

## Introduction: Self-employment and entrepreneurship

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Self-employment is regarded by many as something purely and genuinely good. More entrepreneurs mean more innovation and new ways of organizing production. People do not only provide themselves with employment, they also employ others. This creates economic growth. And the larger number of self-employed will increase competition and efficiency. Taken together, this will increase the real incomes in society. In the political discussion, the desirability of self-employment is seldom questioned. And many people are very sure about which policies promote self-employment and which do not.

At the same time, there is considerable ongoing international research on self-employment and entrepreneurship in social sciences. This research is sometimes multidisciplinary. There is a lot to learn from the research. In a recently published book, Professor Simon Parker (2004) surveys the growing theoretical and empirical research on self-employment and entrepreneurship. In his conclusions, he writes (Parker, 2004, p. 269):

“... it is unclear why governments wish to promote entrepreneurship in the first place. One is led to suspect that their involvement is motivated by ideology rather than by a pragmatic evaluation of the costs and benefits. Many governments apparently believe that entrepreneurs create jobs and that higher levels of enterprise promote economic growth. There is certainly no shortage of small-business practitioners and academics that have vested interests in encouraging these beliefs, despite the limited evidence we found in this book to support them ... . It rarely seems to be acknowledged in these circles that entrepreneurial ventures might also possess drawbacks. For example, small firms do less training and pay lower wages than large firms, so a policy of encouraging small firms at the expense of large ones might actually damage the national skill base.”

One of the objectives of the Economic Council of Sweden is to provide information about important economic policy research. The

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Council, therefore, organized a conference on self-employment and entrepreneurship on 22 March 2004 in Stockholm. Six researchers from Europe and North America were invited to present their research on self-employment and entrepreneurship. The Swedish Research Council provided financial support for organizing the conference.

The papers presented included one discussing recent trends in self-employment in OECD countries and another studying self-employment in Britain. The importance of independence for the decision to become self-employed was the topic of one paper. The papers also discussed the interactions between self-employment, on the one hand, and taxes, education, and social norms on the other. Each paper was commented on by a discussant. The present issue of Swedish Economic Policy Review publishes revised versions of the papers and comments.

This introduction is organized as follows: In the first section, I present some stylized facts concerning self-employment in Sweden during the period 1970-2003. I summarize the main conclusions of the six papers in the second section. Finally, the policy implications are the topic of Section 3.

## **1. Some stylized facts for Sweden**

I would like to start by discussing two figures showing time series for self-employment in Sweden during the last decades. From these figures, I will make observations on important stylized facts for Sweden. Many of the observations, however, are general for most developed countries and do not only apply to Sweden.

Figure 1 shows how self-employment for men in Sweden has evolved since 1970. It is clear from the figure that the number of self-employed men, as a share of total male employment, has varied around 15 percent. Figure 2 shows the corresponding figure for women; note the different scaling of the vertical axes. The female self-employment rate has varied around 7 percent.

The *first* observation is that self-employment is less common among women than among men.

Employment in agriculture has decreased rapidly in Sweden. In 1970, 6.2 percent of total employment was in agriculture; in 2003, this share had decreased to 1.7 percent. This has had a direct impact on self-employment. For men, this shows up in the decline during the

1970's (see Figure 1). It is clear from Figure 2 that the decline in agriculture for women has primarily affected the number of family helpers.

The *second* observation is that the employment decline in agriculture reduces self-employment.

Most self-employed do not have any employees. This is true both for men and women, see the figures. Some claim that only those who employ others can be regarded as entrepreneurs. Others connect the term entrepreneurs more with innovations.

The *third* observation is that most self-employed do not have any employees.

It is not clear-cut to define who is self-employed. The Swedish Labor Force Surveys were changed in the mid-1980's. This is indicated by the breaks in the time series in the figures. One of the changes was that owner-managers, people who own the companies from which they get salaries, started to be classified as self-employed. This explains why there are jumps in the shares of self-employed with employees in the figures.

The *fourth* observation is that it is difficult to define who is self-employed and who is not.

**Figure 1. Self-employed men in Sweden, 1970-2003**



Source: The Swedish Labor Force Surveys.

