, the size of innovation-driven consumer surplus is unclear, and it is unclear whether such rents are more likely to be created by start-ups like Uber or large corporations like Apple.

Even assuming the presence of positive social externalities from entrepreneurship, one also must consider the social costs of disruptive innovation. When a new company thrives, an old competitor falters, often leading to job losses and reduction in the value of related investments.[25] The resulting costs are partly socialized through the bankruptcy process and the costs of government-funded social welfare programs.

II. IS JOB CREATION AN IDEOLOGY?

The empirical case for job creation is weak. What, then, explains its widespread acceptance?

A. Entrepreneurship As a Euphemism for Rich People

It is not unthinkable that high net-worth individuals might, through trade associations and the like, lobby Congress for special tax breaks. Rather than lobby for declining marginal rates at the top, which could attract attention, lobbyists use entrepreneurship as cover.

Section 1202 of the tax code, for example, affects a very small percentage of companies and is not widely understood.[26] Until it was made permanent in 2015, it had been extended several times on a temporary basis

23. *See generally* Victor Fleischer, *Curb Your Enthusiasm for Pigovian Taxes*, 68 VAND. L. REV. 1673 (2015).

24. *See generally* James M. Buchanan & Roger L. Faith, *Entrepreneurship and the Internalization of Externalities*, 24 J.L. & ECON. 95 (1981) (noting that successful entrepreneurship causes pecuniary losses to market incumbents and that the institutional design to support entrepreneurship requires that entrepreneurs enjoy the gains but not be held liable for the competitors' losses).

25. *See* C. Mirjam van Praag & Peter H. Versloot, *What Is the Value of Entrepreneurship? A Review of Recent Research*, 29 SMALL BUS. ECON. 351, 358 (2007).

26. *See* I.R.C. § 1202 (2012).

by Congress, making it the sort of tax provision that is lucrative for the recipient and Congress alike.[27]

Claims about job creation, in other words, simply could be masking run-of-the-mill interest group politics. Congress doles out economic rents to campaign contributors and threatens to take them away to ensure continued contributions.

It is possible, but my sense is that the prevailing attitude toward tax breaks for entrepreneurs is sincere and not (just) a cynical ploy to shovel money at rich constituents. Many of the tax breaks for entrepreneurs and their investors are hiding in plain sight, as part of our system's favorable treatment of investment income. Politicians seem to be sincere in their belief that tax cuts will benefit not just rich people but the country as a whole.

B. Entrepreneurship Policy As Hero Worship

Hero worship is off-putting. To most scholars, tax policy is judged in terms of fairness, efficiency, simplicity, and administrability. How the story fits into a cultural narrative is neither here nor there.

Still, the stories that make the American entrepreneur into a hero have a power to persuade that data alone cannot match. You can choose to love or hate Steve Jobs, but you cannot ignore him. We have a natural instinct to shape our empirical observations into stories and, especially, into stories about heroes and villains.[28] Can one really blame Congress for doing this?

Well, yes. There is no reason to think that heroes need a tax break to do the right thing. A firefighter does not charge into a burning building because of the tax consequences. Moreover, it is hard to conjure a reason why an entrepreneur deserves tax-hero status but a firefighter does not.

In any event, while hero worship may explain why some policymakers seem to ignore the evidence, I still think there is more to it. Politicians always like a good story, but our understanding of the relationship between taxes and entrepreneurship is not based on adding up individual stories of heroic acts of entrepreneurship. It is part of a broader system of beliefs, ideas, and stories—ideology.

C. Entrepreneurship As Ideology

Entrepreneurship has long been recognized as a kind of ideology, with both positive and negative connotations.[29] The prevalence of ideology over

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27. *See* Joseph W. Bartlett, *December 2015: Critical Change in Section 1202 of the Tax Law*, VC EXPERTS BLOG (Jan. 19, 2016), http://blog.vcexperts.com/2016/01/19/critical-change-in-the-tax-law/ [https://perma.cc/3M5D-2SRC]. *See generally* Victor Fleischer, *Tax Extenders*, 67 TAX L. REV. 613 (2014).

28. *See generally* JOSEPH CAMPBELL, THE HERO WITH A THOUSAND FACES (2d ed. 1968).

