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Cross-country differences in self-employment rates: the role of institutions

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Abstract

This paper examines the role of institutional variables in determining the large disparities observed in self-employment rates across OECD countries. We develop a simple model analysing the role of taxation and tax evasion opportunities. This model predicts tax evasion opportunities to have an unambiguous positive impact on self-employment, while taxation can either spur or reduce the self-employment rate depending on the country attitude towards tax evasion. We find empirical support for the model predictions using a panel of OECD countries. We also show that the selfemployment rate depends negatively on the share of workers in the public sector, while we do not find any robust relationship with employment protection legislation. We find a positive correlation with product market regulation and a negative one with the unemployment benefit replacement rate, but their relevance is sensitive to model specification.

JEL classification: J23; J24
Keywords: Self-employment; Institutions; Taxation; Tax evasion

1. Introduction

Until recently, most cross-country labour market analyses have focused on paidemployment, while research on self-employment has been mostly conducted at the micro-level.[1] Yet, self-employment rates show great cross-country variation, which is likely to affect

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[1] See Le (1999) for a survey on empirical studies of self-employment.

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labour market performances and certainly deserves to be understood. Recently, also due to a resurgence of self-employment in countries that had previously experienced a steady decline in the self-employment rate (OECD, 2000), several studies have tried to fill this gap. Cross-country analyses include Acs et al. (1994), who focus on differences in factor endowments (capital per worker), industry composition and demographic characteristics and Blanchflower (2000) who studies the role of labour market conditions and worker characteristics. Other cross-country studies (Staber and Bogenhold, 1993; Robson and Wren, 1999; Parker and Robson, 2000; OECD, 2000) and several country specific contributions have investigated the role of institutional variables, such as taxation and labour market regulation.

The empirical literature has shown a rather robust, negative relationship between the per capita GDP level and self-employment rate, so that richest countries typically have a lower incidence of self-employment. This stylised fact, taking per capita GDP as a proxy for capital per worker, can be rationalised theoretically by the model of Lucas (1978), which predicts a decline in returns to entrepreneurship relative to wages, as economies become more capital-intensive. Moreover, certain industries, like private sector services, have been shown to display higher self-employment rates than others, so that changes in industry composition and cross-country differences in industry specialization could explain changes over time in self-employment spread and cross-country differences in self-employment rates (Acs et al., 1994). These factors, however, do not seem to account for the persistence of the observed large cross-country differences.

Following a rather vast literature, we thus study the role of a selected number of institutional variables, with a particular focus on the size of the public sector and taxation. Previous cross-country empirical studies have almost ignored the potential role of the public sector in crowding-out self-employment opportunities. In fact, public sector expansion can both tilt distribution of workers between industries toward public services where self-employment has no role (e.g. general administration), and crowd out private business in sectors like education and health where the State typically gets involved. We provide evidence that these effects have a significant negative impact on self-employment in a panel of OECD countries.

As to taxation, whose impact on self-employment has received most attention, we show with a simple model the theoretical relevance of considering jointly tax rates and tax law enforcement. Previous empirical literature has mostly assumed a positive relationship between the level of taxation and self-employment, on the ground that self-employed workers would have higher opportunities to hide their income from the tax authorities. A tax increase would thus increase the incentive to become self-employed in order to avoid taxation (Blau, 1987; Evans and Leighton, 1989a,b; Parker, 1996; Shuestze, 2000). From a theoretical point of view, however, this negative relationship cannot be taken for granted. If the income of self-employed workers is more sensitive to individual effort than wage income, a tax increase will hurt self-employed workers more than employees (Robson and Wren, 1999).[2] This effect could offset the benefit of greater opportunities of evading

[2] For a review of theoretical models of self-employment with an analysis of the impact of taxation, see De Witt (1993). This survey presents models with heterogeneity in risk aversion or entrepreneurial abilities, where taxation has ambiguous effects depending on the specification of the model.