

Does self-employment reduce unemployment?

A. Roy Thurik^{a,b,c,*}, Martin A. Carree^d, André van Stel^{b,e}, David B. Audretsch^{c,f}

^a *Erasmus University Rotterdam, The Netherlands*

^b *EIM Business and Policy Research, Zoetermeer, The Netherlands*

^c *Max Planck Institute of Economics, Jena, Germany*

^d *University of Maastricht, The Netherlands*

^e *Cranfield School of Management, Cranfield University, UK*

^f *Institute for Development Strategies, Indiana University, USA*

Abstract

This paper investigates the dynamic relationship between self-employment and unemployment rates. On the one hand, high unemployment rates may lead to start-up activity of self-employed individuals (the “refugee” effect). On the other hand, higher rates of self-employment may indicate increased entrepreneurial activity reducing unemployment in subsequent periods (the “entrepreneurial” effect). This paper introduces a new two-equation vector autoregression model capable of reconciling these ambiguities and estimates it for data from 23 OECD countries between 1974 and 2002. The empirical results confirm the existence of two distinct relationships between unemployment and self-employment: the “refugee” and “entrepreneurial” effects. We also find that the “entrepreneurial” effects are considerably stronger than the “refugee” effects.

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1. Executive summary

Entrepreneurship has become increasingly important to developed countries as a source of economic growth and employment creation. As public policy has turned to entrepreneurship to generate employment and economic growth, policy makers have turned to the scholarly literature for guidance about the appropriate approach and context. However, while seeking guidance about the appropriate role for entrepreneurship policy, policy makers have been befuddled with ambiguous results at best.

The relationship between entrepreneurship and unemployment has posed a complex puzzle to scholars. One view, which has been called the unemployment push, or refugee effect, suggests that the decision to become an entrepreneur is a

* Corresponding author. Centre for Advanced Small Business Economics, Erasmus School of Economics, Erasmus University Rotterdam, PO Box 1738, 3000 DR Rotterdam, The Netherlands. Tel.: +31 10 4082232.

E-mail address: thurik@few.eur.nl (A.R. Thurik).

response to either being unemployed or else the perception of dismal future employment prospects. An alternative view suggests that entrepreneurship, by virtue of creating a new venture, contributes to the reduction of unemployment. While the first view suggests a positive relationship between entrepreneurship and unemployment, the second view suggests a negative relation. Further, in each view, the causal link between entrepreneurship and employment are reversed. While the first view has high unemployment rates inducing more people to choose to become entrepreneurs, the second view suggests that the decision people make in becoming entrepreneurs will reduce unemployment at the macro-economic level.

Which of these two polar views concerning the relationship between entrepreneurship and unemployment is correct? There is both considerable theoretical and empirical support for both views and scholars have had trouble unraveling the relationship between entrepreneurship and unemployment. Unraveling it matters because understanding the true relationship can guide policy makers as they decide if, and how, to promote entrepreneurship as they strive to reduce unemployment. Using an econometric approach to disentangle the relationships, this paper attempts to reconcile the ambiguities.

A simple two-equation vector autoregression model is used to estimate both changes in unemployment and self-employment, a common measure of entrepreneurship, for a panel of 23 OECD countries over the period 1974–2002. Using lagged data to explain the current situation, we have modeled the dynamic interrelationship between self-employment and unemployment and found that the relationship between the two variables is both negative and positive. Changes in unemployment clearly have a positive impact on subsequent changes in self-employment rates. At the same time, changes in self-employment rates have a negative impact on subsequent unemployment rates. The latter effect is stronger than the former one.

The results of this study have important implications for public policy. In particular, they unequivocally suggest that public policy to generate jobs and reduce unemployment is well served by focusing on entrepreneurship but that it takes considerable time (eight years or more) for the results to become visible.

2. Introduction

Linking unemployment to self-employment dates to at least Oxenfeldt (1943), who argues that individuals confronted with unemployment and low prospects for wage-employment will turn to self-employment as a viable alternative. This is an extension of Knight's (1921) view that individuals decide between three states — unemployment, self-employment and employment. Although the actual decision is shaped by the relative prices of these three activities, implied is the prediction of a positive correlation between self-employment and unemployment. This simple theory of income choice has been the basis for a range of studies focusing on the decision of individuals to become self-employed (Parker, 2004; Grilo and Thurik, 2005; Grilo and Irigoyen, 2006). Specifically, this theory suggests that increasing unemployment leads to increasing start-up activity because the opportunity cost of starting a firm has decreased (Blau, 1987; Evans and Jovanovic, 1989; Evans and Leighton, 1990; Blanchflower and Meyer, 1994). This effect has been referred to as the *unemployment push, refugee or desperation* effect. There is, however, an important counterargument to this theory: The unemployed tend to possess lower endowments of the human capital and entrepreneurial talent needed to start and sustain a new firm. This, in turn, would suggest that high unemployment may be associated with a low degree of self-employment. High unemployment rates may also imply lower levels of personal wealth which also reduce the likelihood of becoming self-employed (Johansson, 2000; Hurst and Lusardi, 2004). Lastly, high unemployment rates may correlate with stagnant economic growth leading to fewer entrepreneurial opportunities (Audretsch, 1995; Audretsch et al., 2002b).

The counterarguments above suggest that entrepreneurial opportunities are not just the result of the push effect (the threat) of unemployment but also of the pull effect produced by a thriving economy as well as by past entrepreneurial activities. Indeed, while some scholars argue that unemployment influences start-up activity, others claim that the reverse holds true. Firm start-ups hire employees, resulting in subsequent decreases in unemployment (Lin et al., 1998; Pfeiffer and Reize, 2000). Furthermore, increased entrepreneurial activity may influence country-wide economic performance (van Stel et al., 2005). For example, entrepreneurs enter markets with new products or production processes (Acs and Audretsch, 2003). They also increase productivity by increasing competition (Geroski, 1989; Nickell, 1996; Nickell et al., 1997). They also improve our knowledge of what is technically viable; what consumers prefer; and of how to acquire the necessary resources by introducing variations of existing products and services in the market. The resulting learning process speeds up finding the dominant design of product–market combinations. This learning does not just come from experimenting entrepreneurs: Knowledge spillovers play also an important role

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