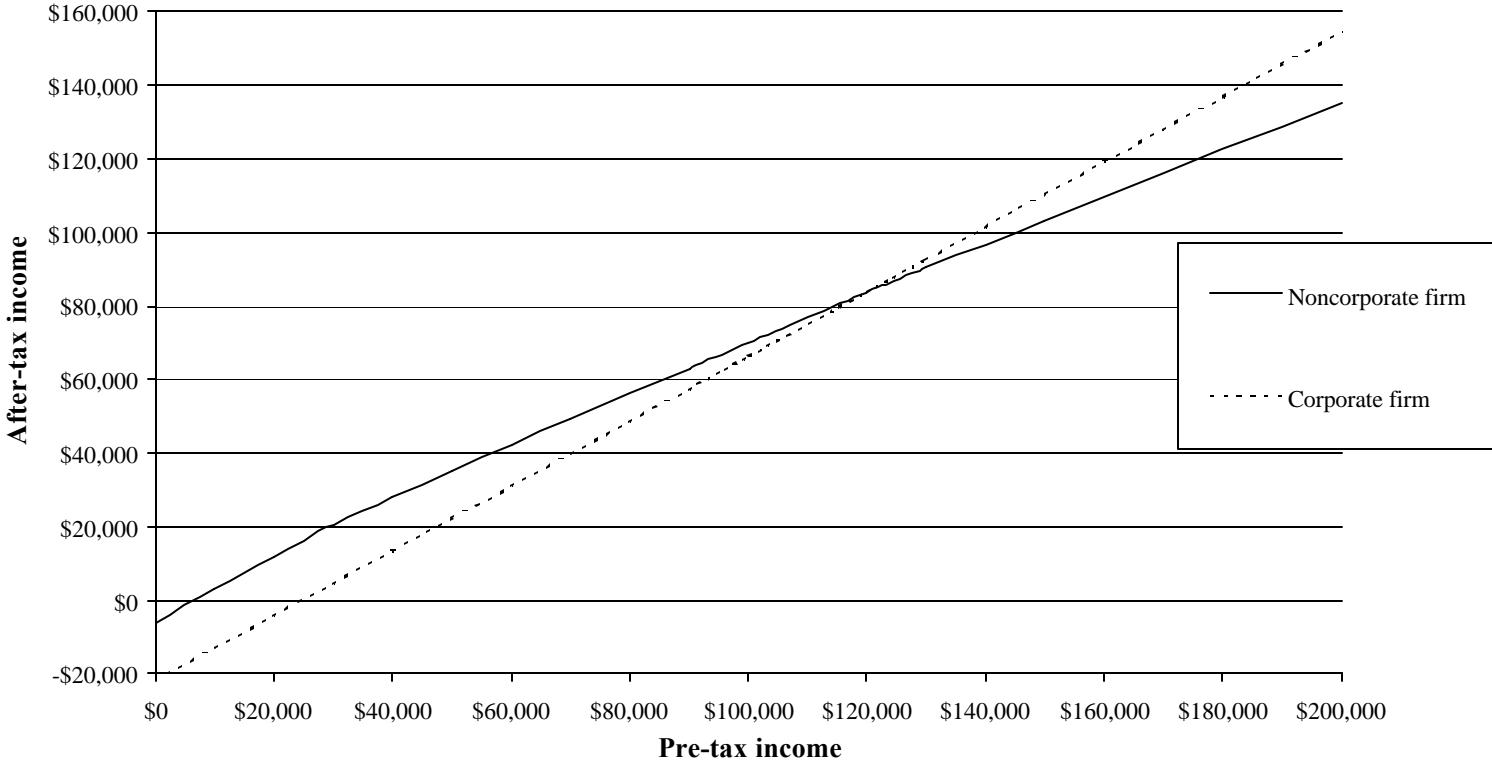
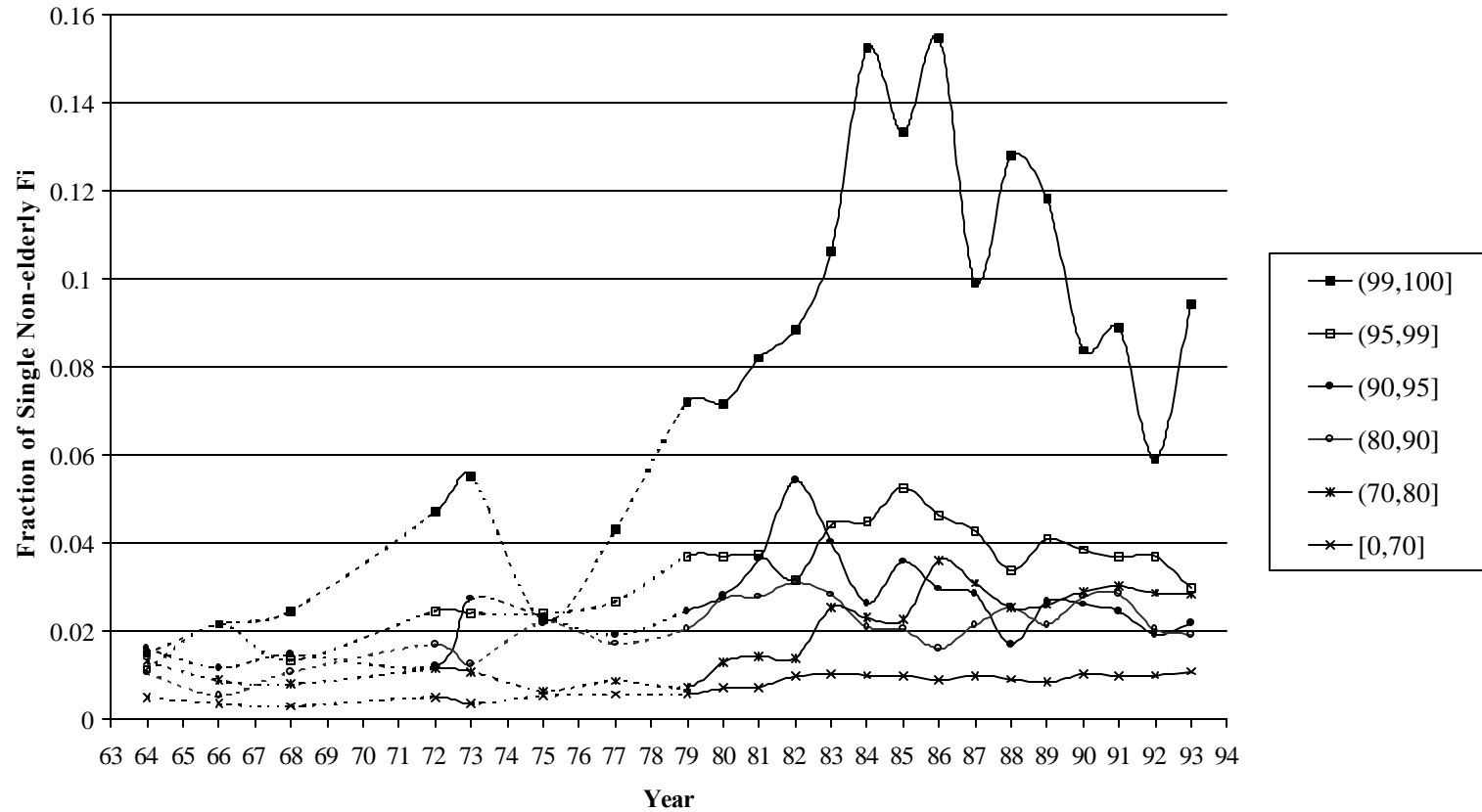