29. John O. Ogbor, *Mythicizing and Reification in Entrepreneurial Discourse: Ideology-Critique of Entrepreneurial Studies*, *in* SOCIOLOGY OF ORGANIZATIONS: STRUCTURES AND RELATIONSHIPS 457, 457 (Mary Godwyn & Jody Hoffer Gittell eds., 2012).

evidence is hardly a new problem. Joseph Schumpeter, for example, lamented about the problem in 1947.[30]

The link between tax cuts and entrepreneurship in particular most likely is traceable to the Reagan revolution. While we mostly remember the 1960s and 1970s for high marginal rates on ordinary income, the tax rate on capital gains had climbed up to 35 percent by 1972.[31] In the 1970s, Martin Feldstein and other "supply-siders" built the intellectual case for reducing capital gains taxes as a way to increase the rate of savings and capital formation.[32]

The idea that when you tax something you get less of it is a powerful idea—so powerful that it has become a core belief of the prevailing economic ideology. The specific idea that low taxes fuel entrepreneurship and job creation is a tenet that is not conditional on underlying facts or institutional context. In this way, the tax treatment of entrepreneurial income more closely resembles constitutional rights like freedom of religion, freedom of speech, or democratic governance. Just as we do not subject free-speech claims to a cost-benefit analysis, policymakers take the effect of taxes on entrepreneurship as a matter of faith, not reason.

Describing job creationism as an ideology does not excuse us, as academics, from our job as skeptics. Setting the consequences of job creationism to one side, there are reasons to question the ideology on its own terms. At its essence, entrepreneurship is about creating economic opportunities. Tax subsidies are justified, if at all, only by reference to the economic opportunities actually created. An ideological preference for entrepreneurship is not, or should not be, about low taxes for the sake of low taxes. By allowing how one thinks about economic freedom to dictate how one thinks about taxes, an ideological approach confuses how we should think about risk, inequality, and merit in an entrepreneurial economy.

Risk. First, consider how tax preferences distort how we view risk. The tax treatment of entrepreneurial income suggests that certain kinds of risk are valued more highly than other kinds of risk. When it comes to labor income, riskiness generally is not valued. We do not, for example, allow lifetime income averaging or other methods of income smoothing. Uncertain pay—such as sales commissions, real estate commissions, or

30. Joseph A. Schumpeter, *The Creative Response in Economic History*, 7 J. ECON. HIST. 149, 159 (1947) ("As it is, most of us as economists have some opinions on these matters. But these opinions have more to do with our preconceived ideas or ideals than with solid fact, and our habit of illustrating them by stray instances that have come under our notice is obviously but a poor substitute for serious research. Veblen's—or, for that matter, Bucharin's—*Theory of the Leisure Class* exemplifies well what I mean. It is brilliant and suggestive. But it is an impressionistic essay that does not come to grips with the real problems involved.").

31. *2012 CCH Whole Ball of Tax*, *supra* note 7.

32. Martin S. Feldstein, *American Economic Policy in the 1980s: A Personal View*, *in* AMERICAN ECONOMIC POLICY IN THE 1980S 1, 13 (Martin Feldstein ed., 1994).

lottery winnings—are all treated as ordinary income, not capital gains.[33] Cyclical labor income, like construction work, can result in high pay during good times—enough so that one does not qualify for the Earned Income Tax Credit—and no pay in lean times, also resulting in no tax credit.

By contrast, the tax code encourages a positive cultural attitude toward entrepreneurial risk by treating certain types of risky pay, such as entrepreneurial income or incentive-based compensation, more favorably than other types of risky pay. Entrepreneurial risk is viewed as noble and selfless, creating jobs and benefiting others. Corporate stock and partnership interests are treated as capital assets even if the value is tied to one's labor efforts.[34] Incentive stock options generate capital gains, not ordinary income.[35] Investors in venture-backed start-ups can exclude up to $10 million in capital gains per investment, rollover gains, or take ordinary deductions for what would otherwise be capital losses.[36]

It is not self-evident why risk taking by rich executives and venture capitalists is more valuable than risk taking by, say, a Korean-American grocer, a Mexican-American restaurateur, a farmer in California, or an Uber driver in Miami. Why should the owner of the pin factory receive a tax subsidy while the success of the baker is left to the invisible hand? A more balanced approach would allow the tax system to play its natural role as an insurance mechanism. For example, higher tax rates on top-end entrepreneurial income would allow for an expansion of the Earned Income Tax Credit.[37]

Similarly, labor mobility is important for an entrepreneurial economy. Yet the tax code does little to compensate workers for the risks associated with moving to a new city, and it makes mobility more difficult by encouraging home ownership over renting.

