

Taxation, Entrepreneurship, and the Choice of Organizational Form

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Abstract

What are the effects of taxation on entrepreneurial activity? This paper studies the dynamic choice of organizational form for startup firms and quantifies the impacts of tax and non-tax advantages of incorporation on the choice of organizational form. I develop two models where entrepreneurs are unable to capture the value of a positive externality to the economy and tie these specific market failures to policies of organizational forms. These models determine rates of personal and corporate taxes as a function of behavioral quantities such as the value of non-tax advantages and the propensity to change organizational forms with respect to changes in tax parameters. I estimate a dynamic discrete choice model of the choice of organizational form using data from the Kauffman Firm Survey. Results from this estimation show that static models underestimate fixed costs of reorganization while overestimating the non-tax advantages of incorporation. The revised estimates also lead to a substantive downward revision of the risk-taking incentive inherent in the flexibility to change organizational forms.

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