**Figure 1. Choice of Organizational Form**



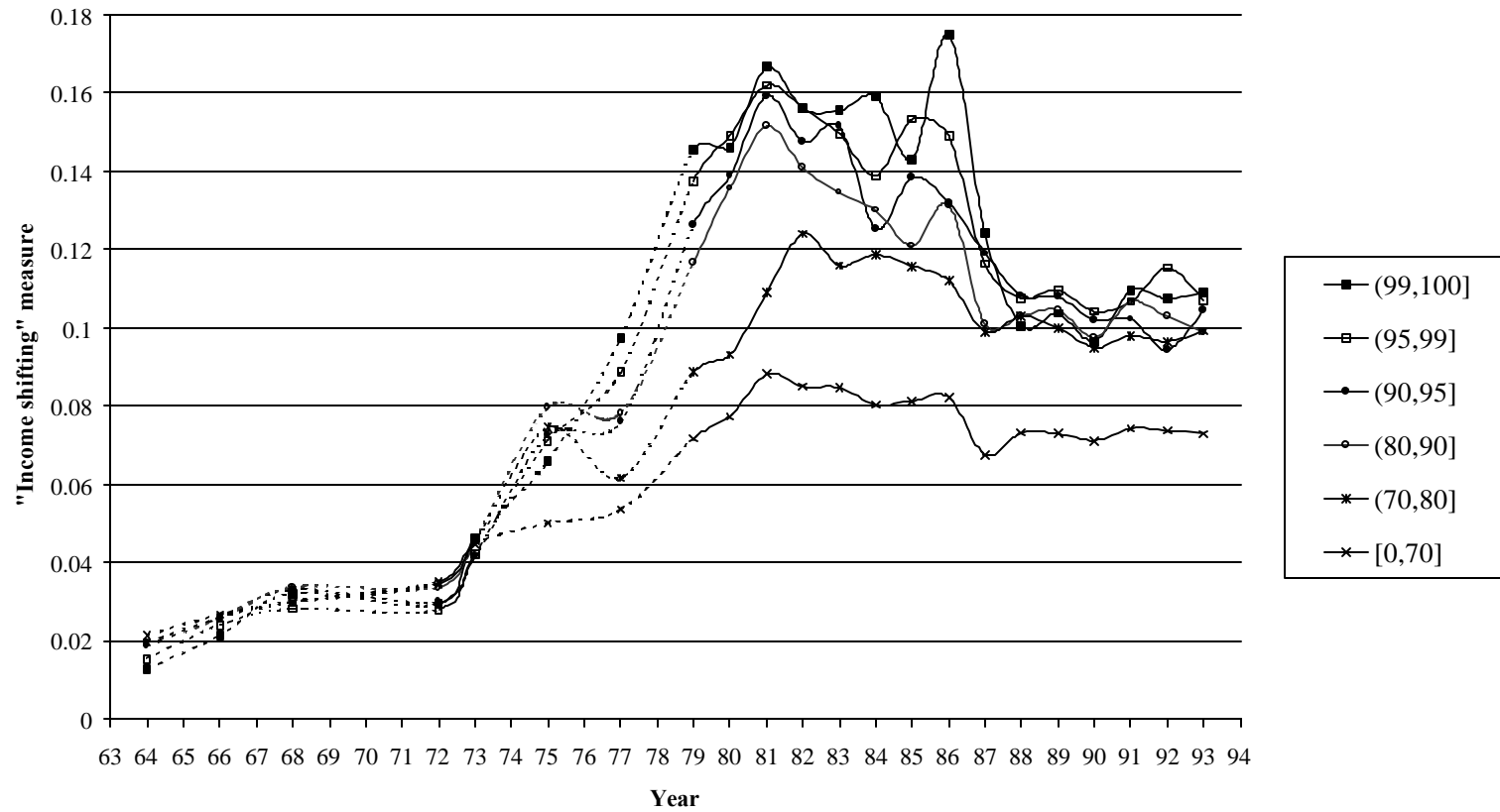
Notes: In this example, the taxpayer is assumed to have total expected income of \$150,000, with \$120,000 in wage and salary earnings and \$30,000 in business income. The solid line shows how after-tax income varies for different realizations of business income when that business income is noncorporate. The dashed line shows how after-tax income varies when business income is corporate. The relationship between pre-tax and after-tax income is calculated based on the 1993 personal income tax, payroll tax, and corporate tax schedules. Here, we calculate effective payroll and capital gains taxes using the methods described in the text. The benefit to incorporation is set to 0.12, consistent with the empirical results.

