

TAXATION OF INDIVIDUAL ENTREPRENEURSHIP AND SELF-EMPLOYMENT INCOME: FUNDAMENTAL PRINCIPLES, INSTITUTIONAL DESIGN

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ABSTRACT: Using comparative institutional analysis and international policy benchmarking, the study reviews global practices in defining the legal status of individual entrepreneurs and self-employed persons, designing simplified tax regimes, and linking tax payments to social protection entitlements. Drawing on the experiences of countries such as Brazil, France, the United States, Germany, the United Kingdom, and Australia, the paper demonstrates that simplified, digitalized, and socially integrated tax systems significantly improve formalization, compliance, and fiscal sustainability. The article concludes that a hybrid and adaptive tax framework, combining simplified regimes for micro-activities with gradual transition mechanisms to general tax systems, offers the most effective approach for taxing individual entrepreneurship and self-employment income. Such a framework not only strengthens public revenues but also promotes social inclusion, labor market formalization, and long-term institutional trust in fiscal systems.

KEYWORDS: Individual entrepreneurship; Self-employment; Pass-through taxation; Simplified tax regimes; Tax equity; Informal economy; Social protection; Tax compliance; Fiscal sustainability

1. INTRODUCTION

The structure of modern labor markets has undergone profound transformation over the past two decades. Alongside traditional employment relationships and corporate entrepreneurship, individual entrepreneurship and self-employment have emerged as dominant and rapidly expanding forms of economic activity. These forms include sole proprietors, freelancers, independent contractors, gig workers, family entrepreneurs, and microbusiness operators who generate income primarily through their own labor, skills, and initiative. According to the International Labour Organization (ILO, 2021), self-employment and own-account work account for more than 40 percent of total global employment, with even higher shares in developing and emerging economies.

The growth of individual economic activity has been further accelerated by digitalization, the expansion of platform-based work, remote service provision, and the low entry barriers characteristic of the microbusiness sector. Individual entrepreneurship is increasingly recognized not merely as a survival strategy but as a fundamental component of innovation, job creation, and inclusive growth (OECD, 2019; World Bank, 2020). At the same time, self-employment plays a critical role in absorbing labor market shocks, reducing unemployment, and expanding economic participation among women, youth, and marginalized populations.

Despite its economic and social significance, the taxation of individual entrepreneurship and self-employment income remains one of the most challenging areas of fiscal policy. Traditional tax systems are generally built around two archetypical models: the corporate entity and the wage-employed worker. Corporate taxation assumes legal separation between the firm and its owners, while labor taxation is based on withholding mechanisms, stable income flows, and employer-mediated compliance. Individual entrepreneurs and self-employed persons fit

neither model neatly. Their activities are typically small-scale, income is volatile, bookkeeping capacity is limited, and the distinction between business and personal finances is often blurred.

As a result, the uncritical application of conventional tax frameworks to individual economic activity frequently leads to inefficiency, inequity, and low compliance. Excessive tax burdens and complex administrative requirements can discourage formalization, pushing individuals into the informal economy. Conversely, overly lenient systems may undermine fiscal sustainability and distort competition between formal firms and individual operators. This tension makes the taxation of individual entrepreneurship not only a technical fiscal issue but also a core question of institutional design and social policy.

From a theoretical perspective, the taxation of individual entrepreneurship intersects with several fundamental debates in public finance and institutional economics. These include the principles of tax equity and neutrality (Musgrave, 1959; Slemrod, 2007), the role of administrative simplicity in compliance behavior (Alm, 2019), and the importance of aligning taxation with social protection systems to promote long-term formalization (ILO, 2021; OECD, 2015). In addition, corporate tax theory, particularly the concept of pass-through taxation, provides a conceptual foundation for treating individual business income as personal income rather than as profit of a separate legal entity (Hines & Rice, 1994; Keen, 2013).

In recent years, international organizations and governments have increasingly emphasized the need to integrate tax systems for individual entrepreneurs with broader development goals. The OECD (2019) highlights that simplified tax regimes, digital reporting systems, and transparent compliance procedures can significantly reduce informality and improve revenue collection. The IMF (2021) similarly stresses that taxing the self-employed effectively is essential for broadening the tax base and ensuring horizontal equity between different categories of workers.

