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Selection into and out of self-employment

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1 SUMMARY

Entrepreneurship and self-employment (the important distinction between the two terms is discussed in Section 2.2) is *widespread* and *appreciated* among Europeans. '*Being one's own boss*' and having an owner-manager as a boss is associated with *greater job satisfaction*. Against this background – while certainly still considerable – the actual entry into and being in self-employment in Europe appears somewhat *modest*; on the other hand this suggests that promoting it has a lot of *potential*.

Entry into self-employment is quite *common*, but entry is followed typically by an *exit* shortly thereafter. Thus, it is crucial to understand how a brief self-employment experience affects subsequent wage and non-wage labour market and other outcomes.

A widely held view among European policy-makers is that self-employment is hindered by a particularly strong *stigma-of-failure*, that is, those leaving self- for paid-employment, after an entrepreneurial spell, are treated too harshly in the labour market. *Unconditionally* – simply directly comparing final hourly wages in paid employment – those re-entering, after being self-employed, appear to have lower wages than those who continue to be employed by others.

Conditionally – once personal characteristics and aspects of selection are taken into account – the difference is more apparent than real: It seems that Europeans *select negatively* into and out of self-employment, that is, the likelihood of entering and exiting entrepreneurship correlates negatively with the individual's ability and productivity while in paid employment; on average *less capable* persons enter into and exit out of self-employment.

Thus, there is *no* solid evidence that a strong stigma of failure associated with a brief self-employment spell would be the main issue of concern in absolute or in relative terms; selection accounts for most if not all of the difference in final wages.

The analysis of non-wage outcomes suggest that the selection is mostly *involuntary*, that is, some individuals may be "forced" into self-employment due to, for example, a malfunctioning paid-employment labour market. Especially for highly educated men, self-employment seems to be unemployment in disguise, that is, they make an entrepreneurial entry in order to avoid the dreadful stigma of unemployment.

The evidence provided in this discussion paper suggests that, as far as self-employment is concerned, the *primary problem* in Europe is that self-employment is *not* an attractive career option for the best and brightest individuals.

The practical objective of policy aimed at enhancing entrepreneurship tends to be defined in terms of the number of individuals engaged in self-employment. This is both dangerous and misleading. The number of people in self-employment can, and does in practice, increase for the wrong reasons. Furthermore, the volume of self-employment *per se* is not directly linked to broader societal goals.

What Europe needs is *positive voluntary* selection into entrepreneurship (instead of the negative involuntary selection that the presented evidence implies). The nature of selection may for example explain why Europe is often said to have an insufficient amount of *growth-seeking entrepreneurial activity*. Policy measures that aim for a more active market for mergers and acquisitions as well as deeper stock markets could facilitate positive selection out-of, and thus also entry into, self-employment.

2 SELECTION INTO AND OUT OF SELF-EMPLOYMENT

2.1 Introduction

Hundreds of thousands of Europeans enter self-employment each year, but self-employment spells are typically brief: most new entrepreneurs discontinue their businesses and *exit* from self-employment soon after entry.

The (former) Commissioner *Erkki Liikanen* (15 June 2000) summarised what appears to be a widely held view among European policy-makers: 'An important factor underlying Europe's poor record on entrepreneurship is indeed the *stigma of failure*. Many would-be entrepreneurs and good ideas are put off by the fear that if you fail once you will loose everything. You will not be given a second chance. This must change. Failure can be regarded as part of the learning curve.' The interest in the issue remains keen: the *Europe 2020* strategy (EC, 2010a) put forward by the European Commission refers to entrepreneurship and to its advancement several times.

This thematic discussion paper primarily elaborates on the following questions in light of the author's prior academic research (particularly Hyytinen & Rouvinen, 2008):

- What precedes one's decision to enter self-employment and establish a new business?
- What is the effect of self-employment experience on (subsequent) wage and non-wage outcomes, such as job security?
- Are those leaving self- for paid-employment after an entrepreneurial spell not given a proper second chance (as, for example, Commissioner Liikanen has suggested)?

