

Understanding Self-Employment Dynamics Among Individuals Nearing Retirement

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Under contract number SBAHQ-13-M-0055.

Purpose

Baby boomers, who were born between 1946 and 1964, are entering their retirement years. Since rates of self-employment rise with age, a disproportionate share of the self-employed is composed of middle aged or older workers. Some of these workers have been self-employed for much or all of their working lives while others have transitioned to self-employment later in their careers, often as a way of moving into retirement.

Future predictions of baby boomers as a key catalyst for small business growth in the next decade and beyond have tended to neglect an important trend. The self-employment rate among those nearing retirement (defined as individuals aged 55-64) has dropped substantially in the past 20 years. This study addresses two questions about this decline. First, has the decline in self-employment rates among near-retirees been driven by: 1) lower rates of individuals in this age group choosing to become self-employed (often called the entry rate) or remaining self-employed (called the continuation rate), 2) an increase in number of current self-employed choosing to retire or find a job with a firm (called the exit rate), or 3) fewer individuals being self-employed when entering these years? Second, what economic and policy variables help to explain the change in these factors over time? This study explores almost 20 years of U.S. Census Bureau data from 1994-2012 to describe in greater detail the continuation, exit, and entry rates with respect to self-employment.

Background

The self-employed constitute a substantial and important part of the workforce in the United States.

Research has indicated that the annual total non-agricultural self-employment rate (including unincorporated and incorporated businesses) has generally exceeded 10 percent over the past 20 years (see Figure 1). In addition, several papers have shown that the rate of self-employment increases as individuals near retirement. However, since 1994, the self-employment rate among those nearing retirement has steadily declined. The self-employment rate among near retirees was above 18 percent in 1994, but dropped to around 16 percent in the early 2000s, and dropped further to 14.3 percent in 2012 (Figure 1). No existing study has examined the reasons for this substantial decline in self-employment among near-retirees.

Overall Findings

The study's key finding is that the decline in the self-employment among 55- to 64-year-olds over the 1994-2012 period was driven by three factors:

(1) The self-employed are choosing to find a job at a firm rather than being self-employed. The movement (i.e., exit rate) to wage and salary employment increased over the sample period, particularly among the unincorporated self-employed, and particularly to the private sector (Figure 2). The increase is apparent across all regions of the country and across retail and service industries.

(2) The rate of self-employment among 55-year-olds (who comprise about 12 percent of the self-employed aged 55-64) decreased over the sample period; these declines were particularly notable among the unincorporated self-employed and those in the retail sector. Further, the self-employment

rate among this group is lower than in the full 55- to 64-year-old cohort.

(3) The share of 55-year-olds in the 55- to 64-year-old cohort increased.

Other important findings indicate that a higher after-tax price of self-employed health insurance is associated with decreases in entries into self-employment among wage and salary workers (see “Tax Treatment of Self-Employed Health Insurance Premiums” box). The study also finds the following demographic factors are important among those nearing retirement:

- Women and African-Americans are less likely to enter into self-employment and are more likely to leave self-employment for a wage-and-salary job or retirement.

- Older individuals are less likely to leave self-employment for wage-and-salary employment and more likely to leave for retirement; they are less likely to enter self-employment from retirement.

- Being married is positively associated with exits to retirement.

In terms of income and wealth variables:

- Individuals with greater wealth (measured by investment income) are less likely to leave self-employment for wage-and-salary work although they are more likely to leave for retirement.

- Individuals with more labor and transfer income are more likely to leave self-employment for wage-and-salary work but less likely to leave for retirement.

- Having an employer pension plan in the prior year is negatively related to entry into self-employment from a wage-and-salary job, but positively associated with entry from not working.

In terms of state-level policy and economic variables, neither an improving economy (as measured by lower unemployment rates or higher average wages) nor stricter disability insurance policy significantly impacts either the entrance to self-employment or the rate of exit from self-employment for those aged 55-64 or those at age 55.

Regarding the propensity to be self-employed at age 55, these findings apply:

- Women and African-Americans have a lower propensity to be self-employed at age 55.

- Self-employment at age 55 increases with educational level and income.

- Having an employer pension in the prior year is not significantly related to self-employment at age 55.

Policy Recommendations

The significant declines in self-employment rates suggest a need for policies to reduce the exits of near-retirees from self-employment to private wage and salary employment and to increase entrepreneurship among younger cohorts.

