



# How former business owners fare in the labor market? Job assignment and earnings

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## ABSTRACT

This study uses detailed longitudinal matched employer–employee data to examine the impact of entrepreneurial experience on job assignments, careers, and wages. The results suggest that there are significant differences in career mobility between former business owners and workers who were always wage employees. Former business owners enter firms at higher job levels and progress faster up the hierarchy than wage employees without entrepreneurial experience. The majority of the former business owners find jobs in small firms. The return to business ownership experience is lower than the return to wage employee experience, thus suggesting that the labor market imposes a penalty for business ownership experience.

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## 1. Introduction

A considerable amount of theoretical and empirical work in economics focuses on individual choices between wage employment and business ownership (or entrepreneurship). Seminal work by Lucas (1978) and Jovanovic (1982) provide the basis for a significant stream of literature linking entrepreneurial ability to firm size dynamics, and the evolution of markets. Another literature stream examines the role played by pecuniary and non-pecuniary rewards in the occupational choice between self-employment and wage employment (see, for instance, Rees and Shah (1986) and Taylor (1996)). Work originating mostly in the management and organizational theory literatures increasingly focuses on the individual decision to exit entrepreneurship (Gimeno et al., 1997; McGrath, 1999) and on the characteristics of former business owners who re-enter entrepreneurship (see, for instance Westhead and Wright, 1998).

Conversely, only a few recent studies examine how well individuals who forsake business ownership and return to wage employment fare in the labor market. Research comparing earnings of former business owners who have become wage employees with those of others of similar age and educational background who did not experience self-employment over their careers provides mixed results and generally fails to account systematically both for the matching between worker and firm characteristics, and the specifics of career dynamics within firms.

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The present study uses longitudinal matched employer–employee data that include detailed information about individuals' backgrounds, job assignments, and career progress within firms to examine the impact of business ownership experience on job assignments, careers, and wages. An explanation for the empirical evidence obtained is provided based on the extant theoretical literature, paying attention in particular to the framework proposed by Gibbons and Waldman (2006) with regard to task-specific human capital. We largely follow the broad empirical strategy employed by Baker et al. (1994a, 1994b), asking three main questions that seek to account for the main features of the impact of business ownership experience on careers and wages:

- i. Are former business owners more or less likely to be assigned to higher levels in the firms' hierarchies at the time of hiring than other workers of comparable characteristics?
- ii. Do former business owners progress up the job ladder faster or slower than other workers of comparable characteristics?
- iii. What is the overall return to business ownership experience in the labor market?

The following section provides the background for this study and surveys the empirical literature examining wage incomes and the labor market performance of former business owners. The third section describes the dataset used in the present study. Section 4 presents empirical evidence on the role played by business ownership experience in the internal economics of the firm with regard to careers, while Section 5 focuses on wages. Section 6 provides some concluding remarks.

For the purpose of the present study, we use a broad definition of entrepreneur, which deliberately overlaps with that of business owner, not delving into a conceptual distinction between those terms. The same applies for the definition of entrepreneurship, which must be understood in a broad economic sense. The terms 'entrepreneur' and 'business owner', as well as 'entrepreneurship experience' and 'business ownership experience' will be used interchangeably in the present work as including those individuals who report themselves as business owners, regardless of whether they have full or partial ownership, and have started, acquired or inherited the business.

## 2. Background

### 2.1. Entrepreneurship and the ability to supervise and coordinate

While entrepreneurship's links with risk/uncertainty and innovation have lately taken somewhat of a spotlight, entrepreneurial activities have also been connected with supervision and coordination tasks at least since the work of Say (1803/1971). In *A Treatise on Political Economy or the Production, Distribution and Consumption of Wealth*, the entrepreneur plays a central coordinating role both in production and distribution. Also within the firm, he is the coordinator and moreover, the modern leader and manager; say is the first author to emphasize this managerial role for the entrepreneur.

For Marshall (1890/1920), within the firm, the owner/entrepreneur bears all the responsibility and exercises all control. The entrepreneur directs production and he is both the manager and employer. Kaldor (1934) stresses that, in addition to uncertainty-bearing, the "entrepreneurial function" includes supervision and coordination. Supervision is necessary in the case of cooperative production in order to ensure that contracts already entered into should, in fact, be carried out. Coordination, on the other hand, is that part which determines what sort of contracts should be entered into.

More recently, Lazear (2005) proposes a theory of entrepreneurship based on the view that entrepreneurship "is the process of assembling necessary factors of production consisting of human, physical, and information resources and doing so in an efficient manner" (Lazear, 2005, p. 649). An entrepreneur must possess the ability to combine talents and manage those of others. Furthermore, he must combine those talents with physical capital and ideas to create a new product or to produce an existing one at a lower or competitive cost. Because the entrepreneur must bring together many different resources, he must have knowledge, at least at a basic level, of a large number of business areas.

Lazear's theory predicts that individuals with more balanced skill sets (i.e. generalists rather than specialists) are more likely to become entrepreneurs, and will enjoy higher entrepreneurial incomes. He tests the predictions of the theory using data on Stanford University alumni (Lazear, 2004, 2005) finding that those who have more varied work experience are more likely to be entrepreneurs; and students who study a more varied curriculum are more likely to become entrepreneurs. A further test of Lazear's theory is provided by Wagner (2003) based on a representative sample of the German working population.<sup>1</sup> Wagner's findings give support to Lazear's theory, as the estimated probabilities of being self-employed are positively related with both the number of different kinds of professional training and the number of changes of professions.

In a recent paper, Åstebro and Thompson (2011) suggest an alternative view to that of Lazear. They predict that those with greater taste for variety are more likely to invest in generalist skills and become entrepreneurs, but entrepreneurs will actually see their incomes decrease with greater skill variety. Using data from a survey of entrepreneurs and individuals from the general population, they confirm that entrepreneurs typically have a more varied labor market experience. However, the more varied their experience, the lower their household income.

<sup>1</sup> Lazear originally published his theory of entrepreneurship in an NBER Working Paper (#9109, August 2002). Wagner's test is based on that version of Lazear's work.

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