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New evidence on the relationship between risk attitudes and self-employment

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HIGHLIGHTS

- Analyse causality of the relationship between risk attitude and self-employment
- Study this relationship when transmitted s.e. experience is confined by law

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ABSTRACT

This paper analyses the impact of risk attitudes on the decision to become self-employed among individuals who grew up under the communist regime in Ukraine, which banned self-employment so that individuals could not observe what it is like to be self-employed. Since the intra-family transmission of self-employment experiences was largely shut down, the observed correlation between risk preferences and self-employment after transition is unlikely to be driven by parents transmitting self-employment experience and risk preferences to their children. Robustness checks on a sample of East Germans confirm that such a third factor explanation is implausible, thus shedding light on the causal nature of the relation between risk preferences and the decision to become self-employed.

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1. Introduction

Self-employment is an important driver of economic activity. Not surprisingly, the determinants of self-employment have been on the economic research agenda for a long time, and several factors have been identified.¹ Already in 1755, Cantillon recognised that entrepreneurial activities are risky. He argues that the employed face a more

variable stream of earnings because of uncertain product demand, which results in revenue fluctuations and can lead to business failure.²

Given the risky nature of self-employment, heterogeneity in risk preferences across individuals should affect the choice of employment status (see also Kihlstrom and Laffont, 1979).³ A host of empirical studies have established a robust positive correlation between individual willingness to take risks and the probability of being self-employed (e.g. Cramer et al., 2002; Ekelund et al., 2005; Fossen, 2011). Skeptics might raise the concern that self-employment experience makes individuals more willing to take risks. In order to preclude that such exposure effects drive the relation between risk preference and self-

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¹ A non-exhaustive list of micro-level self-employment determinants includes financial aspects, i.e. liquidity constraints, access to credit markets, wealth (Evans and Jovanovic, 1989; Lindh and Ohlsson, 1996; Hundley, 2006); human capital, i.e. formal education, skills, labour market experience (Rees and Shah, 1986; Evans and Leighton, 1989; Lazear, 2004, 2005); entrepreneurial ability (Hartog and van Praag, 2010); social capital and networks (Gomez and Santor, 2001); risk attitude (van Praag and Cramer, 2001; Ekelund et al., 2005) and personality traits (Evans and Leighton, 1989; Schiller and Crewson, 1997; Burke et al., 2002).

² Empirical studies on earnings distributions consistently show that self-employed earnings are more variable than wages. See, for example, Falter (2007b), Rosen and Willen (2002); Parker (1999) and references therein.

³ The role of the entrepreneur as a risk-bearer has been discussed already in early theoretical work, e.g. (Knight, 1921; Schumpeter, 1934, 1939).

employment status, [Caliendo et al. \(2009\)](#) show that risk attitudes measured in the 2004 wave of the German Socio-Economic Panel Study (SOEP) predict the respondents' transition into self-employment in 2005. Similarly, [Brown et al. \(2011\)](#) document that risk attitudes measured in the 1996 wave of the Panel Study of Income Dynamics (PSID) predict the respondents' decision to become self-employed up to 9 years later, suggesting a causal effect of risk attitude on the probability of entering self-employment. But the authors caution the reader that an unobserved third factor that influences both the decision to become self-employed and risk attitude might drive their result.

A plausible third factor is the influence of parents who shape their children's risk attitudes through intergenerational preference transmission ([Dohmen et al., 2012](#)) and potentially affect children's decision to become self-employed indirectly or directly. The most obvious direct channel is the transfer of businesses from parents to children.⁴ But there are also indirect channels such as the transmission of information and beliefs about self-employment through which children of self-employed parents might grow more likely to become self-employed themselves ([Hout and Rosen, 2000](#); [Falter, 2007a](#); [Andersson and Hammarstedt, 2010](#)). For example, growing up with self-employed parents can provide children with invaluable information on what it is like to be self-employed.

In this paper, we analyse a setting in which the scope for this kind of third factor explanation is limited or even non-existent. We provide new evidence that supports a causal interpretation of the correlation between risk attitudes and the probability of becoming self-employed. We exploit the fact that self-employment was banned for at least 45 years in Ukraine, so that the cohorts, whose self-employment decision after transition we study, grew up without exposure to self-employment. A very substantial fraction of these individuals has parents who never had the right to become self-employed during their active labour market career.⁵

We describe our research strategy in the next section and describe the data that we use in [Section 3](#). In [Section 4](#), we report the findings from our empirical analysis, and end with a conclusion.

2. Empirical strategy

We start by illustrating the relation between family background, risk attitudes and self-employment in [Fig. 1](#).