Merit. The tax code distorts our concept of merit by treating entrepreneurial income as if it is more socially valuable than labor income. It is not clear why this should be the case even if one favors entrepreneurship as a general matter. Entrepreneurial income is partly derived from virtues and talents, but it also is derived in part from social advantages, family ties, or luck. By defining entrepreneurial income as virtuous, the tax code reinforces our tendency to treat entrepreneurs as heroes even outside the four corners of a tax return.[38] Successful

33. *See* I.R.C. § 1221(a) (2012) (generally defining a capital asset as "property held by the taxpayer").

34. *See generally* Fleischer, *supra* note 6.

35. *See* I.R.C. § 422.

36. *See* I.R.C. §§ 1045, 1202, 1244.

37. *See* Richard V. Reeves & Joanna Venator, *Are Obama and Ryan Proposals for EITC Expansion Pro- or Anti-Mobility?*, BROOKINGS (Aug. 1, 2014), http://www.brookings.edu/blogs/social-mobility-memos/posts/2014/08/01-ryan-poverty-plan-eitc-reeves [https://perma.cc/4NVD-9LQ6].

38. *See* Paul Caron, *Fleischer: Dear Apple*, TAXPROF BLOG (May 23, 2013), http://taxprof.typepad.com/taxprof_blog/2013/05/fleischer--1.html [https://perma.cc/YH8E-W6M9]; Lydia Depillis, *Grilled Apple*, NEW REPUBLIC (May 21, 2013), https://

entrepreneurs have become the natural aristocracy, a class of people whose success in the business realm justifies higher social status and increased influence in the political realm.

Inequality. Finally, the tax code's favorable treatment of entrepreneurial income distorts the way we think about income inequality. One could infer that entrepreneurial risk is noble, and entrepreneurial income must be derived from merit. It follows that those individuals who become wealthy by those means are noble and meritorious. And it follows that redistribution from the meritorious to the less meritorious would be unjust.

Even if this were a valid way to think about merit and inequality, it obscures the problem of opportunity. Entrepreneurial income is gained justly only if others have been given similar opportunities. As income inequality increases, the opportunities to earn entrepreneurial income tend to go to the graduates of Harvard, Stanford, Princeton, and other elite schools. And we know that admission to those schools is not purely a matter of innate talent.

Fifty years ago, it was easier for an immigrant with nothing but talent and drive to start a small business and create a vehicle for social mobility for herself and her children. Today, small businesses must compete with Wal-Mart and Amazon. Most of the tax breaks passed under the guise of helping small business entrepreneurs have the effect of helping those who are already well educated and well funded: fund managers and the founders of venture-backed companies.

Tax policy did not cause inequality. But the tax treatment of entrepreneurial income makes inequality worse at the high end, and the stories we tell ourselves about taxes and entrepreneurship perpetuate a myth that our treatment of entrepreneurs reduces inequality and promotes social mobility.

Symbolic gestures in the tax code are costly. They complicate the tax code, reduce revenue, encourage wasteful tax planning, and drive up overall tax rates, reducing economic efficiency.[39] A complex economy demands that tax policy be driven by evidence, not ideology. If it so chooses, the government should use other, less-costly methods to affirm the social status of entrepreneurs and business executives symbolically.

D. Entrepreneurial Capitalism

The strongest argument that entrepreneurship holds a special place in our legal system is one grounded in institutional economics. One reasonably could argue that our system of entrepreneurial capitalism is a superior engine of economic growth than the welfare state capitalism of Northern Europe, the state-guided capitalism of China, or other varieties of

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newrepublic.com/article/113269/apple-ceo-tim-cook-testimony-leads-political-theater [https://perma.cc/6APF-VP2Q].

39. *See generally* Michael S. Kirsch, *Alternative Sanctions and the Federal Tax Law: Symbols, Shaming, and Social Norm Management As a Substitute for Effective Tax Policy*, 89 IOWA L. REV. 863 (2004).

capitalism observed around the world. To be sure, as an empirical matter, it is hardly self-evident that our system is superior in terms of gross domestic product, overall social welfare, average happiness, the welfare of our most vulnerable, or any other social welfare function. The answer of which economic system is "best" depends on history, culture, the relationship of economic freedom to other freedoms, and other institutional considerations that are easier to observe than to quantify. But it is a reasonable claim to make.