**Figure 2. Fraction with Active Noncorporate Losses by Year and Ability Quantile**



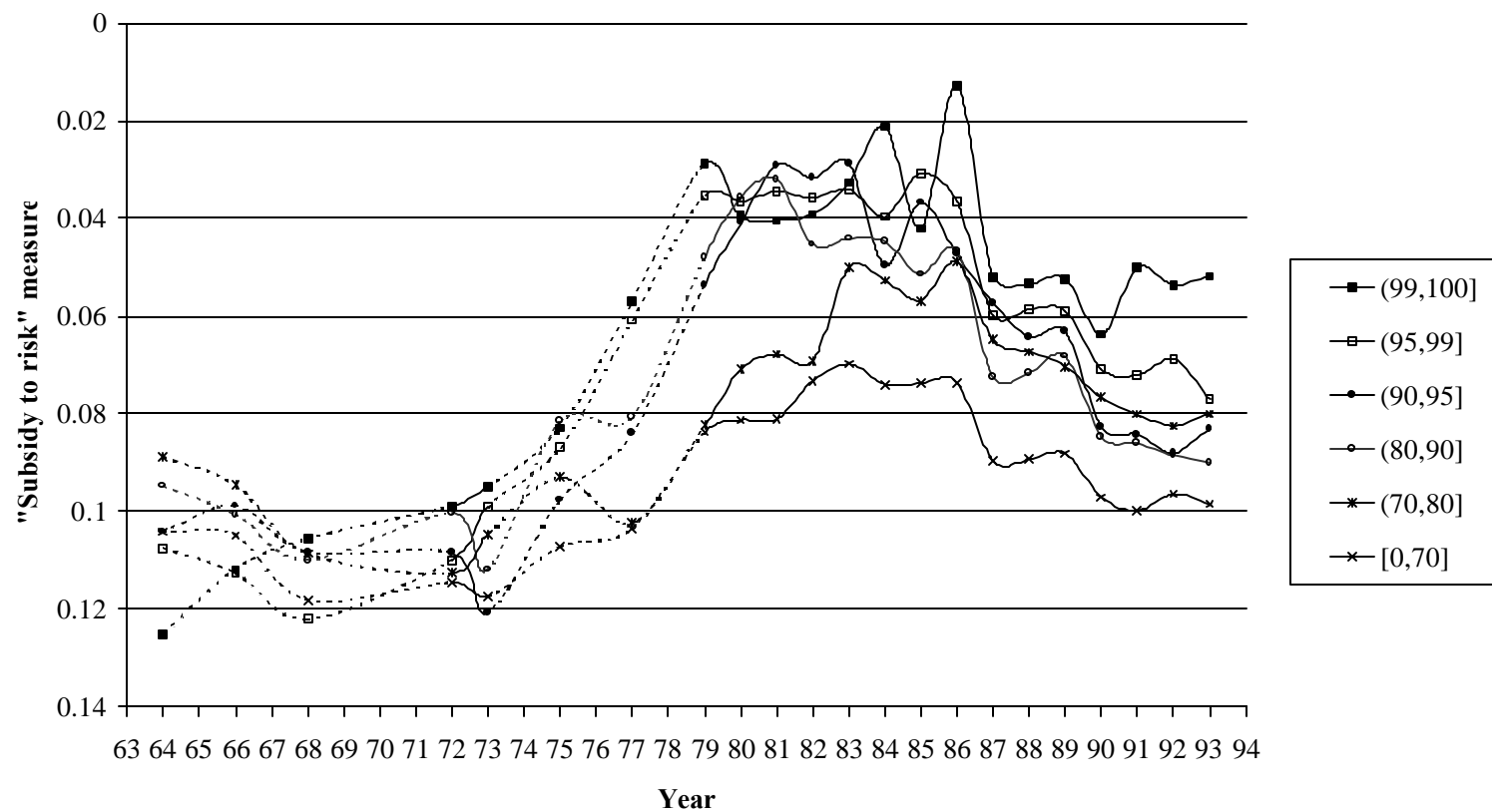
Notes: Taxpayers are assigned to one of six ability quantiles based on relative predicted earnings in each year. Individuals are classified as having active noncorporate losses if the absolute value of sole proprietorship, partnership, or S-corporation losses exceeds 10% of wage and salary income.

