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The labor market consequences of experience in self-employment

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Abstract

Many public policies are designed to encourage self-employment. However, because self-employment experiences are typically brief, it becomes important to understand the long-term consequences of entering and then leaving self-employment. Using the Panel Study of Income Dynamics (PSID), we examine the effects of brief self-employment experience on subsequent labor market outcomes. We find that, relative to continued wage employment, brief spells in self-employment do not increase—and probably actually reduce—average hourly earnings upon return to wage employment. We also find that those who experience self-employment have difficulty returning to the wage sector. However, these consequences are small compared to similar experiences in unemployment.
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1. Introduction

Should public policy be designed to explicitly favor small businesses and self-employed workers? Citing the many potential benefits of entrepreneurship, a large number of countries and an increasing number of US states are actively encouraging individuals to become self-employed. For example, US tax policies have traditionally favored sole proprietors relative to wage earners and larger businesses. The US Small Business

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Administration also invests billions of dollars annually to help new firms get started. More recently, self-employment programs have targeted individuals who are receiving unemployment insurance or other public assistance benefits.[1] The hope is that not only would these workers eventually leave the public program rolls as a result, but also that they might create new jobs for other unemployed individuals.

Perhaps as a result of this menu of public policies, a growing number of American workers are leaving the wage-and-salary ranks to start their own businesses. Indeed, nearly 1 in 10 American workers is self-employed and a growing number of women are becoming self-employed each year. At the same time, it is widely known that many spells in self-employment end within the first few years of business. Thus, in evaluating the potential costs and benefits of public support for entrepreneurial activities, it becomes important to understand the labor market consequences associated with entering and then leaving self-employment.

In a sense, self-employment can be viewed as a human-capital-enhancement or job-training program. It has the potential to increase general human capital, thereby enhancing earnings and employment options in the wage sector after exiting self-employment. Alternatively, it might stagnate any job-specific skills that had previously been gained in wage employment or serve as a signal of labor market instability, leading to reduced earnings or employment prospects after exiting.[2] Therefore, uncovering the consequences of spells in self-employment is left to empirical analysis.

With the exception of Evans and Leighton (1989), Ferber and Waldfogel (1998), and Williams (2000), little attention in terms of empirical research has been given to the longer-term consequences faced by those leaving self-employment for a wage job. These studies, which focus on the effects of self-employment experience on earnings outcomes, while instructive have a number of shortcomings which we attempt to overcome.

We improve on previous estimates of the relative wage returns of self-employment experience to wage sector experience by utilizing panel data that are more representative of the population (the Panel Study of Income Dynamics (PSID)) and by controlling for the implied job change associated with a transition into self-employment. In addition to wage outcomes, we also examine the consequences of self-employment experience for other labor market outcomes, including the probability of unemployment and part-time employment.[3]

Our main findings are as follows. Within 5-year windows between 1979 and 1990, a significant proportion of wage workers experienced a short spell (lasting four years or less) of self-employment. These short spells of self-employment tended to be very brief—two-thirds to three-quarters of them lasted 1 year or less. Unlike previous research, we find evidence that short spells of self-employment are associated with lower wages upon return to the wage and salary sector for men. However, when we control for job turnover, these negative wage effects dissipate. For American women, while spells of self-employment are also associated with a reduction in wages, the results are generally not statistically

[1] For an exhaustive review of some recent attempts in the US, see Vroman (1997).

[2] See Williams (in press) or Uhly (2001) for more on the latter possibility.

[3] Unfortunately, the PSID does not contain sufficiently detailed information on important fringe benefits such as health insurance, pensions, and family leave, which would allow us to go beyond an analysis of wage earnings.

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