Another crucial dimension is the growing recognition that taxation should not be perceived merely as an extraction mechanism but as a gateway to social rights. The “tax-for-rights” approach links tax compliance directly to access to pensions, health insurance, unemployment benefits, and other social protections. This approach has proven particularly effective in countries such as Brazil, France, and Turkey, where simplified regimes combine tax payments and social contributions into unified systems (OECD, 2018; ILO, 2021).

Against this background, the present study aims to develop a comprehensive analytical framework for the taxation of individual entrepreneurship and self-employment income. It seeks to identify the fundamental principles that should guide tax policy in this domain, examine the institutional foundations of pass-through taxation, analyze international experiences with simplified regimes and social protection integration, and propose generalizable policy directions applicable across diverse economic contexts.

The core research questions of this article are:

1. What fundamental principles should govern the taxation of individual entrepreneurship and self-employment income?
2. Why is pass-through taxation the most appropriate conceptual model for individual business activity?
3. How can tax systems be designed to balance simplicity, equity, efficiency, and fiscal sustainability?
4. What institutional mechanisms most effectively integrate taxation with social protection systems?

5. What lessons can be drawn from international experiences for the design of inclusive and sustainable tax frameworks?

Methodologically, the study adopts a qualitative and comparative institutional approach, combining normative tax theory with international policy benchmarking. It draws on reports and datasets from the OECD, IMF, ILO, World Bank, and European Commission, as well as on academic contributions in public finance, labor economics, and institutional theory.

The contribution of this paper is threefold. First, it systematizes the fundamental principles of taxing individual entrepreneurship into a coherent conceptual framework. Second, it provides a comprehensive analysis of pass-through taxation and its institutional implications for fiscal design. Third, it integrates taxation with social protection and formalization policies, offering a holistic vision of how tax systems can support inclusive economic development.

2. LITERATURE REVIEW

The theoretical foundation of taxation rests on classical principles developed in public finance, most notably equity, efficiency, simplicity, and certainty. Adam Smith's canons of taxation emphasized fairness, convenience, and transparency as essential conditions for legitimate and effective tax systems. These principles were later refined by Musgrave (1959), who introduced the modern framework of equity, efficiency, and administrative feasibility as the core objectives of fiscal policy.

Equity is typically divided into horizontal and vertical dimensions. Horizontal equity requires that individuals in similar economic positions bear similar tax burdens, while vertical equity implies that individuals with greater ability to pay should contribute more (Musgrave, 1959). In the context of individual entrepreneurship, equity is complicated by income volatility, heterogeneous cost structures, and the difficulty of distinguishing business and personal expenditures. The IMF (2021) argues that without carefully designed rules, self-employed individuals may either be overtaxed relative to wage earners or undertaxed relative to corporations, undermining fairness and competition.

Simplicity and transparency are equally critical. Slemrod (2007) emphasizes that complex tax systems impose high compliance costs and reduce voluntary compliance. For small-scale entrepreneurs and self-employed persons, excessive administrative requirements often function as a *de facto* barrier to formalization. The OECD (2015) finds that simplified regimes and presumptive taxes significantly increase registration rates and tax participation among microbusinesses.

Economic efficiency refers to the extent to which taxation minimizes distortions in behavior and resource allocation. Keen (2013) argues that poorly designed taxes on small businesses can discourage entry, reduce productivity, and perpetuate informality. For individual entrepreneurs, tax rates and compliance costs must be low enough not to suppress entrepreneurial incentives while still ensuring adequate revenue mobilization.

Administrative efficiency concerns the cost-effectiveness of tax collection for both governments and taxpayers. Alm (2019) shows that digitalization and automation are particularly effective in reducing administrative burdens and improving compliance among small taxpayers. In the case of self-employment, mobile-based reporting systems and pre-filled declarations can substantially enhance efficiency.

Finally, fiscal sustainability requires that tax systems generate stable and predictable revenue. While simplified regimes often involve lower rates, their broader tax base and higher compliance levels can compensate for reduced per-unit revenue (OECD, 2019).

Together, these principles form the normative backbone of any effective taxation system for individual entrepreneurship and self-employment.

The concept of pass-through taxation originates from corporate tax theory and institutional economics. Under this model, business income is taxed directly at the owner's personal income level rather than at the entity level. This approach is particularly appropriate when there is no

legal or economic separation between the business and the individual, as is the case for sole proprietors and most self-employed persons (Hines & Rice, 1994).

Entity theory treats firms as legally independent entities with their own rights and obligations. While this framework is suitable for corporations, it is conceptually inconsistent with individual entrepreneurship, where ownership, management, and liability are unified. As Keen (2013) notes, applying corporate tax principles to such activities creates unnecessary complexity and potential double taxation.

