

Self-employment and Manna from Heaven – A Summary

Why do people become self-employed? And why do they continue to work as self-employed? Our report has two purposes. The first is to report some facts about the development of self-employment in the OECD. The second purpose is to provide a survey of economic research around the choice of self-employment.

During the period 1950–1980 the share of self-employed in total employment decreased in the OECD countries. The decrease in self-employment coincided with urbanisation and the growth of mass production industries.

In the 1980s the share of self-employed started to increase again in most of the OECD countries. One of the reasons for this increase is that industrial production tends to be replaced by an increasing production of services.

Our research survey focuses on those economic factors that are important for the individual's decision to choose self-employment. Questions concerning economic structure, for example the scope for small firms in the economy, are only touched upon as background facts.

The international economic research on the determinants for the individual's choice of self-employment has been distinctly modest. In recent years, however, this line of research has attracted more attention.

This coincides with an increase in the political interest in self-employment. The entrepreneurial abilities of the self-employed have been considered as an important ingredient in promoting growth and employment.

Swedish economic research on self-employment is still very limited. It is an important task, therefore, to make the international

research results available to an audience outside of the research community.

Self-employment and Entrepreneurs

A self-employed person is gainfully employed but does not receive wages or a salary. Among the self-employed we will find both unpaid family members helping out in the family firm and executives with major stock holdings in large and successful firms. The local pizza baker and the baby-sitter, as well as highly paid management consultants and some successful researchers, are defined as self-employed. They are all in some sense entrepreneurs, but their contributions to production are obviously different in many respects.

Sometimes it is claimed that it is always better to have more self-employment. That is not true. Countries lagging in economic development often have large shares of self-employment. For example Turkey and Greece have the highest shares of self-employment among the OECD countries. Most of this self-employment is represented by small scale and relatively inefficient production.

Self-employment is sometimes the only option for those who do not want to be or do not have the opportunity of being employees. There are dynamic, independent, resourceful and creative entrepreneurs that choose self-employment. But there are also persons who become self-employed because they are excluded from the regular labour market. Previously hired employees who become self-employed often received relatively low wage or salary income as employees.

At the same time there are many people who wish to become self-employed but are restrained by lack of own capital as well as sufficient venture capital. Were it not for this capital threshold, more people would have the opportunity to become self-employed. Lottery winnings and gifts, therefore, give people an opportunity to become self-employed that they would otherwise not have had.

This does not imply that the number of self-employed would actually increase in the absence of this threshold. If the current

threshold is efficient in only excluding those who are unfit to survive as self-employed, a lowered threshold would only increase the turnover of self-employment.

Determinants of Self-employment

Research shows that the decision to become self-employed depends to a large extent on psychological and social factors. The opportunities to increase personal income also play a role.

Self-employed persons are to a higher degree than others convinced that they are in control of their own fate. They are also less risk averse. Many have close relatives who are self-employed. They also belong to social and ethnic groups that are less well integrated in society, for example immigrants.

Opportunities to increase personal income hypothetically mean that self-employed persons earn more than a person with the same background and personal characteristics would earn in employment. But this does not rule out the fact that employees in general would earn more as self-employed than those who actually are self-employed. Many studies find this to be the case.

How large the estimated increase in personal income is depends on the extent to which background factors and personal characteristics have been taken into account. Often the increases are quite low. Psychological and social factors are much more important for the decision to become self-employed. It seems that a large part of the utility derived from being self-employed has nothing to do with money. Median incomes for the self-employed are in fact lower than for employees in most countries.

The studies surveyed here cannot conclusively determine whether the self-employed are better off. The non-pecuniary benefits are hard to measure.

Nor is there any conclusive evidence about the effects of taxation. Some results indicate, however, that high marginal taxes may increase self-employment. That may be because self-employment makes it possible to lower the tax rate on own labour. This does not contradict the fact that high marginal taxes decrease the pro-

pensity to hire labour in the own firm. The trend in the OECD towards a larger share of self-employed without any employees points in that direction.

Some macroeconomic studies find a positive relation between unemployment and the share of self-employed. This may, however, simply be due to the fact that the number of employees decreases faster than the number of self-employed in recessions.

In studies on the regional or individual level one usually finds that the relation between unemployment and the self-employment share is negative. The local demand situations seems to be more important for self-employment than the higher probability for unemployed to become self-employed.

Liquidity constraints

Own wealth increases the probability to become self-employed. This indicates that own capital and venture capital for self-employment cannot be borrowed without collateral to the extent desired. In economic literature this is referred to as liquidity constraints. A person without own assets to use directly or as collateral is then cut off from the opportunity to choose self-employment. This interpretation is strongly supported by the fact that persons who have received inheritances or won in lotteries, which is unrelated to their ability as self-employed, are also more likely to be self-employed than others. Thus, it is possible, but hardly efficient, to increase the number of individuals who becomes self-employed by randomly distributing large sums of money to those who are liquidity-constrained.

Some people, without means of their own, cannot become self-employed even if they would be more productive as such. Is this then a reason for government intervention?

Liquidity constraints arise due to an information problem. It is difficult for a lender or investor to assess the risks associated with a self-employment project. An important reason for this is that the success of the project to a large extent depends on the personal characteristics and efforts of the self-employed person wishing to

borrow. It is also hard to check whether the borrower fulfils his obligations or simply uses the loan to finance a leisurely life style or an extensive travel program for a time before going bankrupt.

Present research cannot determine whether lenders solve this problem efficiently by requiring private means of some sort in order to grant loans. It is possible that the public sector, as compared to private agents, may have certain advantages in pooling information about technical prerequisites for different projects and the evaluation of the creditworthiness of individuals. If it were possible to diversify the risks to a higher degree, for example by providing public credit insurance for self-employment financing, the capital markets might become more socially efficient in this respect.

An argument against this is that public credit insurance easily becomes less efficient than private counterparts, since public administrators in general do not have the same personal incentives to avoid bad risks. The household wealth distribution is very unequal. This implies that many, in particular young people, are liquidity constrained and find it difficult to become self-employed. Let us imagine that these persons are equally likely to succeed as self-employed as persons with sufficient own or family assets. In that case many people would be able to improve their own well-being and at the same time contribute to a more efficient economy, if only the liquidity threshold could be lowered.