

Effects of the United States tax system on transitions into self-employment

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Abstract

This paper examines the impact of US income and payroll taxes on the decision of wage-and-salary employees to become self-employed. I exploit variations in the tax treatment of wage and self-employment income using the Panel Study of Income Dynamics. Results show that differential taxation has significant effects on the probability of making a transition into self-employment. Reducing an individual's *marginal* tax rate on self-employment income while holding his marginal wage tax rate constant reduces the probability of entry. Conversely, reducing his relative *average* tax rate in self-employment increases this probability by a smaller amount. © 2000 Elsevier Science B.V. All rights reserved.

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1. Introduction

The number of self-employed Americans has grown steadily since the early 1970s, due largely to the increased entry of female entrepreneurs and growth in the number of independent contractors in the economy. A recent estimate finds the size of this group to be about 14 million, or 23 million if independent contractors are counted (Pink, 1998). Drawing upon data from the US Current Population Surveys, Schuetze (1998) notes that the self-employment rate among American prime-age males was 12.4% in 1994. While growing bodies of research have

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documented the dynamics of self-employment as well as various behavioral effects of taxation, the effects of taxes on self-employment have received relatively little attention.

Differential tax treatment could affect the decision to become self-employed in various ways, two examples of which were noted by Goode (1949). First, the taxation of self-employment income depends on voluntary compliance, while most of the wage-and-salary tax payments are withheld by employers. Second, many expenses related to self-employment are deductible in calculating taxable income. These two factors represent conditions that might pull potential entrepreneurs into self-employment. More generally, tax changes could change self-employment rates by making self-employment relatively more or less attractive than wage-and-salary work. Such effects might include a general increase in taxes, such as rate increases or base-broadening measures, which might push workers out of wage-and-salary jobs.

Some important changes in the relative tax treatment of these two types of work occurred during the 1980s that made self-employment much less tax-advantaged than it had previously been. It is the goal of this study to use this variation in relative tax treatment to estimate the incentive or disincentive effects of the US income and payroll tax systems on self-employment start-ups. If the tax system is indeed discouraging entrepreneurship, the resulting misallocation of productive inputs away from self-employment causes economic inefficiency. However, if the original tax advantages bestowed upon the self-employed were misguided, the recent changes could represent an overdue correction. While I do not attempt to estimate the socially optimum number of self-employed workers, I do examine the relative responsiveness to tax changes among those potentially considering entrepreneurship.

The remainder of the paper is organized as follows. Section 2 provides a brief history of the differential tax treatment of the self-employed. Section 3 reviews the existing empirical literature on taxes and self-employment and Section 4 describes the data and empirical strategy used. Empirical findings are presented in Section 5, with conclusions and suggestions for further research in Section 6.

To anticipate the primary results, I find that taxes have significant effects on the probability that an individual will leave a wage-and-salary job to become self-employed. The most robust estimates indicate that a five percentage point increase in the (wage-and-salary minus self-employment) difference between an individual's expected marginal tax rates reduces his transition probability by about 2.4 percentage points.

2. A history of the differential tax treatment of the self-employed

Since their inception, the US income and payroll tax systems have treated income from wage-and-salary and self-employment differently. This distinction has been necessary due to the lack of a third party (the firm) in the tax collection

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