The self-employment rate increased considerably during the severe recession in Sweden at the beginning of the 1990's. This was the case for both men and women. In absolute numbers, there were 20,000 more self-employed men in 1993 as compared to two years before, while the corresponding increase for women was 7,000. When the economy expanded after the recession, the self-employment rates decreased.

The *fifth* observation is that self-employment varies negatively with the business cycle.

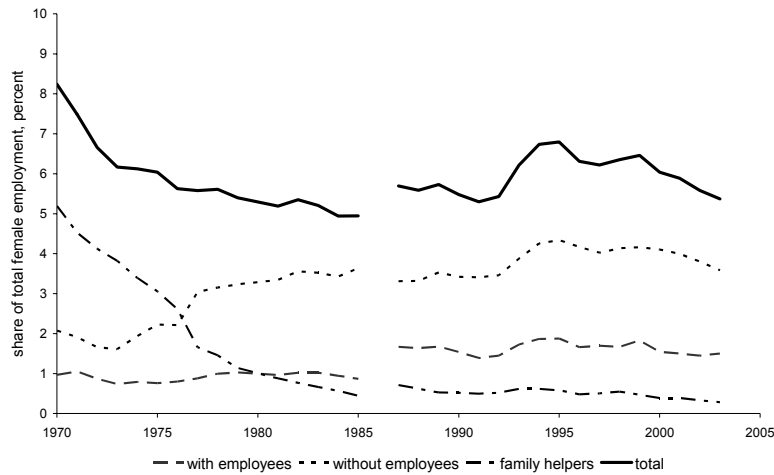
The share of self-employed without employees has gone down slightly during the last decade. For women, however, the share of self-employed without employees is much higher now than in the 1970's.

The *sixth* observation is that self-employment has decreased in the last decade because the share of self-employed without employees has gone down.

The share of self-employed with employees has, on the other hand, remained constant during the last decade. The share is slightly higher now than at the end of the 1980's.

The *seventh* observation is that entrepreneurship in Sweden, measured as the share of self-employed with employees, is stable.

**Figure 2. Self-employed women in Sweden, 1970-2003**



Source: The Swedish Labor Force Surveys.

Finally, there is an important aspect of self-employment that is not immediately apparent in the figures. When discussing self-employment, it is important to distinguish the stocks of self-employed, which are shown in the figures, from the inflow to self-employment and the duration of self-employment. The share of self-employed can increase because of a higher inflow, but it can also increase because of longer duration of self-employment which reduces the outflow. There are considerable flows into and out of self-employment each year. In many cases, this concerns the same people.

## 2. The papers in this issue

The papers in this issue all belong to the tradition of neoclassical microeconomics. In one way or the other, their starting point is occupational choice. People are assumed to compare the returns of self-employment and paid-employment, and choose the type of occupation with the highest return. Relative income is not necessarily the only crucial factor. Non-pecuniary returns, affecting job satisfaction in general, may be more important than pecuniary returns.

People differ in their entrepreneurial ability and their willingness to take risks. Such personal characteristics may also affect if people are, become, and stay self-employed. But willingness is not enough; the opportunity to be self-employed is also determined by factors in the economic environment.

*David Blanchflower* presents a survey of the development of self-employment in 80 countries.

Self-employment rates have decreased in general with the UK and New Zealand as exceptions. Men are more likely to be self-employed than women, older workers are more likely than younger workers. More education decreases the probability of self-employment in Europe whereas the effect is the opposite in the US.

Self-employed report many negative aspects of their work: pressure, stress, strain, worry, exhaustion. On the positive side, they are satisfied with their lives because they have control. Latent entrepreneurship is considerable in most countries; many employees say that they would prefer to be self-employed, but few become so. This may be in their best interest. *Blanchflower's* conclusion is that more self-employment may not be better. *Magnus Henrekson*, in his comment, argues that it is necessary to look deeper into the specific institutional

and situational context to draw normative conclusions about the optimal number of self-employed.