**Figure 3. Baseline "Income Shifting" Incentive by Year and Ability Quantile**



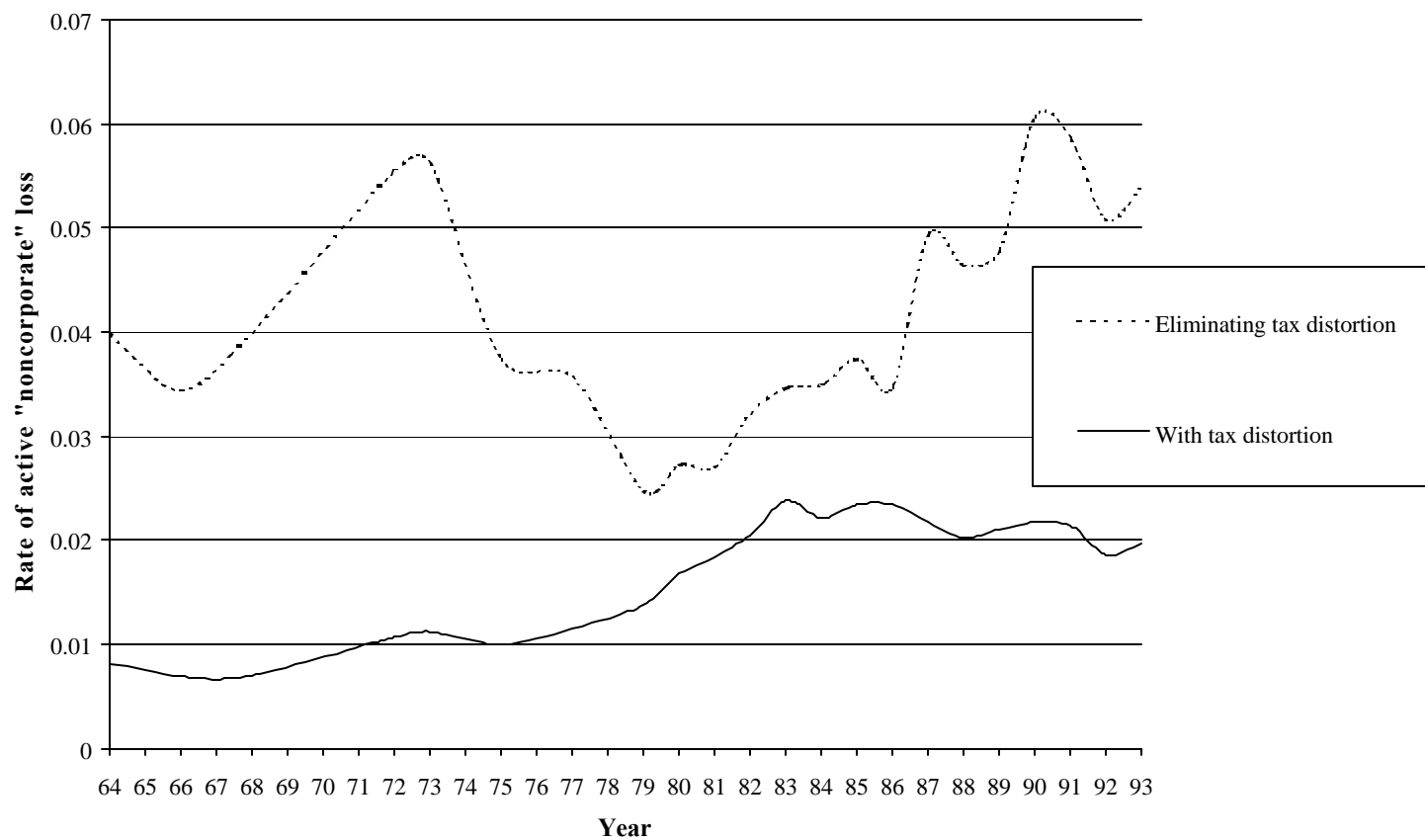
Notes: Taxpayers are assigned to one of six ability quantiles based on relative predicted earnings in each year. The "income shifting" incentive is calculated under our baseline assumptions: i) risk neutrality, ii) no nontax benefits to incorporation, iii) the coefficient of variation of business income is equal to 2, iv) the effective corporate rate is equal to the minimum corporate rate, and v) the effective capital gains rate is .25*gt*.