Capitalism succeeds when its economic institutions allow people to respond to market incentives, reward innovation, and allow people to participate in economic opportunities.[40] Entrepreneurship can help expand economic opportunities and prevent the stagnation of the upper class in economics and politics. It follows that we should not single out entrepreneurship for punitive taxes. But it does not follow that we should single out entrepreneurship for low taxes, either. From a public policy standpoint, entrepreneurship is a means to an end, the goal of which is a free society that provides economic opportunity to all and rewards innovation, creation, and hard work. Tax policy toward entrepreneurs should be judged based on metrics like the quality of jobs created, social mobility, and knowledge spillovers. Building a system of entrepreneurial capitalism that is sustainable in the long run demands that we pay attention to a much broader range of issues and policy instruments beyond tax.

Recall Schumpeter's warning that entrepreneurial capitalism sows the seeds of its own demise.[41] The current tax code has become an echo chamber for the economic forces driving the increase in income and wealth inequality, the blurring of economic and political influence, and the degradation of paid work. Entrepreneurial capitalism creates a dynamic and turbulent economy, and the United States is unlikely to adapt to embrace a robust welfare state that would cushion the weak from the destruction of entrepreneurship.

CONCLUSION

Our system of entrepreneurial capitalism is sustainable only if most people believe that upward mobility is possible. Historically, entrepreneurship has served as an important engine of social mobility, especially for immigrant groups, and it may continue to do so in the future. The current array of tax breaks for entrepreneurial income is best described as a system that favors rich incumbents and also helps out a few entrepreneurs. We should instead focus on creating an economy that maximizes opportunities and leave the tax code out of it.

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40. *See generally* DARON ACEMOGLU & JAMES A. ROBINSON, WHY NATIONS FAIL: THE ORIGINS OF POWER, PROSPERITY, AND POVERTY (2012).

41. *See generally* JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY (Rutledge 2003) (1942).

APPENDIX

Preference	**Primary Implied Empirical Claim**	**Empirical Evidence**
Generally Applicable Departures		
Capital gains preference. Gains for the sale of capital assets held for more than one year are currently taxed at 20 percent, compared to a top marginal rate of 39.6 percent on ordinary income.[42]	A low capital gains rate creates jobs.	*Scant*. A 1998 paper by Gompers and Lerner finds an implausibly large marginal effect, with a one point decrease in the capital gains rate increasing the number of VC-backed startups by about six per one thousand residents.[43]
Carried interest. Carried interest, a fund manager's share of partnership profits, often qualifies as a capital gain even when it represents a return on labor rather than capital.[44]	The preferential treatment of carried interest creates jobs.	*None*
Founders' stock. The founders and early employees of a start-up often receive common stock with a value near zero in exchange for future labor efforts. Appreciation in the stock is taxed at capital gains rates.[45]	The preferential treatment of founders' stock creates jobs.	*None*

42. *See* I.R.C. § 1 (2012).
43. *See generally* Paul A. Gompers & Josh Lerner, *What Drives Venture Capital Fundraising?*, 1998 BROOKINGS PAPERS ON ECON. ACTIVITY: MICROECONOMICS 149.
44. *See generally* Fleischer, *supra* note 11.
45. *See generally* Victor Fleischer, *Taxing Founders' Stock*, 59 UCLA L. REV. 60 (2011).

Deferral. Under the realization doctrine, gain or loss in the value of a capital asset is not taxed until disposition of the asset. One can minimize tax liability by deferring the sale of appreciated assets. In the context of entrepreneurial income, the entrepreneur forgoes wage income, which would have been taxed immediately, and, instead, the value of her labor is reflected in an (tax-deferred) increase in the value of the business.	Mark-to-market or retrospective capital gains taxation would be too difficult to implement.	*Mixed*. The United States has not attempted accrual or retrospective taxation. A 2003 paper suggests that an attempt by Italy did not go smoothly.[46]
Step up in basis at death. When a capital asset such as founders' stock or partnership equity is transferred by bequest, the heir takes a stepped-up basis in the asset.[47] The appreciation in the value of the capital asset is never subject to the income tax. The value of the stock is, however, included in the value of the estate, and may be subject to the estate tax.	The income from appreciated property already has been taxed by the estate tax.	*Mixed*. Founders often set up trusts, funded with pre-IPO stock, to avoid or mitigate the impact of the estate tax. On the other hand, the presence of the estate tax induces some increase in capital gains realizations.[48]

46. *See generally* Julian Alworth et al., *"What's Come to Perfect Perishes": Adjusting Capital Gains Taxation in Italy*, 56 NAT'L TAX J. 197 (2003).
47. *See* I.R.C. § 1014.
48. *See generally* Gerald Auten & David Joulfaian, *Bequest Taxes and Capital Gains Realizations*, 81 J. PUB. ECON. 213 (2001).

