



The long term returns of attempting self-employment with regular employment as a fall back option



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HIGHLIGHTS

- On average those who attempt self-employment (ASE) are not punished for doing so.
- After 15 years, the ASE realize 8–20% higher present discounted values of income.
- This premium is driven by the ASE's higher working hours and similar wages.
- The ASE who are technical/professional earn large wage premiums and work more hours.
- Positive effects in income and wages are driven by the upper tail.

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ABSTRACT

There is a substantial body of research investigating the returns to self-employment. Relatively little attention has been paid to the returns from attempting self-employment while acknowledging that the decision to try self-employment is reversible. But this is the option considered by the worker deciding whether to become self-employed, as are any resulting positive or negative changes to the worker's wages, hours worked, or likelihood of job or business termination and resulting unemployment. The full consequences of attempting self-employment are determined by comparing the actual income streams of individuals who do and who do not attempt self-employment. Selection on observables is controlled by employing nearest-neighbor matching with bias correction. The main result is that there is no significant evidence that individuals who attempt self-employment are punished for doing so: after 15 years, those who attempt self-employment receive an (insignificant) 8% and a (significant) 22% premium in labor income and in labor and asset income, respectively. The consequences of attempting self-employment vary by occupation: individuals in technical and professional occupations realize significant gains, of 45% to 62% after 15 years, whereas craftsmen see no significant differences in income. Quantile treatment effects on the treated are estimated and reveal that the average positive premiums are driven by the upper tail of the treatment effect distribution.

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1. Introduction

In 2009, 15.3 million individuals, or about 1 in 9 workers in the U.S., were self-employed, according to the Bureau of Labor Statistics (Hipple, 2010). More than 1 in 5 American men are estimated to have tried self-employment over the period from 1979 to 1993, although the majority of these spells were brief: between two-thirds and three-quarters of them lasted a year or less (Williams, 2000).

The significant portion of the labor force that either is self-employed or has tried self-employment is driven in part by government programs designed to promote exactly this. Tax incentives are given to sole

proprietors, and small businesses are exempted from certain regulations.¹ The Self-Employment Assistance (SEA) program encourages the unemployed to become self-employed by waiving the work-search requirement when the applicant is spending their time establishing a business. In 2012, the U.S. Labor Department announced that an additional \$35 million would be directed toward improving the SEA.² The Small Business Administration (SBA), whose mission is “to maintain and strengthen the nation's economy by enabling the establishment and vitality of small businesses,” was recently given the go-ahead, via the Small Business Jobs Act of 2010, to increase the lending support available to small business owners to more than \$12 billion and to provide up to \$50 million in grants to Small Business Development Centers

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¹ See Blanchflower and Oswald (1998) and Bruce and Schuetz (2004).

² See the U.S. Labor Department press release number: 12-1073-NAT.

across the country. This is in addition to the counseling the SBA already provided. The new programs are designed to increase self-employment by easing informational and financial barriers in an effort to spur economic growth and provide individuals with a route out of poverty.

Although self-employment is often used as a proxy for entrepreneurship, the choice to work for oneself is important in its own right, as are its consequences.³ The criterion for eligibility for many of the programs above is self-employment, where no distinction is made between what [Baumol \(2011\)](#) calls “replicative” entrepreneurs, who make up the majority of the self-employed, and “innovative” entrepreneurs.⁴ A substantial portion of the labor force attempts self-employment, which motivates its study, according to [Hamilton \(2000\)](#), who tries to determine which labor-market model best reconciles the observed returns from attempting self-employment. If self-employment is encouraged as a pathway out of poverty, the pecuniary rewards ought to be positive. By using OLS and quantile regression, Hamilton finds that the returns of self-employment are substantially lower than those of remaining an employee, and he concludes that those who try self-employment have strong preferences for such non-pecuniary benefits as “being your own boss.”

[Bruce and Schuetze \(2004\)](#) point out that any evaluation of the costs and benefits of the above government programs must examine the consequences to the individual attempting self-employment. If individuals who attempt self-employment are penalized for doing so, then encouraging the unemployed to become self-employed rather than to find a job may not be good policy. By using the PSID, Bruce & Schuetze estimate, via pooled OLS, the effects of short spells of self-employment (between one and four years) on wages among individuals who began in and returned to full-time wage or salary employment. They find that short spells of self-employment reduce average hourly earnings.