2.2 Entrepreneurship *vs.* self-employment

The difference between entrepreneurship and self-employment is of importance.[1] Whereas *entrepreneurs*, individuals who (in-/outside existing/new organisations)

- perceive new economic opportunities and
- introduce them in the market place,

Are the *main source* of long-term economic growth, the role of *self-employed* (mostly sole proprietors) in this respect is *less obvious*.

Policy should undoubtedly promote *entrepreneurship*. There are, however, less compelling *economic* reasons to promote *self-employment*; possibly important cultural, psychological, social and other non-economic reasons for promoting self-employment are not elaborated on in this discussion paper.

In statistics some entrepreneurs *are* recorded as being self-employed; some self-employed individuals *do* fulfil the definitions of an entrepreneur. Thus, the two concepts *overlap* but the intersection is not large – at the very best it covers one-tenth of either group.

This being said, all self-employed persons necessarily have entrepreneurial aspirations and 'drive'. Furthermore, the multi-tier selection process – the focal point of this paper – is more similar across the two groups than what the 'empirical' overlap seems to suggest.

[1] A self-employed person works but is not employed by anyone; s/he may employ others, even if typically s/he does not. An entrepreneur is a person who, alone or with others and in-/outside existing/new organisations, perceives and creates new economic opportunities, as well as introduces them in the market place (Wennekers & Thurik, 1999). S/he also faces the competition and business risks, as well as makes decisions regarding location, form, and use of resources and production.

While the author of this note wishes to emphasize the difference between entrepreneurship and self-employment, in the following sections this distinction is mostly pushed aside and the two terms are used somewhat loosely and interchangeably.

2.3 Some stylized facts on self-employment

In developed countries some 80–90% of all businesses are operated by self-employed persons. Since these businesses are typically small, their economic significance is somewhat less than what their large share would seem to suggest. Within the EU-25, self-employment accounts for *one-sixth* of the total employment (Eurostat, 2006);[2] the rates are the highest in the Southern Member States (Greece 32%; Italy 29%) and the lowest in the Baltic Member States (Latvia 7%; Estonia 8%).

There is even more desire for self-employment that the actual figures suggest (EC, 2010b): 45% of EU-27 citizens indicate their preference for self-employment as their labour market status of choice; the rates of preference vary from 26% in Slovakia to 66% in Cyprus.

While there are difficult measurement issues as well as arguments for both over- and under-reporting, it is commonly thought that self-employment income is both more *variable* and more *skewed* than paid-employment income (Van Praag & Versloot, 2007). The *median* self-employment income tends to be lower than in paid employment; since a few self-employed 'superstars' earn very high incomes and lift the average, the *mean* incomes across the two groups are roughly equal. For a typical person monetary rewards are not the only reason for having a preference for self-employment, that is, it carries substantial non-pecuniary benefits (Hamilton, 2000).

The self-employed may also employ others. From the outset, this paid employment seems inferior to the paid employment offered by non-entrepreneurial (larger) firms (Van Praag & Versloot, 2007): employees in entrepreneurial firms tend to earn less and have lower job security. Even so, they tend to be more satisfied with their jobs than other employees – an indication of some non-pecuniary benefits also here.

The two-year survival rates of new European businesses range from 47.3% in Bulgaria to 87.3% in Sweden (Eurostat, 2010). As a rule-of-thumb, typically *less than half* of new businesses survive beyond the third year of operation. For the smallest businesses and self-employment ventures the survival rates are considerably lower (EC, 2004): the exit rates of the smallest European enterprises (0–4 employees) is about 4–5 times higher than those of slightly larger ones (5–9 employees). Thus, typical self-employment spells are indeed brief, as discussed further below.

2.4 General aspects of selection into self-employment

While the reasons underlying the decision to enter self-employment and to establish a new firm are manifold, it is preceded by a consideration of its pros and cons *vis-à-vis* other career opportunities and labour market statuses.

The consideration starts with *entrepreneurial aspirations* and is *forward-looking*, that is, it takes into account not only:

- immediate entry and opportunity costs as well as
- post-entry net returns, but also
- the consequences of the possible exit and its implications for subsequent life both professionally and privately.