Targeted Tax Breaks		
Exclusion of gains from qualified small business stock. Section 1202 provides for an exclusion of up to $10 million in gains from the sale of qualified small business stock.[49] Qualified small business stock is defined to include only Subchapter C Corporations, not Subchapter S Corporations, partnerships, or LLCs.[50]	Eliminating the capital gains tax up to $10 million reduces the cost of capital for new start-ups organized as C Corporations.	*Scant*. Gunther and Willenborg do find that section 1202 reduced underpricing of penny-stock IPOs.[51]
Rollover of gains from qualified small business stock. Section 1045 provides for the unlimited rollover of gains from one start-up investment to another.[52]	Deferring capital gains reduces the cost of capital for new start-ups organized as C Corporations.	*None*
Ordinary deduction for loss investments. Section 1244 provides for an ordinary deduction of up to $100,000 on what would otherwise be a capital loss resulting from an investment in qualified small business stock.[53]	Allowing an ordinary deduction reduces the cost of capital for start-ups.	*Scant*. Cullen and Gordon find that reducing income tax rates *decreases* entrepreneurial activity by reducing the relative tax benefits of entrepreneurship; by increasing loss offsets for investors, section 1244 provides a

49. I.R.C. § 1202(b)(1)(A).
50. *Id.* § 1202(c).
51. *See generally* David A. Guenther & Michael Willenborg, *Capital Gains Tax Rates and the Cost of Capital for Small Business: Evidence from the IPO Market*, 53 J. FIN. ECON. 385 (1999).
52. I.R.C. § 1045.
53. *Id.* § 1244(b).

		modest increase to entrepreneurial activity.[54]
Amortization of start-up expenses. Sections 195, 248, and 709 provide favorable rules for deducting or amortizing expenses related to investigating and organizing a new business.[55]	Avoiding the normal capitalization rules increases the success rate of start-ups, which in turn creates jobs.	*Scant*. Carroll et al. provide indirect evidence that the cost of capital affects the rate of capital expenditures by sole proprietors.[56]
	Gaps in the Tax Base	
S Corporation avoidance of payroll taxes. Allocations of S Corporation income are not wages and avoid the burden of payroll taxes.	S Corporation owners pay themselves a reasonable salary subject to payroll taxes.	*None*. Bull and Burnham find that S Corporation owners fail to report 35 percent of labor income.[57]

54. *See generally* Cullen & Berry, *supra* note 8.
55. I.R.C. §§ 195, 248, 709.
56. *See generally* Robert Carroll et al., *Entrepreneurs, Income Taxes, and Investment* (NBER Working Paper Series, Working Paper No. 6374, 1998).
57. *See generally* Nicholas Bull & Paul Burnham, *Taxation of Capital and Labor: The Diverse Landscape by Entity Type*, 61 NAT'L TAX J. 397 (2008).

Special Burdens on Entrepreneurial Income		
Loss limitations. A symmetric income tax would impose no burden on risk-taking. As illustrated first in a model by Domar and Musgrave,[58] the government acts as a silent partner in investments, taking a share of the profits but also sharing in losses. Taxpayers scale up investments in risky activities to counterbalance the government's role. In practice, however, capital-loss limitations impose an overall tax burden on investments.	Loss limitations discourage investment in risky activities.	*Scant*. The limitation rarely is binding.[59]
Corporate tax. The double tax on corporate profits imposes an indirect economic burden on entrepreneurial income.	Entrepreneurs bear the incidence of the corporate tax, which discourages entrepreneurial entry.	*None*. Entrepreneurs bear at least some of the burden of the corporate tax. But so does labor outside of the entrepreneurial context. Whether the incidence is higher or lower in one context or the other is unclear, given that most start-ups do not pay any corporate tax.

58. *See* Evsey D. Domar & Richard A. Musgrave, *Proportional Income Taxation and Risk-Taking*, 58 Q.J. ECON. 388 (1944).

59. *See generally* Alan J. Auerbach et al., *Capital Gains Taxation and Tax Avoidance: New Evidence from Panel Data*, *in* DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH 355 (Joel Slemrod ed., 2000).