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Testing the Impact of Unemployment on Self-Employment: Evidence from OECD Countries

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Abstract

The impact of unemployment on self-employment is rather an ambiguous issue in economics. According to *refugee effect* approach, there are two counter arguments: the theory of income choice argument suggests that increased unemployment may lead to increased self-employment activities whereas the counter argument defends the view that an increase in unemployment rates may decrease the endowments of human capital and entrepreneurial talent causing a rise in unemployment rates further. The empirical evidence on this issue seems to support both hypotheses. This research presents fresh and more comprehensive evidence on this issue from 28 OECD countries using the ARDL approach to co-integration technique over the period 1986-2013. The empirical results indicate that the first hypothesis holds in the case of Belgium, Canada, Sweden and the UK whereas the second hypothesis is valid in the case of Greece, Luxembourg and Portugal. The empirical results for the remaining OECD countries did not reveal any long-run relationship between the variables in question. The empirical results are also evaluated briefly for policy recommendations.

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1. Introduction

The relationship between self-employment and unemployment presents a lively debate in economics. The origin of this debate is related to *refugee effect* which forms two conflicting hypotheses. According to the theory of income choice, as the level of unemployment raises it is expected that self-employment starts to increase too. As far as the counter argument is concerned, the increased level unemployment also leads to the depreciation of human capital and skills which exacerbates the existing unemployment situation. The first argument of the *refugee effect* is also known as the “*unemployment push*” hypothesis which states that high unemployment may reduce the opportunity to gain salaried employment and thus positively affect self-employment as discussed in Glocker and Steiner (2007). According to Audretsch et al. (2005), the second hypothesis is coined as the “*unemployment pull*” which suggests that unemployed people tend to possess lower endowments of human capital and entrepreneurial talent to start and sustain a new firm.

The empirical research on this issue seems to be rather ambiguous since the growing number of studies present evidence for the existence of both hypotheses. The ambiguity in this issue might be related to the fact that the time span, econometric methodology and the variables in question vary considerably as far as the studies are concerned.

The main motivation of this research is based on the fact that self-employment is regarded as one of the major economic policy solutions to reduce the unemployment in all countries. Thus, measuring the impact of unemployment on self-employment should reveal valuable policy information for policy makers.

This research aims to contribute to the existing literature by providing further time series evidence on the *refugee effect* from 28 OECD countries using Auto Regressive Distributed Lag (ARDL) approach to cointegration procedure. To our existing knowledge, there exists no other study utilizing this method previously in estimation of the *refugee effect*. Moreover, the data span and the extent of OECD countries in this study exceed the scope of other studies in the same category. Thus, the empirical results should be considered as more comprehensive. However, the primary aim of this study is to analyze empirically only the *refugee effect*; the econometric model is based on a univariate function disregarding other possible factors that may have impact on *the refugee effect*.

This research is outlined as follows: the next section provides a brief review of theoretical and empirical studies; section 3 outlines the econometric methodology; section 4 presents and evaluates the empirical results; and the final section is devoted to conclusions.

2. A Brief Literature Review

The discussions between self-employment and unemployment lead the way to a growing body of empirical studies in the literature in the last two decades. Considering the size limitations, this research focuses on selected number of studies to provide the main discussion points of the literature. The back bone of this discussion revolves around the concept of the *refugee effect*. The *refugee effect* originated from the simple theory of income choice which argues that increased unemployment will lead to an increase in start-up activity on the grounds that the opportunity cost of starting a firm is less than being unemployed. In the same strand of this literature, a counter argument indicates that the impact of unemployment might be detrimental on self-employment due to the fact that unemployed people not only lose their jobs but they may be deprived of the human capital and entrepreneurial skills which are required for new business activities. The second strand of the discussion is related to the *Schumpeter effect* which indicates that new-firm start up reduces the level of unemployment. That implies that the direction of relationship runs from self-employment to unemployment.

Different aspects of the *refugee* and *Schumpeter effects* have been discussed and evaluated theoretically and empirically in a large number of studies (Evans and Leighton, 1990; Alba-Ramirez, 1994; Audretsch and Thurik, 2000; Audretsch et al., 2002, 2005; Carree et al., 2002, 2007; Ritsila and Tervo, 2007; Baptista and Preto, 2007; Glocker and Steiner, 2007; Faria et al., 2010; Fairlie, 2011; Yu et al., 2014; and Aubry et al., 2015). Self-

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