Figure 4. Baseline "Subsidy to Risk" Incentive by Year and Ability Quantile



Notes: Taxpayers are assigned to one of six ability quantiles based on relative predicted earnings in each year. The "subsidy to risk" incentive is calculated under our baseline assumptions: i) risk neutrality, ii) no nontax benefits to incorporation, iii) the coefficient of variation of business income is equal to 2, iv) the effective corporate rate is equal to the minimum corporate rate, and v) the effective capital gains rate is equal to .25 $g_t$ .

**Figure 5. Time Pattern of Entrepreneurial Activity**



Notes: The solid line depicts aggregate rates of "active" noncorporate losses predicted from our baseline specification in the first row in Table 2. The dashed line shows predicted rates when the two tax terms are set to zero. The aggregate rate is calculated by weighting the predicted rate for each quantile by that quantile's share of total predicted earnings in that year.

**Table 1. Baseline relationship between active loss rates and tax incentives (q=0)**

Case	Income shifting term	Risk subsidy term	Adjusted SSR	Corporate tax treatment	Level of risk	Denominator for tax terms	Exclusion rule
Dependent variable = log odds ratio for rate of active self-employment losses							
(1)	3.14 (3.26)	-16.56** (4.44)	0.0569	Min rate + capital gains	s=2	$1 - T_1^e$	10%
(2)	4.09 (2.97)	-14.13** (4.01)	0.0597	Min rate	s=2	$1 - T_1^e$	10%
(3)	5.87 (3.07)	-11.93** (3.85)	0.0598	Full schedule + capital gains	s=2	$1 - T_1^e$	10%
(4)	7.34** (1.62)	-	0.0660	Min rate + capital gains	s=0	$1 - T_1^e$	10%
(5)	-0.39 (4.05)	-40.93** (15.42)	0.0593	Min rate + capital gains	s=1	$1 - T_1^e$	10%
(6)	5.44 (3.54)	-11.19** (3.71)	0.0609	Min rate + capital gains	s=3	$1 - T_1^e$	10%
(7)	3.02 (4.35)	-18.34** (4.82)	0.0595	Min rate + capital gains	s=2	$1 - T_2^e$	10%
(8)	0.31 (3.70)	-21.79** (5.12)	{0.0897}	Min rate + capital gains	s=2	$1 - T_1^e$	20%
Dependent variable = log odds ratio for rate of active sole proprietorship losses							
(9)	1.42 (3.39)	-15.66** (4.86)	{0.0723}	Min rate + capital gains	s=2	$1 - T_1^e$	10%

Notes: Each row corresponds to a separate regression of the dependent variable indicated on the tax measures, as well as shares and indicators for ability quantiles and year indicators. The assumptions used in the calculation of the tax incentives measures are indicated in each row. All share the assumption of risk neutrality and zero non-tax benefits (or costs) to incorporation. The sum of squared residuals (SSR) is divided by the degrees of freedom to account for the fact that some specifications include different numbers of regressors (brackets highlight cases where the dependent variable has changed). Robust standard errors are reported in parentheses. The number of observations is 132. \*\* Indicates significance at the 5% level. \* Indicates significance at the 10% level.

**Table 2. Incorporating non-tax benefits to incorporation and risk aversion**

Case	Income shifting term	Risk subsidy term	Selection term	Domar-Musgrave term	Adjusted SSR	Gain to Incorporation	Level of risk aversion
Dependent variable = log odds ratio for active self-employment losses							
(1)	3.14 (3.26)	-16.56** (4.44)	–	–	0.0569	$\theta=0$	$\beta=0$
(2)	8.50 (11.89)	4.40** (1.31)	–	–	0.0731	$\theta=-\infty$	$\beta=0$
(3)	1.56 (3.33)	-15.50** (6.07)	1.00** (0.53)	–	0.0538	$\theta=0.12$	$\beta=0$
(4)	23.38** (9.92)	-13.34** (5.35)	0.79 (0.51)	-15.60** (7.45)	.0492	$\theta=0.12$	$\beta=2$
(5)	23.32** (9.81)	-20.98** (5.61)	0.77 (0.50)	-7.43** (3.94)	0.0488	$\theta=0.12$	$\beta=4$
(6)	23.10** (10.28)	-46.36** (13.88)	0.86 (0.48)	-3.08** (1.70)	0.0483	$\theta=0.12$	$\beta=10$
(7)	25.43** (6.46)	-224.02** (53.24)	0.81 (0.50)	-0.74** (0.19)	0.0449	$\theta=0.12$	$\beta=50$