The comparison of the available options involves the changes in current and future earnings as well as in non-pecuniary benefits (such as life satisfaction).

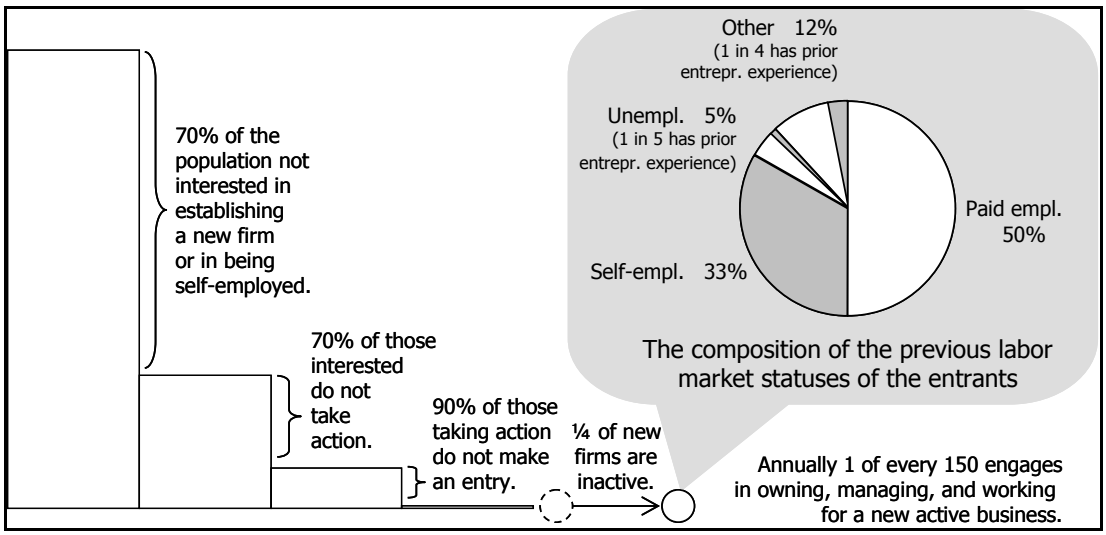
[2] Across the non-financial business economy (NFBE), that is, *excluding* agriculture, public administration and other non-market services, as well as obviously the financial services sector.

The population of individuals who ultimately consider becoming entrepreneurs or self-employed is an outcome of a lengthy *selection process*, in which each person has, at least implicitly, made his or her forward-looking consideration.

An entrepreneurial *entry* takes place only if the perceived net benefits are sufficiently higher than in paid employment (or other alternatives). There is a similar 'trigger point' in *existing* entrepreneurship. In between the two thresholds no change takes place and the *status quo* is maintained (Dixit & Rob, 1994).

Figure 1 displays a heuristic account of the selection process. It suggests that the selection is rather harsh: despite considerable interest, annually roughly one out of every 150 engages in owning, managing, and working for a newly established active firm. The positive message of Figure 1 is that the *potential* for new entry is *manifold* compared to its realisation.

Figure 1: A heuristic account of the selection in establishing a new active firm and the previous labour market status of the new entrants in Finland



Source: Pajarinen and Rouvinen (2006).

Diverse life and work experience, as well as experimentation and networking in previous employment, *increase* the probability of an entry. Long paid employment history and being a civil servant *decreases* the probability. Somewhat alarmingly, and perhaps contrary to the situation in some other advanced countries such as the United States, in Finland the probability of an entry also *decreases* with the innovation intensity and the level of productivity of the current employer, thus potentially reducing the number of high-potential entries.

