

Response to Magnus Henrekson:
Is more self-employment good or bad?

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Magnus Henrekson has put a great deal of time and trouble into his comments which is much appreciated. I do not agree with him however on many of the points that he has raised. The difference between us is that I present hard evidence on what the self-employed say and do.

1. Henrekson suggests that I draw ‘normative’ conclusions regarding the optimal level of self-employment. I do not. I have simply argued that there is neither empirical evidence nor theory that tells us what the optimal rate of self-employment is or should be. Consequently, it is virtually impossible to know at any one moment of time whether a higher or lower self-employment rate is better. For an individual, moving to self-employment is a risky option that is fraught with dangers and may not be in his or her best interests, but he or she will find out if it is soon enough. If there is a market demand they will swim, otherwise they will sink, and that is how it should be. That means that, in my view, there is no way for us to determine whether self-employment is a first, seventh or even a ‘second-best solution to institutional deficiencies at either the firm or social level” (p1).

2. The fact that a distinction is made in the literature between push and pull factors doesn’t mean that it is so. I have a number of micro-data samples of the self-employed and I am unable to classify any of them as being a ‘push’ or a ‘pull’. If I can’t do so then the concepts are empirically worthless. I agree that it is potentially misleading to assume that all the self-employed are entrepreneurs or vice versa especially in a comparable way across countries. That is why I presented evidence for the self-employed with and without employees. The self-employed who have employees are probably as close as it comes empirically to identifying entrepreneurs. We still know relatively little about the make-up of the elusive entrepreneur.

3. It may be that many self-employed do the wrong thing. Failure rates of small businesses are high and failure may well come at a high cost – loss of unemployment benefits, savings, marriage, home etc.. I do observe that the desire among so many people to become self-employed in so many countries stands in contrast to the actual numbers of self-employed. In my judgment it is a risky choice to become self-employed: even though many individuals say they would like to be self-employed but significant proportions of them choose not to make such a move. Presumably part of the explanation is because of liquidity constraints but also because it is hard to come up with an idea and as my paper shows, the job is very stressful and can interfere with family life. In such circumstances it may well make sense for workers to remain as employees and not become self-employed.

4. “Hinting that people are not the best judges of their own true preferences is rather unusual in mainstream economics”. That may be so, but in the real world people don’t have perfect information and hence may make mistakes. It is well known that a high proportion of small businesses will fail, often with devastating personal consequences. Business owners who fail are apparently aware of the dangers but don’t expect that it will happen to them. In my view this

quote says more about the weakness of mainstream theory than it does about the preferences of the self-employed. Don't confuse me with the facts.

5. "Moreover, labor markets are highly regulated in many western countries, which tends to increase the value of a wage contract". Table 1 of my paper makes clear that there is no evidence to support such a claim: self-employment rates in countries with highly regulated labor markets do not appear to have higher self-employment rates than those with less regulated ones. The self-employment rate in the unregulated US in 2002 was 6.4% which is lower than the more regulated economies of Norway (4.9%) and about the same as that of France (6.7%). Interestingly moves to make labor markets more flexible in Great Britain and New Zealand were accompanied by near doubling of self-employment rates which by 2003 were considerably higher (11.0% and 15.8% respectively) than those of the more regulated labor markets Germany (9.5%), Sweden (8.5%) or France.

6. "Would it be welfare-improving if the self-employed were forbidden to work long hours, just like trade unions forbid overtime exceeding certain limits for workers?" I have never suggested that it would be appropriate – or even possible - to limit the hours of the self-employed. My point is that it should be the government's role to remove such controls and let the market work: the laws of supply and demand work better than any government can. You can't buck the market. Inappropriate regulation is likely to spawn black markets, which one might consider to be another, although illegal, form of largely unmeasured entrepreneurship. Interestingly, there is some evidence that such black market work may actually act as an entry port to self-employment. Fairlie (2000), for example, finds using data for the US from the National Longitudinal Survey of Youth, that drug dealers are 11%-21% more likely to be self-employed in later years than non-drug dealers. Drug dealers who sold more frequently and used less frequently themselves were more likely to choose self-employment than other drug dealers. Fairlie suggests that what is actually going on is that "drug dealers possess unobserved characteristics such as low risk aversion, high levels of entrepreneurial ability, and preferences for autonomy, that are positively associated with future self-employment".