*Mathias Benz* and *Bruno Frey* study job satisfaction more closely using data from a large number of countries. They find that the self-employed are substantially more satisfied with their jobs than those employed. This is not because of higher pay or lower working hours. And, it is not because of personal characteristics. Instead, it can be directly attributed to the greater independence and autonomy the self-employed enjoy. This may make some self-employed reluctant to employ others.

The increase in self-employment in the UK, which contrasts the decreasing trend in most other countries, makes it a particularly interesting country to study. *Mark Taylor* shows that the strong increase in the share of self-employed during the 1980's was due to an increase in the inflow rate. The outflow rate started to increase at the beginning of the 1990's; this is the main (accounting) explanation of why the increase in the self-employment rate did not continue. Data from the British Household Panel Survey show that the self-employed report higher levels of job satisfaction with pay and the work itself, but lower levels of satisfaction with job security.

*Justin van der Sluis* and *Mirjam van Praag* compare the returns to education for self-employed with the corresponding returns for employed. Using data for the US and the Netherlands, they find that the returns to formal schooling for self-employed are higher than for employees.

The authors suggest that this might be because self-employed are freer to optimize the use of their education. Employed may be more constrained by hierarchies. It is possible that also the composition of education is important. *Lazear (2002)* finds that those who have many and broad skills are more likely to be self-employed than those who have few but deep skills.

The objective of *Herbert Schuetze* and *Donald Bruce* is to survey the research on the impact of tax policy on entrepreneurship. Theoretically, a proportional income tax system has two counteracting effects on the returns to risky activities such as self-employment. On the one hand, the expected return is reduced which discourages the activity. On the other hand, the government will share the risk, which encourages the activity. There is little consensus in the empirical literature. Many studies find that higher tax rates lead to higher rates of entrepreneurial activity. The explanation is that high taxes drive workers

out of paid employment into self-employment where they can more easily avoid and evade taxes. Other studies question these findings. There are studies showing that higher marginal income tax rates decrease self-employment, whereas higher average income tax rates have the opposite effect.

The authors come to the conclusion that there is fairly convincing evidence in the economics literature which suggests that self-employed are less likely to comply with the tax code. This may result in considerable economic distortions. An increase in the self-employment rate is, therefore, likely to increase the overall non-compliance and may require a further increase in tax rates to finance the shortfall.

*Mariassunta Giannetti* and *Andrei Simonov* study self-employment in Sweden using data from the LINDA panel data set. They estimate models of entry into and exit from self-employment as well as for the income from self-employment. Their objective is to compare the effects of social norms with the effects of individual characteristics and economic environment. The finding is that social norms matter although other factors are more important.

### 3. Public policy

We now know much more about which personal and other characteristics that make a person more likely to be, become, and remain self-employed from the growing empirical literature (Holtz-Eakin and Rosen, 2004, is a recent contribution). This knowledge is important, but it does not answer the normative questions: Are there too few self-employed? And, if so, should the government do something about it?

The approach of Parker (2004) is to think of a market for self-employed with demand and supply. There may exist market failures on this market creating inefficiencies. Positive externalities of ideas, products, and employment might create higher social returns to self-employment than the private returns. This creates a *resource allocation* motive for public interventions on this market.

Another motive for public intervention has to do with *income distribution*. Self-employment might be a road out of poverty, unemployment, and dependence. Andersson and Wadensjö (2004) study self-employment among immigrants in Sweden and Denmark. The self-employment rate among immigrants is higher than for others in both

countries. The incomes of self-employed immigrants are, however, lower than the incomes of natives with the same characteristics.

Boadway and Trembley (2004) discuss arguments for and against government policy intervention. They also recognize that new products, new technologies, new talents, etc may have spillover benefits. But, at the same time, this may also create spillover costs for incumbent firms. This crowding out has also to be taken into account.

Another possible market failure is the non-financial barriers to entry. Boadway and Trembley distinguish between the barriers created by the natural advantages of incumbents, the actions by incumbents, and policies such as taxes. Financial barriers may arise because of constraints on risk trading. Asymmetric information may lead to self-employed becoming constrained in the amount of credit they can obtain.