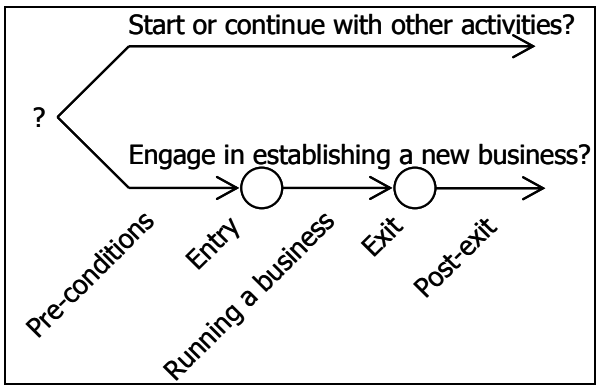
As can be seen in Figure 1 (see the pie), 8 out of 10 new entrants were also previously employed (in paid or self-employment); 4 out of 10 have at some point in time (or immediately before) worked for themselves (as indicated by the combination of the four grey slices of the pie). The unemployed are *not* more likely to start working for themselves.

Figure 2 outlines an individual's forward-looking consideration of whether or not to enter self-employment. In principle anybody considering an entry will answer the following question:

- Given my personal characteristics, current situation in life, as well as features of the operating environment, what is the net present value of entry vis-à-vis other alternatives, for example, remaining in paid employment?

All monetary and other benefits and drawbacks enter into the calculation. Factors relating to entry itself and actually working for oneself at one's own risk have been discussed extensively in the academic literature. It is, however, often forgotten that the potential *exit* and its subsequent consequences are also taken into account.[3]

Figure 2: A sketch of the forward-looking consideration of whether or not to engage in owning, managing, and working for a newly established active firm.



Source: The author's sketch.

2.5 Hyytinen and Rouvinen (2008) on the consequences of self-employment spells

Hyytinen and Rouvinen (2008) take a closer look at the selection implied in Figure 2. In particular, they consider the effect of self-employment experience on outcomes. They employ the *European Community Household Panel* (Eurostat, 2003) in replicating and extending an earlier study (Bruce & Schuetze, 2004) using a comparable panel collected in the United States, thus enabling a comparison between Europe and the United States (US).

The analysis of Hyytinen and Rouvinen (2008) mainly compares those who, first, are initially in paid employment, second, enter self-employment within a five year window, and third, exit self-employment and return to paid employment by the end of the window to those that remain in paid employment throughout through the window. It should be noted that the numbers and estimates below apply to this rather specific setup and may not be applicable in other contexts.

Hyytinen and Rouvinen (2008) study similar unemployment spells for comparison; this discussion paper only considers the self-employed. They consider outcomes for both males and females; in the interest of space this discussion paper follows the convention in the literature and only considers the results for males. They consider both net and gross wages; unless otherwise mentioned, this discussion paper refers to gross wages in order to be directly comparable with the afore-mentioned American study.

2.5.1 Some descriptive statistics and univariate analysis

Both in the EU and in the US those in paid-employment rarely experience brief self-employment spells: in the EU less than 2% and in the US over 5% did so within the five-year windows considered. In the EU 55% and in the US 77% of these spells lasted for only one year; also otherwise self-employment spells tend to be somewhat longer in Europe than in the US.

If one simply compares the end-of-window average hourly wages of those with and without a self-employment spell, the aforementioned conjecture of Commissioner Liikanen appears

[3] It should be emphasized that the thinking illustrated in Figure 2 does not assume that people are hyper-rational calculating computers – quite the contrary in fact: possible (even systematic) biases and misconceptions, as well as unwillingness and inability to make formal calculations, are essential elements of the system.

to be correct: In the EU, the hourly wages of those returning to paid-employment from self-employment are only three-quarters of the corresponding wages of those that remained in paid-employment; in the US there is hardly any difference.

The most obvious explanation for the differences is that workers who become self-employed for a short spell may do so because of their low productivity (and thus poor earnings capacity) in the wage sector. Looking at the simple difference between the beginning-of-window and the end-of-window wages suggests that this might indeed be the case; this observation is conformed in multivariate regression analysis discussed below.

2.5.2 Multivariate analysis

Comparing regressions with and without the beginning-of-window wage as a control for selection suggests that the estimated (negative) effect of brief self-employment spells reduces more in the EU than in the US when selection is controlled for in this way.