Hines and Rice (1994) demonstrate that multi-layer taxation of business income reduces investment incentives and distorts capital allocation. Slemrod and Bakija (2017) further argue that pass-through systems enhance neutrality by aligning tax treatment across organizational forms.

In practice, many countries have institutionalized pass-through taxation through legal structures such as sole proprietorships, partnerships, S-corporations (United States), flow-through entities (Canada and Australia), and micro-entrepreneur regimes (Brazil and France). These arrangements treat profits as personal income and eliminate the corporate tax layer.

The relationship between taxation and informality has been extensively studied. Schneider and Enste (2013) show that high tax burdens and complex regulations are among the primary drivers of informal economic activity. Conversely, simplified tax regimes can serve as transitional mechanisms from informality to full formalization (OECD, 2015).

Presumptive taxes, turnover-based taxes, and fixed payments are widely used instruments to reduce compliance costs for small taxpayers. While they sacrifice some precision, they improve coverage and administrative feasibility (IMF, 2018).

The integration of taxation and social protection has become a central theme in development economics and social policy. The ILO (2021) argues that linking tax payments to tangible social benefits significantly increases compliance among informal and self-employed workers.

OECD (2018) studies show that unified payment systems, combining tax and social contributions, enhance transparency and institutional trust. Brazil's MEI regime and France's auto-entrepreneur system are widely cited as successful examples.

This literature supports the view that taxation of individual entrepreneurship must be embedded in a broader institutional framework that connects fiscal obligations with social rights.

3. METHODOLOGY

This study adopts a qualitative, conceptual, and comparative institutional research design. Rather than relying on econometric modeling or country-specific microdata, the article focuses on developing a theoretically grounded and internationally applicable analytical framework for the taxation of individual entrepreneurship and self-employment income. This approach is particularly appropriate because the subject matter concerns institutional design, normative principles, and policy architecture rather than short-term empirical outcomes.

The research integrates three complementary methodological components:

1. **Normative public finance analysis**, used to derive fundamental principles of taxation such as equity, efficiency, simplicity, and fiscal sustainability.
2. **Institutional analysis**, examining how legal forms, tax regimes, and social protection systems structure the behavior of individual entrepreneurs.
3. **Comparative policy benchmarking**, drawing on international experiences reported by the OECD, IMF, ILO, World Bank, and European Commission.

This triangulation allows the paper to connect theory with practice while maintaining generalizability across different economic systems and levels of development.

The conceptual framework of the study is based on three core assumptions:

1. **Unity of economic and legal identity.** Individual entrepreneurship is characterized by the absence of separation between the individual and the business. Income generated by

the business is fundamentally personal income, making pass-through taxation the most consistent model.

2. **Heterogeneity and vulnerability of taxpayers.** Self-employed individuals and micro-entrepreneurs exhibit wide variation in income, capacity, and administrative literacy. Tax systems must therefore be flexible, adaptive, and inclusive.
3. **Taxation as an institutional contract.** Taxation should be understood as an exchange relationship: individuals comply with tax obligations in return for legal recognition, social protection, and economic security.

This framework links taxation not only to revenue collection but also to institutional trust, labor market formalization, and social inclusion.

4. ANALYSIS AND DISCUSSION OF RESULTS

The taxation of individual entrepreneurship and self-employment income must be understood as a problem of institutional design rather than merely a technical question of tax rates and bases. Unlike corporate entities or wage employment, individual entrepreneurship is characterized by the unity of the economic actor and the business activity, limited administrative capacity, high income volatility, and strong sensitivity to regulatory burdens. These features require a tax system that is flexible, simple, and socially embedded while remaining fiscally sustainable and equitable.

At its core, an effective tax framework for individual entrepreneurship must reconcile two potentially conflicting objectives. On the one hand, it should ensure fair and stable revenue collection for the state. On the other hand, it must avoid creating barriers that discourage formalization, entrepreneurial activity, and participation in the tax system. This balance can only be achieved if taxation is treated as part of a broader institutional contract between the state and the taxpayer, in which compliance is rewarded by legal recognition, economic security, and access to social protection.

4.1. Fundamental Principles of Taxation for Individual Entrepreneurship

The first analytical result of this study is that taxation of individual entrepreneurship requires a specific configuration of normative principles that differ in emphasis from those applied to corporations and salaried workers. While general tax theory highlights equity, efficiency, and administrative feasibility, their interpretation must be adapted to the realities of small-scale and self-directed economic activity.