Notes: The dependent variable in all specifications is the log-odds ratio for the active rate of self-employment losses. Each row corresponds to a distinct method used to calculate the tax incentive measures, with the characteristics of that method as indicated. For all of these cases, we assume that the coefficient of variation for business income is 2, the effective corporate rate is the minimum rate, and that the effective capital gains rate is as described in the text. A selection term, equal to the log of the percent of individuals with active losses predicted to be observed as such in our noncorporate data, is included in the specifications with a positive non-tax benefit to incorporation. The sum of squared residuals (SSR) is divided by the degrees of freedom to account for the fact that some specifications include different numbers of regressors. All regressions include shares and indicators for ability quantiles and year indicators, as well as the incentive measures shown. Robust standard errors are reported in parentheses. The number of observations is 132. \*\* Indicates significance at the 5% level. \* Indicates significance at the 10% level.

**Table 3a: Forecasted rates of entrepreneurship in 1993; baseline specification**

Tax parameters	Ability quantile						Aggregate
	[0,70]	(70,80]	(80,90]	(90,95]	(95,99]	(99,100]	
Under 1993 tax law	0.009	0.021	0.018	0.024	0.037	0.113	0.020
Minimum corporate rate reduced to 10%	0.019	0.047	0.040	0.055	0.082	0.234	0.043
Personal income tax rates reduced by 5 percentage points	0.008	0.015	0.013	0.018	0.024	0.073	0.014
20% flat tax	0.010	0.028	0.026	0.034	0.045	0.093	0.023
2001 personal income tax reforms	0.008	0.017	0.015	0.020	0.029	0.082	0.016
Negative income tax	0.028	0.046	0.039	0.052	0.071	0.205	0.045

Notes: The rates in each panel are forecasted based on the estimation results from our baseline specification (row 1 in Table 2). Each column shows the predicted rate of active self-employment losses for the ability quantile indicated. To calculate the aggregate rate shown in the final column, we weight the rate for each quantile by its share of overall predicted earnings. In the first row, the two tax incentive measures are calculated using the actual tax schedules for 1993. The following rows are calculated under specific adjustments to the 1993 tax code. Under the 20% flat tax, both personal and corporate rates have been reduced to a single 20% rate and the EITC and capital gains taxes have been eliminated. Under the negative income tax, negative personal income generates a rebate based on the minimum marginal tax rate.



**Table 3b: Forecasted rates of entrepreneurship in 1993; specification with nontax benefits to incorporation**

Tax parameters	Ability quantile						Aggregate
	[0,70]	(70,80]	(80,90]	(90,95]	(95,99]	(99,100]	
Under 1993 tax law	0.016	0.026	0.021	0.024	0.038	0.116	0.025
Minimum corporate rate reduced to 10%	0.033	0.057	0.045	0.058	0.083	0.232	0.052
Personal income tax rates reduced by 5 percentage points	0.015	0.021	0.017	0.021	0.028	0.081	0.020
20% flat tax	0.017	0.034	0.029	0.036	0.046	0.094	0.028
2001 personal income tax reforms	0.015	0.023	0.018	0.023	0.031	0.088	0.021
Negative income tax	0.021	0.032	0.025	0.032	0.045	0.137	0.030

Notes: The rates in each panel are forecasted based on the estimation results from the specification with  $\theta=0.12$  and  $\beta=0$  (row 3 in Table 2). We ignore the selection term when predicting loss rates, so that the rate includes individuals who would choose to report active losses as corporate income. Each column shows the predicted rate of active self-employment losses for the ability quantile indicated. To calculate the aggregate rate shown in the final column, we weight the rate for each quantile by its share of overall predicted earnings. In the first row, the two tax incentive measures are calculated using the actual tax schedules for 1993. The following rows are calculated under specific adjustments to the 1993 tax code. Under the 20% flat tax, both personal and corporate rates have been reduced to a single 20% rate and the EITC and capital gains taxes have been eliminated. Under the negative income tax, negative personal income generates a rebate based on the minimum marginal tax rate.

**Table 3c: Forecasted rates of entrepreneurship in 1993; specification with nontax benefits to incorporation and risk aversion**

Tax parameters	Ability quantile						Aggregate
	[0,70]	(70,80]	(80,90]	(90,95]	(95,99]	(99,100]	
Under 1993 tax law	0.014	0.026	0.021	0.026	0.037	0.114	0.023
Minimum corporate rate reduced to 10%	0.008	0.016	0.012	0.015	0.023	0.071	0.014
Personal income tax rates reduced by 5 percentage points	0.013	0.020	0.016	0.019	0.026	0.076	0.018
20% flat tax	0.039	0.090	0.073	0.088	0.114	0.213	0.068
2001 personal income tax reforms	0.013	0.021	0.017	0.021	0.029	0.085	0.019
Negative income tax	0.023	0.038	0.029	0.036	0.050	0.149	0.034

Notes: The rates in each panel are forecasted based on the estimation results from the specification with  $\theta=0.12$  and  $\beta=4$  (row 5 in Table 2). We ignore the selection term when predicting loss rates, so that the rate includes individuals who would choose to report active losses as corporate income. Each column shows the predicted rate of active self-employment losses for the ability quantile indicated. To calculate the aggregate rate shown in the final column, we weight the rate for each quantile by its share of overall predicted earnings. In the first row, the two tax incentive measures are calculated using the actual tax schedules for 1993. The following rows are calculated under specific adjustments to the 1993 tax code. Under the 20% flat tax, both personal and corporate rates have been reduced to a single 20% rate and the EITC and capital gains taxes have been eliminated. Under the negative income tax, negative personal income generates a rebate based on the minimum marginal tax rate.