Should one take the mostly imprecisely measured coefficient estimates seriously, they would suggest that an additional year in self-employment reduces the post self-employment wage by 2–3% in the EU and by 11% in the US. Thus, if anything, the effect of discontinued self-employment on subsequent wages is nearly non-existent and possibly *less* severe in European labour markets. For the highly educated Europeans, the negative effect is 4–5%, but it is not statistically significant at conventional levels and it remains less than in the US.

The findings in the previous paragraph only employ the beginning-of-window wage to control for the selection. Hyytinen and Rouvinen (2008) continue their analysis by further considering the selections *from* paid- *into* self-employment and *vice versa,* as well as the initial selection into paid-employment (at the beginning of the five-year window) by employing sophisticated econometric techniques.

Considering the three types of selection jointly confirms that if anything, the data are *inconsistent* with the perceived lack of sympathy of the European labour market towards returning entrepreneurs: European entrepreneurs do *not* seem to suffer from a disproportionately strong *stigma of failure* upon return. It moreover seems that some form of negative selection accounts for most, if not all, of the end-of-window wage difference between those with self-employment experience and those with a continued paid work experience. The explanation offered for this selection is that the likelihood of entering (and exiting) entrepreneurship correlates negatively with the unobservable ability and/or productivity of the individual in question.

2.5.3 Non-wage outcomes

How can we reconcile the large unconditional end-of-window wage difference between those with and without self-employment experience with the lack of a conditional wage difference (when selection and other factors are accounted for)?

While it appears that negative selection provides an obvious reconciliation, what remains to be understood is whether the selection is *voluntary* or *involuntary.* Selection by low-wage (low-ability) employees into and then subsequently out-of self-employment is likely to be *involuntary*, if self-employment is unemployment in disguise (Earle & Sakova, 2000) and, in particular, if the low-ability employees face a higher likelihood of becoming displaced from wage work. On the contrary, selection is probably *voluntary* if it is negative due to low (unobservable) reservation wages that correlate, for example, with the likelihood of having a preference for being one's own boss.

By exploring the probability of looking for a new job, Hyytinen and Rouvinen (2008) reveal that self-employment may be unemployment in disguise, especially for highly educated males; a finding that is more consistent with involuntary than voluntary selection into self-employment.

A regression analysis of non-wage outcomes further reveals that brief spells of self-employment are associated with increased probability of part-time employment upon

returning to the wage sector, increased likelihood of outright unemployment, and decreased job security. This suggests negative involuntary selection.

In summary it seems that attachment to the paid-work labour market seem to be weaker after a self-employment spell.

2.5.4 Findings

The analysis of Rouvinen and Hyytinen (2008) suggest that European employees select negatively into (and possibly out-of) self-employment, i.e., that the likelihood of entering (and exiting) entrepreneurship correlates negatively with the unobservable ability and/or productivity – on average less-capable individuals tend to enter self-employment in Europe.

The findings suggest that European entrepreneurs do *not* seem to suffer (either in absolute terms or relative to their US counterparts) from a disproportionately *strong stigma of failure* upon return.

The analysis of non-wage outcomes suggest that it could be negative *involuntary* selection – that is, in a sense some individuals may be "forced" into self-employment due to, for example, a malfunctioning paid-employment labour market – that explains the large end-of-window wage difference between those with self-employment experience and those with continuing work experience. Especially for highly educated men, self-employment seems to be unemployment in disguise, that is, they make an entrepreneurial entry in order to avoid the (more) dreadful stigma of unemployment.

The findings of Rouvinen and Hyytinen (2008) suggest a number of conclusions that are relevant to the design of these policy efforts:

First, they help to better understand the incentives of Europeans to enter self-employment in the first place. It seems that the prospect of having to face a hostile labour market upon return (after a short spell of self-employment) is not what hampers European entrepreneurship.

