Pigeons: how to tax entrepreneurial income? (2/2)

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After having proposed in the 2013 Budget Bill to tax gains from the sale of securities at the progressive scale used by France’s income tax, and no longer at a proportional rate of 19%, the government has now promised to correct its course, under the pressure of a group of entrepreneurs who rallied on the social networks under the hashtag #geonpi (“pigeons”, using French verlan slang, which inverts syllables). An amendement proposed by the government introduces an exemption from the income tax rate on the condition of a specified period of ownership (2 years), a percentage of ownership of the shares (10% of voting rights) and status as an employee or director. Entrepreneurs will thus remain subject to the proportional tax rate of 19%. In a first post, we described how capital gains should be taxed in an equitable way with levies on income from work. In what conditions could entrepreneurs and people with a significant stake in a company justify special treatment of their gains from the sale of securities?

At first glance, the joint taxation of capital income and labour income is particularly relevant for entrepreneurs, who can choose to pay themselves either in the form of wages or in the deferred form of capital gains. In this context, the neutrality of the tax is fair and effective in so far as it does not distort the entrepreneur’s choice.

Advocates for the special treatment of entrepreneurship advance several arguments: (1) Entrepreneurship contributes a strong positive externality in terms of innovation, growth and employment. (2) Entrepreneurs are deserving (they work hard and take risks). (3) The risks taken by entrepreneurs cannot be diversified. They cannot offset their capital losses and gains, so the taxation of capital gains in itself reduces the *ex-ante* yield from entrepreneurship, and therefore the number of entrepreneurs, growth and employment.

The counter-arguments to this are:

(1) Income tax is a poor instrument for taking into account externalities: from this perspective, researchers, teachers, social workers, doctors, and in general all occupations in activities that produce externalities (health , education, culture, etc.) could claim a tax benefit (journalists have already managed to hold their own), so what is to be feared, in this context, is that the tax benefit reflects the level of influence rather than the economic externality.

(2) From the point of view of equity, there is no reason to treat labour income and the risky income of entrepreneurs differently. Young people without connections who engage in long-term studies also take a risk: like entrepreneurs, they forego an immediate wage income for an uncertain future income (they may fail in their studies or choose a poorly paid career, etc.). The entrepreneur’s income already takes into account the risk and the effort: it is because entrepreneurship is risky and demanding that it is potentially profitable. The government cannot – and should not – distinguish the share of income (labour or capital) that derives from risk, effort and talent from the share that is the fruit of chance, social networks and circumstance. Finally, taking risk into account by rewarding those who have the good fortune to emerge as winners (those with capital gains) reflects a peculiar vision of equity: in the presence of chance, equity advocates compensating the losers rather than adding to the rewards of the winners.

(3) In terms of efficiency, in the presence of a chance event, compensating the losers acts as insurance, which encourages risk-taking. Domar and Musgrave (1944) emphasized

long ago that the proportional taxation of income from business encourages the taking of entrepreneurial risk. This result is based on the assumption of a negative income tax in the presence of losses, so that the State acts as a supportive partner. While this assumption is justified for large corporations that can consolidate the gains and losses of their subsidiaries and / or carry forward certain losses, it is less legitimate for entrepreneurs who cannot diversify the risks they take. The limited liability company, the limitation on the goods that the entrepreneur can pledge, the possibility of being able to refuse an inheritance so that any eventual debts (including tax and social charges) of entrepreneurs facing failure can then be wiped clean (whereas any eventual assets, if successful, may be transmitted) are all devices that favour individual risk-taking. A more favourable tax treatment for the allocation and carrying-forward of shortfalls and capital losses for entrepreneurs and individuals who hold a significant proportion of a company could enhance these opportunities and increase the incentives for entrepreneurship.

Entrepreneurs need to have the benefit of a legal and administrative environment that is simple and accessible. The authorities can strengthen the entrepreneurial ecosystem by bringing together entrepreneurs, financiers (in particular France’s Public Investment Bank), incubators and research laboratories.

Ex-post, from the point of view of equity as well as efficiency, it is the entrepreneurs who fail, and not those who succeed, that must be helped via personal bankruptcy laws, unemployment compensation, and favourable tax systems for deductibility and carrying forward losses. Implicit subsidies for those who succeed, through income tax, while the potential rewards are already extremely large, are instead a form of social Darwinism.