Equity must be understood in both horizontal and vertical terms. Horizontal equity requires that individuals with similar income levels should face similar tax burdens, regardless of whether income is earned through employment or self-employment. In many countries, however, self-employed persons either benefit from preferential treatment or suffer from disproportionate burdens because of poorly designed tax rules. Both situations undermine fairness and distort competition between different forms of work. Vertical equity is complicated by income volatility: a self-employed person may appear wealthy in one year and vulnerable in the next. This calls for flexible assessment methods, income averaging, or simplified presumptive systems that smooth tax obligations over time.

Simplicity and transparency are especially important. For individual entrepreneurs, complex reporting requirements function as an implicit tax that often exceeds the monetary burden itself. When compliance becomes too costly or difficult to understand, informality becomes a rational choice. Therefore, simplicity is not merely an administrative convenience but a core instrument of inclusion.

Economic efficiency requires that taxes do not suppress entrepreneurial initiative or discourage business formalization. Excessive marginal tax rates, high fixed contributions, or unpredictable liabilities create disincentives for entry and growth. In contrast, moderate and predictable obligations encourage individuals to view taxation as manageable and legitimate.

Administrative efficiency refers to the cost-effectiveness of tax collection for both the state and the taxpayer. Simplified regimes, digital filing systems, and unified payment mechanisms significantly reduce these costs and increase compliance.

Inclusiveness emphasizes that tax systems should act as gateways to formality rather than barriers. This principle is particularly relevant in developing and emerging economies, where a large share of economic activity takes place outside formal institutions.

Finally, fiscal sustainability requires that simplified and inclusive systems still generate stable and predictable revenue. This can be achieved not through high rates, but through broad coverage and high compliance.

Table 1. Fundamental Principles of Taxation for Individual Entrepreneurship

Principle	Content	Policy Implication
Equity and fairness	Similar income should face similar tax burden; ability to pay must be respected	Alignment between self-employed and wage earners
Simplicity and transparency	Rules must be easy to understand and comply with	Simplified regimes, digital reporting
Economic efficiency	Taxes should not discourage entrepreneurship	Moderate rates, low entry barriers
Administrative efficiency	Low cost of collection and compliance	Presumptive systems, automation
Inclusiveness	Tax system should promote formalization	Gradual entry regimes
Fiscal sustainability	Stable and predictable revenue generation	Broad base with moderate rates

Together, these principles form the normative foundation for all further institutional design choices discussed in this section.

4.2. Pass-Through Taxation as the Conceptual Core

The second major analytical result is that pass-through taxation constitutes the most appropriate conceptual foundation for taxing individual entrepreneurship. The defining characteristic of individual entrepreneurship is the absence of separation between the owner and the business. The same person provides capital, labor, management, and bears all economic risk. In such circumstances, treating the business as an independent taxable entity is conceptually inconsistent and economically inefficient.

Pass-through taxation recognizes that business income is personal income. Profits flow directly into the individual's tax base and are taxed once, under personal income taxation rules or special simplified regimes. This approach avoids double taxation, reduces administrative complexity, and strengthens neutrality across organizational forms.

Entity taxation, in contrast, is designed for corporations with legal personality, limited liability, and separation between ownership and management. Applying this model to individual entrepreneurs creates artificial institutional complexity and increases compliance costs without any compensating economic benefit.

Table 2. Entity Taxation vs. Pass-Through Taxation

Dimension	Entity Taxation	Pass-Through Taxation
Legal identity	Firm is a separate legal person	Individual and business are unified
Tax base	Corporate profit	Personal business income
Risk bearing	Shared by shareholders	Fully borne by individual
Complexity	High	Low

Suitability for microbusiness	Weak	Strong
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The dominance of pass-through taxation in international practice reflects this logic. Sole proprietorships, partnerships, and simplified micro-entrepreneur regimes are all institutional expressions of this model. They reinforce the idea that individual entrepreneurship is an extension of personal economic activity, not a miniature version of corporate enterprise.

4.3. Simplified Tax Regimes as Instruments of Institutional Inclusion

While pass-through taxation provides the conceptual foundation, simplified tax regimes provide the practical mechanism through which most individual entrepreneurs interact with the fiscal system. Their purpose is not only to collect revenue but to reduce the institutional distance between the state and small taxpayers.