Second, a problem of Europe appears to be its inability to make entrepreneurship an attractive career alternative for its best and brightest. What Europe needs is positive voluntary selection into entrepreneurship (instead of the negative involuntary selection that the presented evidence implies). The nature of selection may for example explain why Europe is often said to have an insufficient amount of growth-seeking entrepreneurial activity. Moreover, if the entries into and exits from short-term entrepreneurship can on average be related to negative selection, it *cannot* be the case that a significant number of the best European talents test their new ideas or technological innovations on the market by making an entrepreneurial entry. The reason for this is that such experimenting is risky: Many of the talented making an 'experimental' entrepreneurial entry should re-enter the wage sector soon after entry, implying (possibly) positive selection.

Finally, policy measures that aim for a more active market for mergers and acquisitions as well as deeper stock markets could facilitate positive selection out-of, and thus also entry into, self-employment.

2.6 Concluding remarks

Certain preconditions for entrepreneurship and self-employment in Europe are good: *Some* interest is nearly universal among the general population. Roughly every other European prefers self-employment to paid employment. Once self-employed, it seems to be more satisfying to be 'one's own boss' than to work for others. Furthermore, it also seems to be more satisfying to be employed by a real person – an entrepreneur – than a faceless corporation. After taking all of this into account, the actual entry into and being in self-employment in Europe appears somewhat *modest*, suggesting that there are widespread institutional obstacles for making an entry and establishing one's own business. On the other hand there is a lot of upside potential in promoting entrepreneurship and self-employment.

As far as entrepreneurship/self-employment is concerned, the primary problem in Europe is that it is *not* an attractive career option for its best and brightest individuals.

There is *no* solid evidence that a particularly strong stigma of failure associated with a brief self-employment spell would be the main issue of concern.

There is some indication that entrepreneurship/self-employment in Europe has been on the increase partly for the *wrong* reasons, that is, people have been pushed to self-employment due to malfunctioning labour markets and that some paid jobs have be re-classified as sub-contracting from the self-employed.

The practical objective of policy aimed at enhancing entrepreneurship tends to be defined in terms of the number of individuals engaged in self-employment. This is both dangerous and misleading. The number of people in self-employment can, and does in practice, increase for the wrong reasons. The volume of self-employment *per se* is not directly linked to broader societal objectives.

Only a small proportion of newly established firms influence the economy in a way that may have non-trivial consequences on a country's long-run economic welfare. This begs the following policy question: Can the afore-mentioned selection into entrepreneurship (Figure 1) as well as the related forward-looking consideration (Figure 2) processes be influenced in such a way that the desired high-potential entrepreneurship – associated with positive and voluntary selection (rather than negative and involuntary documented in this paper) – is maximized? The simple and sound answer is *"yes"*. Unfortunately the answer to the obvious follow-up question on *"how to do it?"* is far from simple; it basically involves going through the processes sketched in Figure 1 and 2 and considering how to provide opportunities and incentives for the right high-potential entrants.

Given the typical personal characteristics of growth-seeking entrepreneurs, they are not particularly impressed by smallish lump-sum business start-up allowances or launching aids: they tend to be rather affluent to start with and the financial needs of their businesses are considerably larger than what a general public program can (or should) provide.

Growth-seeking entrepreneurs are rather interested in opportunities to attract resources for carrying out sizable and risky business plans without much concrete backing besides one's ideas. This clearly has financial market implications, especially when it comes to pre-seed, seed, and start-up funding (family and "angel" as well as "formal" venture capital, although on should immediately note that formal venture capital only touched on a very narrowly defined group of companies). This also requires "two-sided" market responsiveness: once it becomes evident that the entrepreneur's idea indeed has real market potential, the system should work in such a way that financial, labour, and other resources are shifted from alternative uses to back the new idea. The end-market should also be responsive: if the product or service based on the entrepreneur's idea offer superior value, the demand should shift toward it as rapidly and massively as possible. Both sides of market responsiveness are generally promoted by more intense competition and transparency of the respective markets.

The long-term prosperity of a country depends on the magnitude of entrepreneurship that perceives and creates new economic ideas and opportunities, as well as introduces them in the market place. While this process can take place in or outside existing organisations, in practice new growth-seeking start-up firms have an important role to play. Promoting this type of entrepreneurship should be the focal point of economic policy.

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