The author makes several suggestions to this end.

- Increasing the availability and affordability of private health insurance may decrease the rates of exits from self-employment, increase the rates of entry to self-employment, and increase self-employment rates among new entrants into the 55- to 64-year-old cohort. Such changes in health insurance would counter the “job lock” phenomenon particularly detrimental during a recession, e.g., individuals not wanting to leave jobs that provide health insurance.

- Reductions in the after-tax price of health insurance while self-employed may slow or reverse the declining trend in self-employment at age 55.

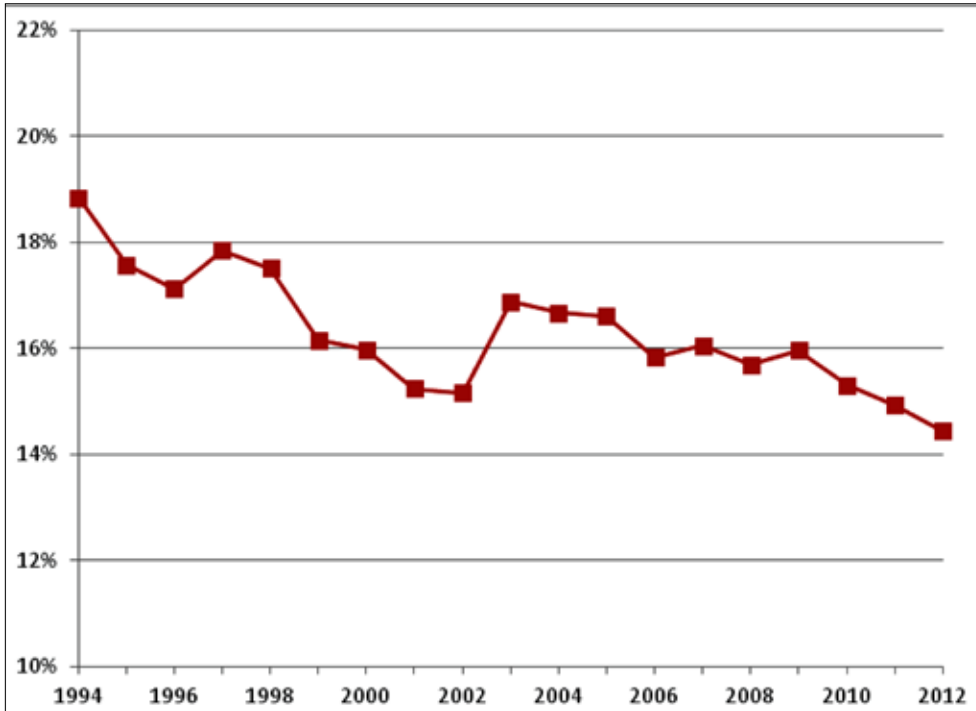
An important area for future research, then, will be to evaluate the extent to which recent changes in health insurance cost and coverage due to the implementation of the Affordable Care Act of 2010 affected rates of self-employment in this cohort.

The author points out that the changes in self-employment rates may also be due to other economic and social factors, such as increased productivity and efficiency among larger businesses, making small businesses less able to compete. If this proved to be the case, it is unclear what policy response would be desirable for the economy as a whole.