Simplified regimes respond to three structural constraints:

1. Limited accounting capacity of small entrepreneurs.
2. High administrative costs of individualized tax assessment.
3. The need to encourage transition from informality to legality.

By replacing complex income calculations with fixed payments, turnover-based taxes, or presumptive income assessments, simplified regimes drastically lower compliance costs. This does not necessarily mean abandoning equity, but rather approximating it in a way that is feasible under real-world constraints.

Different types of simplified regimes reflect different policy priorities. Fixed taxes maximize simplicity but sacrifice precision. Turnover taxes are easy to administer but may overburden low-margin activities. Presumptive systems strike a balance by estimating income based on observable indicators. Unified tax and social payment systems go further by integrating fiscal and social institutions.

Table 3. Main Types of Simplified Tax Regimes

Type	Tax Base	Advantage	Limitation
Fixed tax	Lump-sum	Very simple	Weak equity
Turnover tax	Revenue	Easy administration	May overtax low-margin activities
Presumptive tax	Estimated income	Balanced approach	Approximation errors
Unified tax & social payment	Combined base	Strong compliance incentives	Requires institutional coordination

Empirical evidence from many countries shows that simplified regimes significantly increase registration rates and improve compliance. Their effectiveness depends not only on low rates but also on institutional credibility. When taxpayers perceive simplified regimes as fair, predictable, and linked to tangible benefits, compliance becomes a rational and attractive choice.

Simplified regimes therefore function as institutional bridges between informality and full participation in the general tax system. They create a learning environment in which individuals become accustomed to fiscal obligations and legal recognition.

4.4. Hybrid Tax Architecture and Developmental Dynamics

The final major analytical result is that no single tax regime can adequately serve all stages of individual entrepreneurship. Instead, the most effective systems are hybrid and dynamic. They recognize that entrepreneurs evolve over time: from informal survival activities, to small-scale formal businesses, and eventually to more complex enterprises that resemble standard firms.

A hybrid architecture combines three stages:

1. Entry through simplified regimes that minimize barriers to formality.
2. Transition mechanisms that gradually increase reporting and tax obligations.

3. Integration into the general tax system once business capacity is sufficient.

This progression reflects a developmental view of entrepreneurship. Taxation is not imposed uniformly but adapts to the institutional maturity of the taxpayer. Such a structure avoids both extremes: excessive leniency that undermines revenue, and excessive rigidity that suppresses formalization.

This hybrid approach also strengthens fiscal sustainability. While simplified regimes generate modest revenue per taxpayer, their broad coverage creates a large and stable tax base. As businesses grow and move into the general regime, revenue per taxpayer increases naturally without the need for coercive enforcement.

The analysis shows that successfully taxing individual entrepreneurship depends on four key elements that work together. First, the system must be guided by clear principles, emphasizing fairness, simplicity, inclusiveness, and sustainability. Second, pass-through taxation provides the main conceptual framework, treating business income as personal income and avoiding unnecessary complexity. Third, simplified tax regimes act as practical tools that make compliance easier and encourage formal participation in the economy. Finally, a hybrid structure allows the system to adapt as businesses grow, moving from simplified rules to the general tax system in a gradual and manageable way.

When these four elements are combined, taxation becomes more than just a way to collect revenue. It functions as an institutional tool that promotes entrepreneurship, supports formalization, and connects taxpayers to social and economic benefits.

5. CONCLUSION

This study demonstrates that effective taxation of individual entrepreneurship and self-employment is central to modern economic development. Individual entrepreneurs and self-employed workers contribute not only to employment and income generation but also to innovation, social inclusion, and the reduction of the informal economy. Taxation, when properly designed, can therefore serve as a tool to support economic growth, ensure fairness, and promote social protection.

Key findings indicate that taxation should be guided by principles of equity, simplicity, inclusiveness, economic efficiency, administrative effectiveness, and fiscal sustainability. Pass-through taxation provides a strong conceptual foundation by aligning business income with personal income and avoiding double taxation. Simplified regimes are essential for reducing administrative burdens and encouraging informal workers and micro-businesses to enter the formal economy. Hybrid architectures further support the transition of small and growing enterprises from simplified systems to full tax compliance, ensuring long-term adaptability.

Overall, a taxation system that combines principled design, practical simplification, adaptive frameworks, and integration with social protection can transform individual entrepreneurship from a marginal economic activity into a cornerstone of inclusive and sustainable development.

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