



Self-employment and business cycle persistence: Does the composition of employment matter for economic recoveries?



Alan Finkelstein Shapiro*

Universidad de los Andes, Department of Economics, Calle 19A No. 1-37 Este, Bloque W, Bogotá, Colombia

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ABSTRACT

Self-employment comprises an important share of employment in many countries, and tends to expand during downturns through higher inflows from unemployment. Furthermore, countries with higher self-employment shares exhibit lower cyclical output persistence. I build a business cycle model with frictional labor markets where individuals can be self-employed or salaried employed. I show that economies with larger self-employment shares exhibit faster economic recoveries. Differences in the ease of entry into self-employment as the economy recovers explain the contrasting cyclical dynamics. The model successfully captures the cyclical patterns of self-employment and the relationship between self-employment and output persistence in the data.

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1. Introduction

Countries are well-known to exhibit differences in employment arrangements. While developed economies have high salaried employment and low self-employment shares, developing economies exhibit the opposite pattern (see [Table 1](#) and [Gollin, 2008](#)). Several studies document that a majority of the self-employed are independent workers with no salaried employees, who nonetheless account for an important share of employment, firms, and economic activity ([ILO, 2002](#); [Perry et al., 2007](#); [Kucera and Roncolato, 2008](#)). Despite their small scale and limited capital usage, these individuals are often capital-constrained and must rely on external financing from input suppliers and other informal sources ([Beck et al., 2008](#); [Global Financial Development Report, 2014](#)).

Recent evidence highlights two more facts about self-employment. First, self-employment expands during downturns. Second, this expansion arises mainly from an increase in transitions from unemployment to self-employment in recessions ([Table 2](#); [Bosch and Maloney, 2008](#); [Koellinger and Thurik, 2009](#); [Loayza and Rigolini, 2011](#)). Moreover, [Fig. 1](#) shows a negative relationship between the cyclical persistence of output and the share of self-employment in non-agricultural employment for a sample of developed and developing countries.¹ Combined with the cyclical behavior of self-employment, this fact suggests that self-employment may play an important role for business cycle dynamics ([Table 2](#)).

* Tel.: +57 1 313 805 9115.

E-mail address: a.finkelstein@uniandes.edu.co

¹ This link remains significant even after controlling for other factors that may affect output persistence. See the Appendix for details. This finding is in line with [Calderón and Fuentes \(2010\)](#) regarding the recovery speed in emerging market economies.

Table 1
Cyclical correlations of employment and job-finding rates with output.

Cyclical correlation with output	Brazil	Mexico
Self-employment	–0.219	–0.415
Formal salaried employment	0.616	0.780
Transition rate from unemployment to Self-employment	–0.600	–0.433
Formal salaried employment	0.652	0.798

Notes: Taken directly from [Bosch and Maloney \(2008\)](#). Self-employment corresponds to informal self-employment (own-account workers and business owners with less than 5 employees) as a share of the working-age population. All series are quarterly, logged and HP-filtered with smoothing parameter 1600. Entry into informal (unprotected) salaried employment from unemployment is procyclical and therefore similar to formal salaried employment.

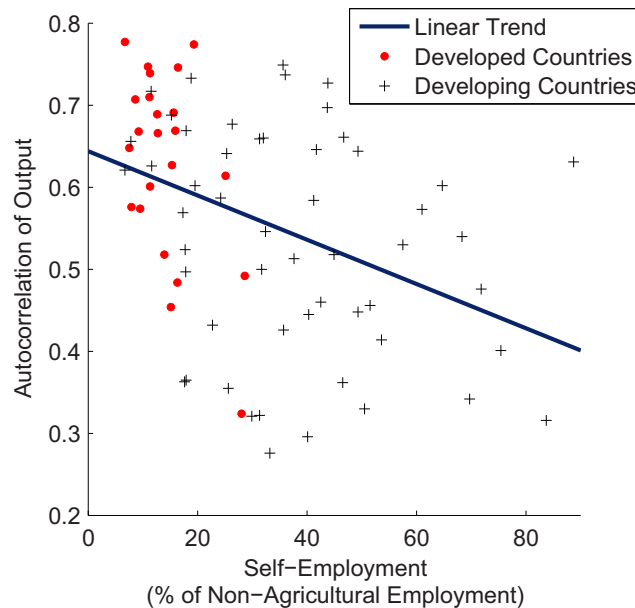


Fig. 1. Self-employment and cyclical output persistence across countries. Notes: Author's calculations. The self-employment share corresponds to the average of annual self-employment as a percent of non-agricultural employment from 2000 to 2007. The autocorrelation of output corresponds to the first-order autocorrelation of the cyclical component of log annual PPP-adjusted real GDP from 1985 to 2007, using an HP filter with smoothing parameter 100. Sources: [OECD \(2009\)](#) (self-employment) and World Development Indicators (2010) from [Catini et al. \(2010\)](#) (real PPP-adjusted GDP). A stronger relationship holds if we consider non-agricultural real PPP-adjusted GDP. Similar results hold if we exclude potential outliers (i.e., countries with self-employment shares higher than 80 percent, or countries with very low persistence).

I build a business cycle model with frictional labor markets and endogenous entry into self-employment where unemployed individuals can transition into salaried work or into self-employment. I use the model to shed light on the channels through which the composition of employment influences the pace of economic recoveries, and show that economies with higher self-employment shares exhibit faster recoveries from adverse aggregate shocks. This result hinges critically on whether self-employment is a feasible alternative to salaried work during downturns, and on the way the cyclical composition of employment affects this outside option to salaried employment as the economy recovers. The average share of self-employment in the economy plays a key role as it affects the strength of the self-employment outside option and the cyclical adjustment of wages in the salaried sector. This influences the hiring and investment decisions of salaried firms in response to shocks, which in turn shape short-run economic activity. This channel has not been previously explored.

In the model, self-employment consists of own-account or independent workers who operate owner-only firms.² Given my focus on cross-country differences in business cycles, I abstract from the determinants of entry into self-employment

² Self-employment exhibits substantial heterogeneity, with a small share of individuals running businesses that start small but grow rapidly (often labeled as opportunity self-employment). I explicitly abstract from opportunity self-employment and instead focus on those with businesses without salaried workers (which represent the majority of the self-employed) to explore whether the presence of an alternative to salaried employment matters for business cycle dynamics. See [Epstein and Finkelstein Shapiro \(2014\)](#) for an expansion of the model in this paper where self-employed firms can endogenously become small salaried firms.

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