**Table 4. Explaining secular time variation in entrepreneurship**

Dep. Var. = Year effect estimated from our baseline specification		
Independent variable	(1)	(2)
Average profit rate among large firms	-27.78** (5.52)	-37.43** (13.63)
Unemployment rate	-4.27* (2.18)	-4.15* (2.29)
Real T-bill rate	-6.50** (1.14)	-7.33** (1.37)
Inflation rate	-4.86 (1.50)	-4.64** (1.61)
Time Trend	—	-0.01 (0.01)

Notes: The dependent variable in each column is the estimated year effect from our baseline specification predicting the log-odds ratio of self-employment losses in column 1 of Table 2. The average profit rate among large firms is calculated from Statistics of Income data on the amount of assets and taxable income by detailed asset size categories. Firms are classified as large if assets exceed \$1 million in 1993 dollars. The average profit rate calculated in this way is highly correlated with the profit rate calculated based on net income (less deficit). The number of observations is 21. Robust standard errors are in parentheses. \*\* Indicates significance at the 5% level. \* Indicates significance at the 10% level.

**Table A1: The Impact of Transitions to Self-Employment on Components of Income**

Variable	Mean in t-2			Difference (4)	Change from t-2 to t		Difference (7)
	(1)	(2)	(3)		(5)	(6)	
Indicator for wage and salary income	0.997 (0.002)	0.999 (0.000)	0.997 (0.000)	0.000 (0.002)	-0.248 (0.012)	0.001 (0.000)	-0.249** (0.012)
Ln(Wage and salary income)	10.076 (0.028)	9.865 (0.003)	10.085 (0.004)	-0.009 (0.030)	-0.499 (0.034)	0.115 (0.002)	-0.614** (0.035)
Indicator for claims property tax deduction	0.429 (0.014)	0.273 (0.002)	0.427 (0.002)	0.001 (0.014)	0.004 (0.011)	0.018 (0.001)	-0.014 (0.011)
Ln(Property tax deduction)	7.018 (0.042)	6.814 (0.006)	7.002 (0.006)	0.016 (0.044)	0.080 (0.027)	0.043 (0.004)	-0.036 (0.027)
Indicator for reports mortgage interest deduction	0.418 (0.014)	0.265 (0.002)	0.418 (0.002)	0.000 (0.014)	0.001 (0.011)	0.010 (0.001)	-0.010 (0.011)
Ln(Mortgage interest deduction)	8.328 (0.041)	8.080 (0.006)	8.326 (0.006)	0.002 (0.043)	-0.024 (0.029)	-0.045 (0.004)	0.021 (0.029)
Indicator for reports interest income	0.646 (0.013)	0.497 (0.002)	0.646 (0.002)	-0.000 (0.014)	0.053 (0.013)	0.016 (0.001)	0.037** (0.012)
Ln(Interest income)	5.989 (0.069)	5.385 (0.009)	5.972 (0.009)	0.017 (0.073)	0.107 (0.055)	0.081 (0.007)	0.026 (0.055)
Indicator for reports dividend income	0.213 (0.011)	0.115 (0.001)	0.213 (0.001)	-0.000 (0.012)	0.011 (0.009)	0.019 (0.001)	-0.008 (0.009)
Ln(Dividend income)	6.246 (0.120)	5.491 (0.020)	6.229 (0.019)	0.017 (0.126)	-0.032 (0.096)	0.056 (0.013)	-0.088 (0.092)
Married Filing Jointly	0.661 (0.013)	0.455 (0.002)	0.660 (0.002)	0.001 (0.014)	0.030 (0.008)	-0.003 (0.001)	0.032** (0.008)
Indicator for any dependents	0.546 (0.014)	0.445 (0.002)	0.542 (0.002)	0.003 (0.015)	0.007 (0.009)	0.005 (0.001)	0.002 (0.009)
Ln(Number of dependents)	0.913 (0.014)	0.905 (0.002)	0.898 (0.002)	0.015 (0.015)	-0.005 (0.009)	-0.007 (0.001)	0.002 (0.009)
<b>Enters self-employment in t-1</b>	<b>Yes</b>	<b>No</b>	<b>No</b>		<b>Yes</b>	<b>No</b>	
<b>Matched "control" group</b>		<b>No</b>	<b>Yes</b>	<b>Yes</b>		<b>Yes</b>	<b>Yes</b>
Number of Observations	1,316	81,938	81,938	83,254	1,316	81,938	83,254