Family background can potentially impact the decision to become self-employed via direct and indirect channels. The most obvious direct channel is the transfer of a family business to children. Indirect channels might include the provision of financial means or access to networks, but also the transmission of information about what it is like to be self-employed. Children who observe their self-employed parents might become more willing to become self-employed themselves. If these indirect and direct channels are at work, we should observe a positive relation between parents' and children's probability of being self-employed. Such a relation is confirmed empirically.⁶

The literature has also shown that risk attitudes are transmitted from one generation to the next ([Dohmen et al., 2012](#)). Suppose that the self-employed were on average more willing to take risks than the non-self-employed. Even if there was no causal effect of risk attitudes on the decision to become self-employed, we would observe a positive correlation between the risk attitudes of labour market entrants and their later self-employment decision when the simultaneous impact of parents on self-

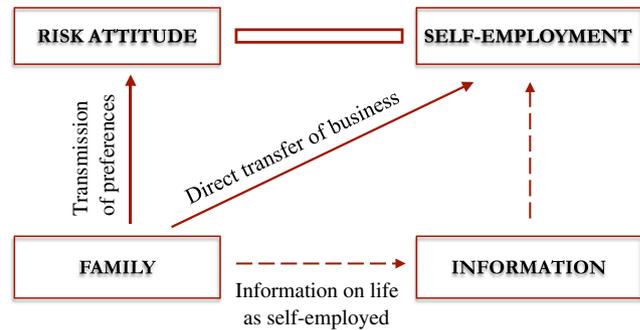


Fig. 1. Schematic relationship between risk attitude, self-employment, and family.

employment propensity and risk attitudes is neglected. This is because children of the self-employed would be more likely to become self-employed and are at the same time more willing to take risks, due to their family background. In fact, we observe that children of self-employed fathers are on average significantly more willing to take risks (0.32 points on the 11-point risk scale, two tailed *t*-test, *p*-value < 0.001) than children whose fathers opted for regular employment, in a sample of 15-year old respondents to the SOEP whose parents' self-employment decision was not constrained by law. In light of this evidence, the relation between risk attitudes and self-employment might not necessarily be causal even if it is identified by using a measure of risk attitudes prior to actually becoming self-employed, because both these measured risk attitudes and the propensity to become self-employed were influenced by parents.⁷ It is therefore still an open question, whether an arrow should point from risk attitudes to self-employment or not.

Our strategy is to shed light on the nature of the relation between risk attitudes and self-employment by shutting down the channel of transmission of information about what it is like to be self-employed and precluding that parents can transfer their business to their children. To this end we focus on a sample of Ukrainians whose parents could not become self-employed due to legal restrictions. In Soviet Ukraine, an extremely restrictive institutional regulation with respect to free trade and entrepreneurial activities was in force from the late 1920's onwards in the East and from the end of World War II in the West until the end of the 1980's. Any private for-profit activity was illegal until 1985, when the 'Perestroika' initiatives heralded a period of reforms. The number of self-employed individuals started growing in the 1990's, after the official separation of Ukrainian SSR (Soviet Socialist Republic) from the collapsing Soviet empire in 1991. Before that, commercial activities conducted not by the state and not for the state were considered a criminal offence (for example, [Gelfand, 1964](#); [Trofimov, 1975](#); [Andruhin, 2011](#)).

We show that the correlation between risk attitudes and self-employment for Ukrainians observed in 2007 is strong and significant. As this correlation cannot be driven by the simultaneous parental transmission of risk attitudes and information about what it is like to be self-employed, we can rule out this third factor explanation that might undermine a causal interpretation of the studies by [Caliendo et al. \(2009\)](#) and [Brown et al. \(2011\)](#), who show that currently measured risk attitudes predict future self-employment decisions.

3. Data and variables

For our main empirical analysis, we use data from the Ukrainian Longitudinal Monitoring Survey (ULMS). For a robustness check, we exploit

⁴ [Fairlie and Robb \(2007\)](#) report that 8.2% of current business owners inherited their business or received it as a gift. Based on the exact match between occupation–sector combination of fathers and sons, [Dunn and Holtz-Eakin \(2000\)](#) report that 36% of second generation self-employed sons are occupational followers as compared to 8% of those who never become self-employed. [Praag and Ophem \(1995\)](#) analyse the determinants and modes of becoming an entrepreneur in The Netherlands and report that 9.5% of entrepreneurs in their sample entered into self-employment by taking over a family firm.

⁵ This is clearly true for individuals whose parents were born after 1930 in West Ukraine and after 1915 in the Eastern part of Ukraine, i.e. whose parents were 15 years of age when self-employment was banned.

⁶ See, e.g., [Praag and Ophem \(1995\)](#).

⁷ Using risk attitudes of the father as an instrument, we find a significant positive effect of own (instrumented) risk attitudes on the probability of being self-employed in the West German sample of the SOEP. This estimation suggests a causal interpretation of the role of willingness to take risk for the probability of becoming self-employed since it is unlikely that risk attitude of fathers were influenced by self-employment experience of their children. However, the instrument is likely to be invalid because of the third factor such as father's self-employment experience.

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