The important question asked by both studies can be answered in a more comprehensive manner. The consequences of attempting self-employment are not reflected solely in the difference in wages between the employed and the self-employed, which is the focus of [Hamilton \(2000\)](#). Nor are they sufficiently captured by considering only the effects on the employee's wages after a spell of self-employment has ended, as this ignores the presumably higher wages of the successfully self-employed individual, a problem [Bruce and Schuetze \(2004\)](#) discuss. The reality lies between these two cases: some of those who attempt self-employment remain self-employed, some return to the wage-and-salary sector, and some become unemployed.⁵ The decision to try self-employment is reversible: workers can return to paid employment should their enterprises fail. This option is taken into consideration by the worker who is deciding whether to become self-employed, as are any resulting positive or negative effects on subsequent wages. That is, in determining what returns he should expect from attempting self-employment, the worker must consider the probability that he will stay self-employed and the wage he can expect to make while self-employed, as well as the probability that he will return to a paid job and the wage he would receive then.⁶

As pointed out by [Kahn and Lang \(1992\)](#) and by [Martinez-Granado \(2005\)](#), most workers who are not self-employed face binding hours constraints: they would like to work more hours but cannot. Self-employment may provide a means of avoiding these constraints.

Differences in the likelihoods of job or business termination, in the likelihood of unemployment resulting from this, and in the length of unemployment that results from an attempt at self-employment are also incorporated into the individual's decision-making process.⁷ Finally, as pointed out by [Hamilton \(2000\)](#), [Moskowitz and Vissing-Jorgensen \(2002\)](#), and [Rosen and Willen \(2002\)](#), the decision to try self-employment is based on both the return to human capital and the return to capital. The method employed in this paper incorporates all of these margins into the calculation of the present discounted value of the future income that an individual considers in deciding whether or not to attempt self-employment.

Some individuals may choose self-employment simply in order to be their own bosses, even in the face of monetary loss. Conversely, impatient individuals may opt for regular employment if the returns from self-employment would take years to materialize, despite how large these returns might be. The main objective of this paper is to compare the ex-ante present values of the future incomes of individuals who attempt self-employment (ASE) and individuals who do not (PE), in order to reveal to what extent the desire for self-employment is driven by either the anticipation of pecuniary rewards or of non-pecuniary benefits.

Although the decision to attempt self-employment is driven in part by average returns, the average effect alone does not fully capture either the returns of the typical ASE or the risk of undertaking such an endeavor. For this reason, the distributions of returns for the ASE and the PE are compared. If individuals who attempt self-employment are in fact punished for doing so, the efficacy of programs such as the SEA can be called into question. If, on the other hand, the effect on the future present discounted value of income from attempted self-employment is non-negative, then the SEA's goal of encouraging self-employment as an alternative to traditional paid work is a reasonable one.

The Panel Study of Income Dynamics (PSID) is used to compare, at the worker level, the income streams of those who do and those who do not attempt self-employment. Specifically, the income streams of individuals who try self-employment are compared to appropriate alternative income streams to establish whether or not those who are attempting self-employment are being paid at a premium. The measurement of income streams used allows for sector switching, spells of unemployment, and variable hours, as well as any subsequent effects on wages. Rather than parametrically estimating the income equations and the probability of sectoral switching, the realized income streams of those who have tried self-employment are observed and compared to the income streams of those who have never tried self-employment. Because actual income streams are used, the full consequences of trying self-employment are better captured: all of the extensive margins and wage effects that a worker considers in his self-employment decision are incorporated alongside any changes in the covariances among them.

Two measures of income are considered in the creation of the present values: annual total labor income and a measure that captures both total labor income and net asset income. The effect of attempting self-employment on the present discounted value of the individual's income is further unpacked by considering separately the annual effect on income, wages, and hours worked.

Selection on observables across the ASE and PE groups is controlled using [Abadie and Imbens's \(2011\)](#) method of matching with bias correction. One advantage of any matching approach is that it forces the researcher to acknowledge issues of balance between the treated and control groups—here, the ASE and the PE—that might lead to extrapolation using traditional regression techniques. The method of Abadie and Imbens, in particular, provides a bias correction for imperfect matching. The more comprehensive the list of control variables, the more likely unconfoundedness is to hold: all variables that are correlated either with the decision to try self-employment or with the outcome variable should be included. The basic control variables used

³ See [Andersen and Nielsen \(2012\)](#) for a survey of the large literature that uses self-employment as a proxy for entrepreneurship. Several recent papers have documented the fact that self-employment is not a good proxy for entrepreneurial activity. [Hurst et al. \(2014\)](#) find that the majority of small businesses do not bring new ideas to the market and do not intend to innovate or grow.

⁴ [Faggio and Silva \(2012\)](#) provide a nice overview of the self-employment literature as well as the research on the distinction between entrepreneurship and self-employment.

⁵ As shown in [Appendix A](#), only 56% of the sample remained self-employed in the year following the attempt. Of the rest, 27% returned to regular employment, 15% started regular jobs in addition to self-employment, and 2% are not working.

⁶ [Williams \(2000\)](#) and [Bruce and Schuetze \(2004\)](#) both provide excellent discussions of this, although both focus on subsequent wages in the regular-employment sector.

⁷ See for instance [Phillips and Kirchoff \(1989\)](#), who find evidence that the self-employed face a higher probability of involuntary job termination.

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