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The role of wealth in the start-up decision of new self-employed: Evidence from a pension policy reform☆

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HIGHLIGHTS

- We investigate the causal relation between wealth change and self-employment transition.
- We utilize the highly discontinuous Dutch pension system reform of 2006 as a quasi-natural experiment.
- The reform abolished early retirement, corresponding to a drop in pension wealth amounted on average to 16,000 euros.
- This reduction reduces the transition rate into self-employment by 38%.

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ABSTRACT

We study whether wealth affects transitions from wage-employment to self-employment using a large sample from administrative panel data for the Netherlands. To isolate the causal effect of wealth, we rely on a reform of the pension system that abolished preferential tax treatment of early retirement for cohorts born after January 1, 1950. This exogenous reduction in pension wealth has a significant negative effect on the transition into self-employment. We compute that the average reduction of net future pension wealth by 16,000 euros in our sample, triggered by the reform, reduces the transition rate into self-employment by 38%.

1. Introduction

Individual labour market transitions between different occupations and employment states may well be affected by the level and composition of household wealth, both liquid and illiquid. Substantive evidence is available for entrepreneurial start-up out of wage-employment. Existing papers show that the level of (liquid or transferable) wealth is a strong predictor of self-employment start-up. Relying on windfall gains, a sizable amount of studies interprets this wealth effect as evidence that credit market imperfections hinder people from starting their own business: in the face of lenders' collateral requirements that imply external finance is conditional on pledging matching capital mainly rich workers sort into self-employment.[1]

We study whether a change in pension wealth affects transitions from wage-employment to self-employment using a large sample from

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[1] Papers in the literature that bring out a number of different aspects of the debate include Evans and Jovanovic (1989), Holtz-Eakin et al. (1994b, 1994a), Black et al. (1996), Fairlie (1999), Quadrini (1999), Moskowitz and Vissing-Jørgensen (2002), Gentry and Hubbard (2004), Hurst et al. (2010).

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administrative panel data for the Netherlands. Here, as in many OECD countries, pensions and annuities are a main component of household wealth, albeit illiquid. Little is known, however, about the importance of such pension wealth for labour market mobility and small business formation. The present study contributes to filling this gap.

We face a couple of complicating factors. One is the fact that pension wealth is a function of (current) pension fund participation and contribution history, rendering pension wealth (partly) endogenous to the transition probability. Our identification strategy allows giving a causal interpretation to (pension) wealth and self-employment start-up correlations in the raw data. For this purpose, we use a structural pension reform, enacted on 1 January 2006, that removed the tax-favored treatment of early retirement arrangements for workers born on or after 1 January 1950. As a result, the entire early retirement system was abolished quite suddenly for the affected cohorts but not for others.[2] Empirical investigation is called for because overall theoretical predictions of the decrease in pension wealth on transitions into self-employment are a priori ambiguous due to the co-existence of several competing pathways. Some of these effects would imply an increase in self-employment transitions, while others imply a decrease.

A first pathway concerns a documented link between pension wealth and private wealth. The literature on crowding-out effects shows that, to a large extent, employees reduce their private savings in the presence of compulsory savings.[3] According to this mechanism, employees reserve a higher part of their private savings for retirement, leaving them with less financial means for business start-up.

Second, risk aversion strengthens this link. While the self-employed are risk-averse, they have a higher risk tolerance than wage-employed (Ekelund et al., 2005; Colombier et al., 2008). The assumption of decreasing absolute risk aversion (dara) leads to the prediction that wealthier individuals are more likely to enter self-employment. Risk-averse individuals who are going to enter self-employment, would implicitly accept an additional future income reduction that is equal to the income risk premium. Due to their risk aversion, they may want to avoid paying this additional price and make the transition into self-employment, once they have already paid the cost of pension wealth implied by the reform. The reform thus discourages potential self-employed, and establishes a positive relation between pension wealth change and self-employment entry (both drop). Yet, if individuals were risk-seeking or if they would anticipate future additional pension cuts, the reform could actually induce a wealth effect in the opposite direction.

Third, pension wealth effects have been documented in the decision to work at old ages.[4] Via (life-cycle) income and substitution effects pension wealth can affect both the decision to continue work and the choice of occupation.

