

Health Insurance Deductibility and Entrepreneurial Survival

Tami Gurley-Calvez, Alexandria, VA 22314

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The purpose of this research is to add to the policy debate by investigating whether closing the health insurance tax incentive gap between employees and the self-employed enhances entrepreneurial survival.

Wage and salary employees are able to purchase health insurance for themselves and their families with pre-tax dollars, thereby lowering their out-of-pocket expense for health insurance. Health insurance premiums paid by the self-employed have historically received different tax treatment. The self-employed were not able to deduct health insurance premiums when calculating income tax or payroll tax liabilities prior to 1987. A self-employed health insurance deduction for income tax purposes was implemented in 1987 and made permanent ten years later. However, this did not equalize the tax treatment of health insurance premiums as self-employed health insurance premiums are still not deductible in payroll tax calculations.

This paper explores how the tax treatment of self-employed health insurance premiums affects entrepreneurial decisions. The study examines tax return data for self-employed entrepreneurs over a three-year period when the tax deductibility of health insurance premiums was being phased in. This data is used to estimate the effect that the deduction had on the probability that an entrepreneurial filer who claimed it would continue in entrepreneurial activities in the following filing year.

Overall Findings

The income tax deductibility of health insurance premiums for self-employed filers has a positive effect on the rate of entrepreneurial survival. The study finds that the rate of exit from entrepreneurial activity decreases when filers are permitted to deduct a portion of health insurance premiums on federal income tax filings. The effect holds for both single

filers (who are generally younger, earlier in their career, and less risk averse), as well as for married filers (who are often older and have dependent family members). The effect of the deduction on married filers is greatest. Married filers who took the deduction are more likely to remain in an entrepreneurial activity. As the value of the deduction grows, single filers' exit rates decline more than those of married filers.

The findings generally confirm the observation that lower tax rates on entrepreneurial income tend to increase entrepreneurial activity; larger deductions of health care expenditures reduce the tax bills of those who purchase insurance. The observed decreases in the probability of entrepreneurial exit are an important consideration when evaluating policies to allow a health insurance deduction in calculating payroll tax liabilities.

Highlights

The author's results offer compelling evidence that health insurance deductibility enhances entrepreneurial survival.

- The presence of a health insurance deduction decreases the probability that a self-employed entrepreneur will choose to exit the entrepreneurial sector by 2.65 percentage points for single filers. The average probability of exit for single filers over the sample period was 24.49 percent, thus the marginal effect of the health insurance deduction was a 10.82 percent reduction in the likelihood of exit.

- For married filers, the presence of a health insurance deduction decreases the rate of exit from entrepreneurship by 10.52 percentage points. Given that the average rate of exit for married filers over the sample was only 16.19 percent, this represents a dramatic reduction in entrepreneurial exit of almost 65 percent.

- Similarly, changes in the dollar value of the health insurance premium deduction also have large effects on the probability of exit from entrepreneurship. For single filers the relationship is almost unit elastic, a 10 percent increase in the value of the deduction reduces the probability of exit by 10.62 percent. However, for married filers the relationship is rather inelastic: a 10 percent increase in the value of the health insurance deduction causes only a 1.23 percent reduction in exit probability.

Scope and Methodology

This research examines the relationship between entrepreneurship and the tax deductible status of health insurance premiums using a dataset of individual tax return data to perform an econometric analysis on the data. The study defines “entrepreneurship” as the existence in a given data year of a Schedule C tax return for a given tax filer. The data are drawn from the University of Michigan Tax Research Database, constructed from public-use tax return data released by the Internal Revenue Service Statistics of Income Division. The data contain a random sample of all filers over the period 1988 to 1990. The sample period was chosen because 1988 was the first year a significant number of Schedule C filers claimed the health insurance deduction, and 1990 is the final year for which data are available. Because the data panel includes observations on a large number of individuals over a number of years,

a random effects regression model was employed to control for unobservable individual heterogeneity. Other variables control for age, household size, presence of and age of children, liquidity constraints, and risk attitudes.

This report was peer-reviewed consistent with Advocacy’s data quality guidelines. More information on this process can be obtained by contacting the director of economic research by email at advocacy@sba.gov or by phone at (202) 205-6533.

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