Tax Treatment of Self-Employed Health Insurance Premiums

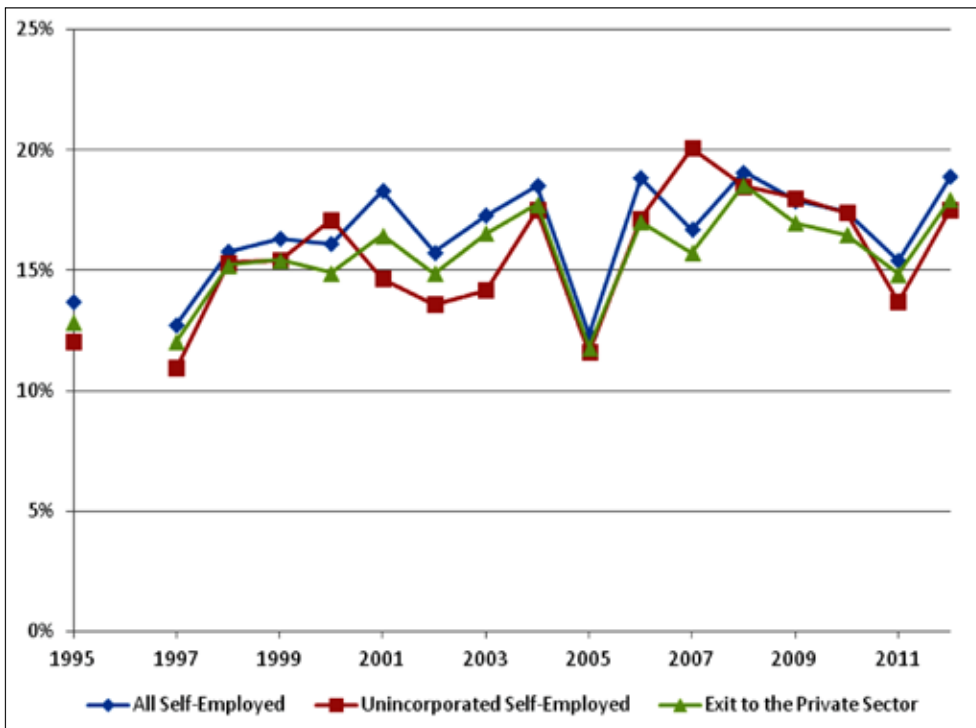
Unlike employees who get health insurance through their employer, the cost of health insurance premiums for the self-employed is not excludable from both income and payroll taxes. Under current law, self-employed health insurance premiums are deductible from income taxes, but are not excludable from the calculation of self-employed payroll taxes (formerly called Self-Employed Contribution Act [SECA] taxes). This increases the after-tax cost of health insurance compared to that of an employee. The SECA tax is 15.3 percent of taxable income however the self-employed are able to deduct half of this tax paid.

Figure 1. Self-Employment Rates of 55-64 Year Olds, 1994-2012



Source: Bradley T. Heim, *Understanding Self-Employment Dynamics Among Individuals Nearing Retirement*, U.S. Small Business Administration Office of Advocacy, 2014. Based on U.S. Census Bureau, 1994-2012 Annual Social and Economic (ASEC) supplements to the Current Population Survey (CPS).

Figure 2. Exit Rates of 55-64 Year Olds to Wage and Salary Sector, 1995-2012



Source: Bradley T. Heim, *Understanding Self-Employment Dynamics Among Individuals Nearing Retirement*, U.S. Small Business Administration Office of Advocacy, 2014. Based on U.S. Census Bureau, 1994-2012 Annual Social and Economic (ASEC) supplements of the Current Population Survey (CPS).

Scope and Methodology

Data for this study come from the 1994-2012 waves of the Annual Social and Economic (ASEC) supplements to the Current Population Survey (CPS), commonly known as the March CPS. The CPS is a nationally representative survey of households administered by the Census Bureau on a monthly basis. It is possible to match respondents across two adjacent March surveys, so that one can observe whether an individual continued in, entered, or exited from self-employment between their first March interview and their second.

There are several advantages to using the CPS for this study. First, the CPS is the dataset that is used in the most commonly referenced tabulations of self-employment rates by other researchers. Second, the March CPS is collected annually, so that annual rates of entry and exit can be examined (in contrast to a data source like the Health and Retirement Study (HRS) in which respondents are interviewed only every other year). Third, the sample size is sufficiently large that it is possible to tabulate rates overall and for a number of subsamples (including incorporation status, industry, and region of the country). However, individuals are observed for at most one two-year pair, and so it is not possible to track individuals over longer periods of time. In addition, although many variables of interest are included in the study, the CPS does not include information on respondents' wealth.

To address the questions about the decline in self-employment among those nearing retirement, the researcher uses a Markov Chain model to relate the self-employment rate in a particular year to rates of continuation within self-employment, entry into self-employment, exit from self-employment, and the self-employment rate among individuals who turn 55 that year. To examine what demographic, economic, and policy variables are associated with entries to or exits from self-employment during the pre-retirement years, and which variables are associated with the level of self-employment among 55-year-olds, a set of multinomial logit estimations is run. Simulations are then performed to examine the extent to which changes in economic and policy variables may have led to changes in rates of continuation, entry, exit, and self-employment at age 55. Counterfactual simulations are presented to examine what trends would have looked like had these variables not changed over the roughly twenty-year period.

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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