Notes to Table A1: The sample is the sub-sample of the 1979-1990 IMF panel of taxpayers that satisfies the same set of restrictions applied to our cross-sectional sample. We exclude taxpayers who: i) report age exemptions, ii) have positive retirement income, iii) are not employed or self-employed, iv) report farm income in excess of 10% of wages and salaries, or iv) are claimed as dependents by another taxpayer. A taxpayer is defined as being actively self-employed if the absolute value of business, partnership, or sub-chapter S corporation net income is at least 10% of wage and salary earnings. The first column presents means in year t-2 for taxpayers that enter active self-employment in t-1 and remain self-employed in t. The continuous variables expressed in logarithmic form are missing

for non-positive values of the underlying variables. The second column presents means for individuals who do not enter self-employment in t-1 nor in t. The third column shows the means for the same sample as in column 2 re-weighted to more closely match those who enter self-employment according to observables in t-2 (based on an initial probit regression as described in the text). Column 4 then shows the difference in means across the sample of those who enter self-employment and the matched sample that does not. Columns 4-6 show the same statistics for changes in characteristics from t-2 to t for these same two samples. Standard errors are in parentheses. All monetary values have been converted to 1990 dollars using the CPI for all goods. \*\* indicates the difference is significant at the 5% level. \* indicates significance at the 10% level.

**Table A2: The Impact of Transitions to Self-Employment with Losses on Components of Income**

Variable	Mean in t-2			Difference (4)	Change from t-2 to t		Difference (7)
	(1)	(2)	(3)		(5)	(6)	
Indicator for wage and salary income	0.992 (0.014)	0.999 (0.000)	0.992 (0.000)	0.001 (0.005)	-0.137 (0.017)	0.002 (0.000)	-0.139** (0.018)
Ln(Wage and salary income)	10.414 (0.055)	9.865 (0.003)	10.416 (0.003)	-0.003 (0.056)	-0.248 (0.045)	0.037 (0.002)	-0.284** (0.045)
Indicator for claims property tax deduction	0.576 (0.025)	0.273 (0.002)	0.574 (0.002)	0.002 (0.026)	-0.067 (0.021)	0.011 (0.001)	-0.078** (0.021)
Ln(Property tax deduction)	7.137 (0.064)	6.814 (0.006)	7.125 (0.006)	0.012 (0.065)	0.055 (0.045)	0.027 (0.004)	0.028 (0.045)
Indicator for reports mortgage interest deduction	0.545 (0.025)	0.265 (0.002)	0.547 (0.002)	-0.001 (0.026)	-0.083 (0.022)	0.003 (0.001)	-0.086** (0.022)
Ln(Mortgage interest deduction)	8.351 (0.072)	8.080 (0.006)	8.335 (0.006)	0.016 (0.073)	-0.009 (0.058)	-0.072 (0.004)	0.063 (0.057)
Indicator for reports interest income	0.736 (0.022)	0.497 (0.002)	0.737 (0.002)	-0.000 (0.023)	0.016 (0.024)	0.009 (0.001)	0.007 (0.024)
Ln(Interest income)	6.399 (0.116)	5.385 (0.009)	6.391 (0.009)	0.008 (0.119)	0.078 (0.105)	0.066 (0.006)	0.012 (0.105)
Indicator for reports dividend income	0.320 (0.024)	0.115 (0.001)	0.322 (0.002)	-0.002 (0.025)	-0.016 (0.016)	0.014 (0.001)	-0.030* (0.016)
Ln(Dividend income)	6.604 (0.183)	5.491 (0.020)	6.576 (0.019)	0.028 (0.186)	-0.016 (0.137)	0.037 (0.014)	-0.053 (0.138)
Married Filing Jointly	0.713 (0.023)	0.455 (0.002)	0.717 (0.002)	-0.003 (0.023)	0.003 (0.013)	-0.002 (0.001)	0.005 (0.014)
Indicator for any dependents	0.594 (0.025)	0.445 (0.002)	0.595 (0.002)	-0.001 (0.026)	-0.028 (0.017)	-0.005 (0.001)	-0.024 (0.017)
Ln(Number of dependents)	0.921 (0.026)	0.905 (.002)	0.911 (0.002)	0.010 (0.026)	-0.041 (0.018)	-0.015 (0.001)	-0.026 (0.018)
<b>Enters self-employment in t-1 (with losses in t)</b>	<b>Yes</b>	<b>No</b>	<b>No</b>		<b>Yes</b>	<b>No</b>	
<b>Matched "control" group</b>		<b>No</b>	<b>Yes</b>	<b>Yes</b>		<b>Yes</b>	<b>Yes</b>
Number of Observations	387	81,938	81,939	82,325	387	81,938	83,325

Notes to Table A2: This table repeats the analysis described in Table A1 for individuals who enter self-employment in year t-1 and have active losses in year t. Individuals are classified as having active losses if net losses from business, partnership, or sub-chapter S corporation activity exceed 10% of wage and salary income. The control group includes individuals who do not transition to active self-employment over the same period.