It is often claimed that most new jobs are created in new firms and small firms. And as a consequence of this positive externality, government policy should favor small firms. But as shown by Davis et al. (1996) for the US, small firms are also responsible for a larger share of job destruction. Inflows to and outflows from self-employment are considerable. There is no clear relationship between net job creation and firm size. Andersson (1999) confirms these results on Swedish data.

It can also be argued that not only the quantity of jobs but also the quality of jobs should be taken into account. It is well established that larger firms pay higher wages and provide more training than small firms.

The most important policy tools for affecting self-employment fall into three different categories: taxes; policies on credit markets; and training, advice, and support. A final caveat is, however, that even if we can establish that there exist market failures, it is nevertheless not certain that government intervention is desirable. Policy is also constrained by failures. These government failures may make it impossible to improve efficiency and equity.

Economic theory is not clear on the effects of *taxes* on the number of self-employed and social welfare. Reducing personal income taxes for all may increase or decrease the number of self-employed. The empirical research does not help us either in determining in which direction the number will go. Some studies suggest that increasing the average tax rate will increase self-employment, whereas increasing the marginal tax rate will have an effect in the opposite direction. And the



most certain empirical fact is that the more self-employed there are, the more tax avoidance there will be. Pissarides and Weber (1989) estimated that non-compliance among self-employed accounted for 5.5 percent of GDP in the UK in 1982. Using a similar approach, Apel (1994) estimated non-compliance in Sweden 1988 to 1.0 percent of GDP.

It should be stressed that so far, we have been discussing the absolute level of taxation. If the taxation of self-employed is reduced relative to the taxation of employed, the incentives to become self-employed will, of course, be strengthened. We would then expect an increase in the number of people who choose to become self-employed.

A person who has the desire to become self-employed, and also has the entrepreneurial ability to succeed, is likely to start her own business if she also has the financial resources. But desire and ability are not enough without the necessary financing. Those who lack own financing will have to rely on loans or venture capital. The *capital markets* are characterized by asymmetric information. It is difficult for lenders to know the true ability and the true desire to succeed of a potential borrower. Liquidity constraints may, therefore, arise.

But it is also the case that some of the people who want external financing have the desire to become self-employed, but not the necessary entrepreneurial ability. Some people should simply not become self-employed. Refusing to lend money to these people is efficient and not a market failure. There is nothing to stop them from wasting their own financial resources if they want to do so, but it is not a good idea that they waste other people's money.

The traditional public policy to try to mitigate liquidity constraints has been to provide loans and loan guarantee schemes. OECD (2000) argues for a number of different policy measures to increase self-employment, including policies to reduce financial barriers. There is, however, little empirical evidence to support that these measures have any significant effects. Some of the businesses would have started anyway without any subsidies. And some of the businesses should not have been started in the first place.

There is some evidence that there exist liquidity constraints, although for example Hurst and Lusardi (2004) provide evidence to the opposite for the US. But the existence of liquidity constraints is not sufficient to warrant public policy. The fundamental question is: Why should the political system and the public administration be better at

providing financing than commercial banks and other credit institutions?

Potential entrepreneurs may also face constraints in their own human capital. Public policy may help overcome these constraints by providing *training, advice, and support* to people who want to become self-employed. Policy can also be targeted towards people who already are self-employed to help them continue successfully.

Kosanovich et al. (2001) study the effects of self-employment programs for unemployed in three US states. They find that the programs are successful in the sense that the self-employment rate of participants increases. The cost efficiency of the programs is more unclear. Carling and Gustavsson (1999) compare the effects of self-employment programs for unemployed with the effects of employment subsidies for the same group. They find that the risk of becoming unemployed again is less than a half for those who participated in the self-employment programs.

It is, however, not clear that it is optimal to target unemployed. The conclusion from the van der Sluis and van Praag paper in this issue is that the returns to education are higher for self-employed than for employed. The policy conclusion from this is that it may be more efficient to stimulate those who are already schooled to become self-employed than stimulate the schooling of self-employed.

To sum up, it is delicate to design public policies that promote entrepreneurship. The solutions are not as simple as suggested by vested interests. Instead, what is needed is careful examination of the available theoretical and empirical evidence. It is my belief that the papers in this issue can contribute to this.

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