Fourth, if the reform induces workers' wish to save for retirement, and if self-employment is considered suitable to generate private wealth, an increase in self-employment would be predicted. Finally, since on average the self-employed benefit much less from the pension system than wage-employees, the reform reduces the expected utility of staying wage-employed relative to becoming self-employed and may therefore increase the transition.[5]

Our main results show that the reform decreases the probability of entering self-employment by 0.42 percentage points when cast in terms of a difference-in-difference estimator. The effect is precisely estimated, despite transitions being infrequent and amounting to 1.17 percentage points per year, on average, implying a relatively large and significant negative causal effect on the transition into self-employment. We also find strong effects when we measure the reform impact through the implied reduction in the retirement replacement rates. We also calculate that a corresponding reduction in net future pension wealth amounted on average to 16,000 euros per employee. Using this reduction in expected total pension wealth due to the reform as measure for the negative changes in pension wealth leads to principally similar findings and a reduction in the transition rate into self-employment by 38%. This main finding is robust to checks on anticipation effects and placebo effects, and remains constant when we narrow cohort selection, or the sample period. We also consider alternative definitions of self-employment.

One plausible explanation is that when pension wealth drops, individuals tend to reserve a higher amount of liquid private wealth for retirement purposes and for precautionary reasons, and therefore, less of liquid financial wealth will be used to start new businesses and to buffer the risk of self-employment. Consequently, wage-employed tend to stay somewhat longer in wage-employment, and the transition into self-employment decreases upon a reduction in pension wealth.

The contribution of our study is two-fold. First, unlike other studies on the nexus between self-employment and wealth, we use a change of wealth induced by policy, rather than individual choices or market developments. Second, for this policy-induced change of wealth the treatment group was large, treatment was quantitatively important for many, and anticipation effects were virtually absent. Several studies have utilized exogenous wealth shocks, such as winning a lottery (Lindh and Ohlsson, 1996; Imbens et al., 2001; Taylor, 2001), receiving an unexpected inheritance (Holtz-Eakin et al., 1994a, 1994b; Brown et al., 2010), or experiencing strong appreciations in house prices (Black et al., 1996; Adelino et al., 2015), to address concerns about potential endogeneity of wealth. We believe that our alternative identification strategy of relying on a broad-based pension reform has the advantage of using a more comprehensive and economically more important change compared to the ones employed elsewhere. For instance, lotteries are typically won by a small, and in terms of risk attitude possibly selected group of individuals. Inheritances have a strongly skewed distribution. In addition, for inheritances to be fully exogenous, they need to be unexpected, which is very difficult to ascertain in the data. Also, some inheritances include the family business, and if entrepreneurial abilities and ambitions are correlated between the bequeathing and the inheriting generation, such dynastic transfers of firm capital are hardly exogenous to the self-employment choice of starters. Finally, capital gains in the form of house price appreciations or stock market gains also only affect the segment of asset owners in the population, who in turn are selected on wealth and risk attitude. The reform used in our study affected large parts of the working population, and it has a sharp discontinuity between two birth dates at a single point in time. This provides for an ideal quasi-experimental setting.

The paper is organized as follows. In the next section, we sketch the institutional frame of the Dutch pension system and the main aspects of the reform. In Section 3, we introduce the data and present descriptive statistics. In Section 4, we discuss the main estimation results, and Section 5 offers brief conclusions.

[2] De Grip et al. (2012) use this same reform to study effects on mental health and individual well-being.

[3] As estimated in Alessie et al. (2013) on European data, the lower bound of crowding-out effects of pension wealth on private wealth is significant and it ranges between 17% and 30%.

[4] Previous studies show this for the relation between pension and social security benefits or the (early) retirement choice among old cohorts. Anderson and Burkhauser (1984) and Krueger and Pischke (1992) conclude that when the amount of social security and pension wealth which workers expect to receive becomes lower, labour supply of older workers declines. Also, Anderson et al. (1986) and Baker and Benjamin (1999) find that unanticipated increases in social security wealth induce earlier retirement, and the reduction of retirement earnings leads old individuals to continue working, who would otherwise have retired.

[5] Hurst et al. (2010) point out that the lack of pension wealth is a potential reason for the difference in the size of wealth holdings between business owners and wage-employees.