

Self-Employment and Macroeconomic Performance

The small number of entrepreneurs is often seen as a major problem for the Finnish economy. This is also emphasized in the current Government's programme. However, a labour market with many self-employed individuals is no guarantee for economic success. Instead, it could be a sign of inefficiencies in the regular wage or salary labour market. Policymakers should focus on removing obstacles that inhibit firms from increasing their workforce, not only maximizing the number of self-employed.



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The body of empirical economic research on self-employment has grown considerably during the last 15 years. Perhaps the most active field of research has been studies on why some individuals become self-employed while others do not. This research has yielded several interesting results.

First, it has been shown in many studies that richer individuals have a higher propensity to become self-employed, holding gender, age, education, and other factors constant. From a theoretical point of view, this result can be attributed to two explanations. The first one has to do with capital constraints. In order to start a business, some start-up capital is needed. This capital can be obtained either by borrowing or by drawing on savings. But to get a loan one needs collateral. So, all else equal, an individual possessing greater wealth will have better opportunities to start a firm. The second explanation has to do with risk aversion. Building a career based on self-employment is riskier than doing so as an employee of a business. However, failing (i.e., bankruptcy) when one is self-employed is not as harmful when that individual has more personal wealth.

Second, the probability of becoming self-employed rises with age, at least up to a cer-

tain extent. Older individuals often have more labour market and other experience than young individuals, which perhaps makes it easier to avoid bad business ideas. Further, older individuals may use self-employment as a kind of part-time retirement scheme, as they have better possibilities to control their working hours. Third, the self-employed tend to be individuals that are not specialists, but have experience from several fields. Fourth, we know from cross-disciplinary research between economics and psychology that an individual's personality affects his or her choice of occupational status; those that are less risk-averse are more likely to be self-employed. These results have been obtained by using psychometric test data in models of occupational status selection.

From a policy point of view, perhaps the most relevant determinant of individual self-employment choice is the fact that richer individuals have higher probabilities of becoming self-employed. Would it not then be a wise policy option to alleviate some of the capital constraints faced by potential entrants to the pool of self-employment by improving the possibilities to receive start-up money or subsidised financing? Indeed, the current government has

said in its programme that entrepreneurship must be made a more attractive career option.

Does a large share of self-employed in total employment benefit the economy? In order to answer a question like this, it is necessary to examine existing research on the effect of the size of the pool of self-employed on important macroeconomic variables such as GDP growth or employment growth. However, before doing that one must differentiate between the terms “self-employed” and “entrepreneur.” A self-employed person is simply someone who is working but is not employed by anyone. Self-employment is therefore more or less a statistical concept used in the national accounts or labour force surveys. Thus, it is clear that this group of individuals is very heterogeneous, encompassing the local kiosk owner or baby-sitter to very successful owners of firms employing many workers.

The term “entrepreneur,” on the other hand, has a long history in economics, and there are many definitions of what entrepreneurship or an entrepreneur is. A modern one, according to Wennekers and Thurik (1999), is as follows. Entrepreneurship is the manifest ability and willingness of individuals, on their own, in teams, within and outside existing organisations, to:

- perceive and create new economic opportunities (new products, new production methods, new organisational schemes and new product-market combinations) and
- introduce their ideas in the market, in the face of uncertainty and other obstacles, by making decisions location, form and the use of resources and institutions.

It is clear that if an entrepreneur is someone who performs these tasks, a large number of such persons in an economy is no doubt a good thing. The problem, of course, is that if entrepreneurship is defined in this fashion, it is very hard to operationalise and measure empir-

ically. This problem is also clearly manifested in empirical research, where the goal has been to examine the role of entrepreneurship on macroeconomic performance. Due to the lack of an adequate indicator of the number of entrepreneurs in the economy, researchers have used the number of self-employed as a proxy. The results have generally been disappointing, as it has been nearly impossible to find any positive relationship between the number of self-employed (in a country for instance) and macroeconomic performance. An important result from these studies is perhaps that self-employed is a bad proxy for entrepreneurial activity. In fact, there is even some evidence pointing to a negative correlation between the number of self-employed in the economy and macroeconomic performance.