7. Henrekson argues that my questionnaire evidence is context dependent. Of course it is: forces that push or pull individuals to self-employment will vary over time and across space as will the potential benefits and costs. That is why it is so hard for any government to know whether it should increase or decrease the self-employment rate. Self-employment has potential advantages but it has accompanying downside risks that need to be considered. The market knows best.

8. The Davis, Haltiwanger and Schuh's (1996a, 1996b) result on the job creating role of small firms is well established and has not been questioned by "many" (footnote #1). I have been unable to find any body of literature questioning Davis, Haltiwanger and Schuh's finding and the absence of any such literature has been confirmed to me in private communications with Steve Davis. Davidson et al (1998) used data from Sweden during a highly atypical period from 1989-1994, which included the deepest recession (1991-1993) Sweden has experienced since the Great Depression of the 1930s. In fact, Davis et al (1996a, b) show that the earlier literature likely overstated the relative growth performance of small firms due to a regression-to-the-mean bias. Of course, that doesn't mean that smaller employers never in any circumstances or any time

periods account for a disproportionate share of employment growth. Davis et al (1996a, b) showed that the regression-to-the-mean bias is very large in the U.S. manufacturing sector using the Longitudinal Research Database (LRD) for 1972-1988 and their treatment of the issue leads to a very different conclusion about small employers and growth. In subsequent work they have shown (Davis and Haltiwanger, 1999) that growth rates rise with size in the U.S. manufacturing sector when you condition on age and other plant characteristics. The age control has large effects on the estimated relationship as smaller employers tend to be young and younger employers tend to grow faster. The failure to condition on age results in an overstatement of the relative growth of smaller establishments. Similar results for French manufacturing were found by Nocke (1994).

In a recent very careful and interesting study, Andersson (1999) examined job flows in Swedish manufacturing from 1972-1996 using annual plant-level data from Manufacturing Statistics (Industristatistiken or IS) produced by Statistics Sweden. This database shares many similar features to the LRD used by Davis et al (1996a, 1996b, 1999) and is not limited solely to a period of recession. Andersson's findings for Sweden stand in stark contrast to those of Davidson et al (1998).

“(S)maller establishments do not only create jobs in disproportional numbers, but they also destroy jobs in disproportional numbers. The smaller establishments have actually contributed more to the negative employment record, than the larger ones have. Given the focus on small plants in the public discussion, it is also worth noting that, although the smaller establishments are more dynamic, a limited share of the work force is employed by them, why most jobs are actually created (and for that matter destroyed) in the larger establishments. With respect to the age of the establishments, we find that younger plants create more jobs than the older ones do. Pretty soon after birth however, the number of jobs destroyed is getting large, why there is no clear relationship between the net job creation rate and age. (Andersson, 1999, p. 28)

There is little evidence of any strong systematic relationship between employer size and net job growth rates.

I do not claim that more self-employment *is* not better, it may or may not be. In the title of my paper I say that more *may not be* better not that more *is not* better. Many governments around the world believe that it is appropriate to try and make the economy more entrepreneurial - but that does not necessarily imply a higher self-employment rate. A lower self-employment rate could conceivably be better.

Can we imagine a dynamic society consisting (almost) exclusively of wage-earners? It would indeed seem unlikely that a self-employment rate of zero - or even of one - would be optimal. Unfortunately we have no way of knowing what number between these upper and lower bounds governments should be aiming for. Natural selection needs to be left to take its course. Let the market rip.

References

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