First, the number of self-employed decreased more slowly than the number of wage or salary earners in Finland during the recession in the beginning of the 1990s. The recession thus affected the self-employment rate (the number of self-employed divided by the number of employed, see the figure below) positively. The reason for this is probably that the wage elasticity with respect to employment (or perhaps a



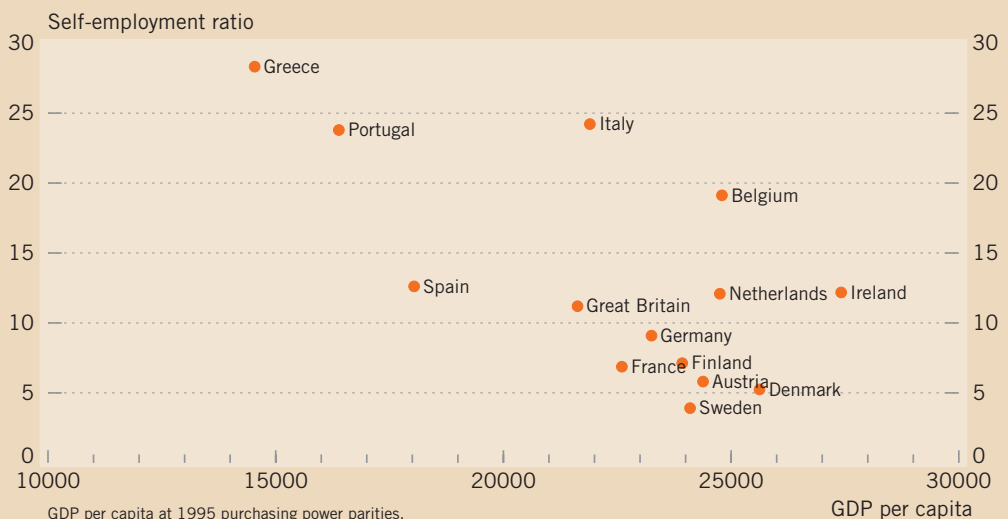
better term for the self-employed would be income elasticity with respect to employment) is much greater for the self-employed than for wage or salary earners. When Finnish companies had to cut costs in the beginning of the 1990s, they resorted to laying off personnel since wages could not be lowered. However, the self-employed stayed in the labour market to a greater extent, but received lower income.

Second, it is clear from a comparison of the self-employment rate and GDP per capita in the EU-15 that richer countries have lower self-employment rates (excluding the agricultural sector). For example, self-employment rates in Greece and Portugal are the highest in the EU, but their GDP per capita are the lowest. The EU's richest countries, Denmark, Ireland, and the Netherlands, have much lower self-employment rates. There are probably several explanations for this phenomenon, but one is most likely that the regular wage or salary labour markets in the Mediterranean countries are too

rigid, which makes it costly for companies to recruit employees, and consequently some individuals are forced into self-employment although they would prefer to work for an employer. And the economy suffers because companies are on average too small.

Third, immigrants have higher self-employment rates than non-immigrants in many EU countries. It is, however, doubtful that immigrants would be better suited as self-employed than non-immigrants. It is more likely that many immigrants end up as self-employed because they themselves are "employers of last resort" as often they face difficulties finding regular employment. Another way to express the same thing is that the productivity of many immigrants is rather low. And as it is expensive to employ people in the EU, immigrants cannot get a "normal" job. By avoiding minimum wage and other costly regulations, self-employment then offers an alternative for providing low-productivity services.

Self-Employment Ratio and GDP per Capita in the EU, 2000



GDP per capita at 1995 purchasing power parities.

Self-employment ratio = number of self-employed/labour force (excl. the agricultural sector).

Source: OECD.

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Thus, there are several reasons for why it is not appropriate to view a large number of self-employed in an economy as a sign of economic progress. A better explanation for a high number of self-employed in an economy may, instead, be that there are barriers to other types of employment, and that self-employment is sometimes a means to avoid regulations.

Thus, the wording in the current government's programme should perhaps be "The government will make it cheaper for companies to hire additional labour." In other words, it is likely that the benefits would be bigger, if policymakers would concentrate on implementing rules that would make it easier for companies to hire additional labour, instead of trying to convince individuals to go into self-employment, even though they would be better off as employees of some firm.

Another, somewhat nastier explanation of why politicians are keen on getting people to become self-employed is that they do not want, or are unable, to implement decisions that would make companies more interested in

expanding their workforce. One such measure would be to cut the tax wedge (i.e., the difference between the gross salary, including all payroll taxes, that the employer pays and the net wage the employee receives) substantially. The prime minister has on several occasions indicated that this may be on the cards, but nothing substantial has thus far happened during this legislative period. And when this is not happening, calling for more entrepreneurs is a suitable smokescreen that can score political points without being too unpleasant.

REFERENCES

Wennekers, S. and Thurik, A.R. "Linking Entrepreneurship and Economic Growth" *Small Business Economics*, 1999, 13(1), pp. 27-55.

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