High Unemployment As An Incentive For Self-employment

From an economic point of view one could argue that in order to overcome unemployment people would choose self-employment. Constant and Zimmermann (2014) call this scenario forced self-employment. Meaning that there is no other source of work available other than self-employment. On the other hand, there is a high risk to take when being self-employed. One reason is that forced self-employment often happens during economic downturn and since success and longevity during economic downturn is even harder to achieve than during economic recovery the risk of failure is quite high. (Constant and Zimmermann, 2014, pp. 62–63)

Therefore, there is no clear answer to this question from an economic point of view. It all depends on a number of conditions. Besides the economic situations and risk assessments those are factors like the role of the government, the mentality of people and also their culture. (Santarelli and Vivarelli, 2007; Constant and Zimmermann, 2014)

Regarding this complexity of the topic, it is important that a number of economic factors are taken into account in order to get to an answer. And it is also clear that this is not a simple Yes or No Question. As has been the case so often in economics, it all depends on different factors. Therefore the topic is well suited for a paper in economics.

Objectives

Knowing that the topic is suitable, the objective of this paper is to understand the relation between unemployment and self-employment. More precisely the goal is to discover whether high unemployment leads to an increase in self-employment. Therefore, the incentives of self-employment will be investigated and put into context with unemployment.

Methodology

In order to get to an answer, the research plan for this paper is to gather a number of theories from different scientific researchers concerning whether or not high unemployment is an incentive for self-employment. In a next step, those theories will be put into connection in order to see how the different arguments connect with each other.

Furthermore, those arguments will be examined to figure out which economic factors the scientist state for incentives regarding self-employment. And finally the conclusion of the arguments will show whether or not high unemployment is the main incentive for self-employment.

Refugee effect / Entrepreneurial effect

In order to start this main chapter, the terms unemployment and self-employment need to be specified. The online platform “Trading Economics” serves this paper to illustrate some examples of unemployment rates in different countries. This platform specifies the term

unemployment as “individuals who are without a job and actively seeking to find work”. (Trading Economics) However, it needs to be kept in mind that this is a very general statement and therefore the data is not very specific either. Long and short-term unemployment is not taken into account for example. Nevertheless, the data used from this platform will work as an example, therefore the generalization of unemployment can be justified.

The data for self-employment for the hereinafter used example was taken from the World Bank institution. There it is stated that “self-employed workers are those workers who are working on their own account or with one or a few partners or in cooperative and hold the type of jobs defined as a self-employment jobs”. (World Bank)

Another more general definition for self-employed people is that they are classified formally as “individuals who earn no regular wage or salary but who derive their income by exercising their profession or business on their own account and at their own risk”. (Parker, 2009, p. 11)

Thurik et al. (2008) talk about two effects which explain the relation between unemployment and self-employment. The first effect is the “refugee effect”. It assumes that a high unemployment rate leads to more start-up companies which therefore results in an increase in self-employment and a decrease in unemployment. Most likely the high unemployment derives from an economic downturn or even a regression. Therefore, people have difficulties getting hired for a paid-job and decide to start their own business.

The second effect is the “entrepreneurial effect”. It suggests that because of low unemployment and therefore economic upturn people are willing to take the risk of self-employment. Here the decision against a paid-job is made deliberately. The incentive for starting a business is made because the risk of failure is lower during economic upturn than during economic downturn.

Both effects can be found in different countries but a study in 23 OECD countries between 1974 and 2002 clearly states that the entrepreneurial effect is happening more often than the refugee effect. (Thurik et al., 2008) Therefore, high unemployment is not an incentive for self-employment. In fact, according to this study it is the other way around. Low unemployment is an incentive for self-employment.

It is worth stating at this point the two effects show that self-employment is either a strategy to escape unemployment. Meaning for those who cannot earn an income in any other way. Or self-employment is used for its entrepreneurial spirit. Meaning people like the advantages of self-employment like not having to report to a supervisor . (OECD Employment Outlook 2018, 2018) Connecting this to Thurik et al. (2008), it states that the survival strategy is not happing as often as the desire for entrepreneurial spirit.

By now it is certainly clear that the initial situation for both scenarios meaning the economic situation is quite different. However, one could argue that those two explanations for self-employment also depend on the preparedness to take risks. If people are more willing to take risks than they would more likely tend to the refugee effect, meaning the survival strategy. And if they are risk averse, they would tend to the entrepreneurial effect where the decision or self-employment is made deliberately. Which should not indicate that starting a business is risk-free. On the contrary, it involves a lot of risk. However, starting the business during economic upturn is less risky than during economic downturn.

Further factors play a big role in the decision making of being self-employed. To name a few there is government support acting like a safety net in difficult situations, cultural habits of people or even the relation between risk and outcome. Fritsch et al. (2015) calls this the “easing of the entrance of new businesses”.

IFritsch et al. (2015) argues that three major changes of the socio-economic environment until 2005 caused this high level of self-employment. First of all, there was a shift towards the service economy. Second of all, a high number of people had a tertiary degree and lastly there was outstanding number of people who were aging towards an age where people are most likely to start entrepreneurial activities. Also in 2005 there was a significant change of start-up subsidies which could have caused the drop in self-employment. (Caliendo et al., 2009)

Another incentive which correlates with an economic recession is that despite a number of disadvantages, like low income, people chose self-employment because the option values are better than in unemployment. Therefore, self-employment is often the better option. (Millán, 2012) This does speak for the assumption that a high unemployment rate is an incentive for self-employment. Millán (2012) argues as well that more unemployed people tend to self-employment than hired workers. That shows as well that unemployment is some kind of incentive.

The arguments stated above indicate that the incentives for self-employment depend on various factors. First of all, they depend on the initial economic situation, meaning does a country find itself in an economic upturn or downturn. Germany is a good example to show that economic upturn does not always lead to self-employment. Whereas the example of Italy shows that an increase in unemployment leads to less self-employment. Furthermore, the self-employment rate also depends on the socio-economic environment or start-up subsidies. Therefore, the reason for increasing self-employment during an economic downturn cannot always be determined clearly.

However, forced self-employment does happen regularly and therefore one could argue that high unemployment is in fact an incentive for self-employment. How decisive the proportion of self-employment is compared to the other factors could not be specified in this paper. A broader research frame would have been necessary to do so.

Conclusion

To conclude, this paper shows that a low unemployment rate as well as a high unemployment rate can be seen as incentives for self-employment. Therefore, unemployment is rarely the only main driver of new firm formation. However, it is often part of the decision. Especially during economic downturns. (Santarelli and Vivarelli, 2007, p. 461)

Also, knowing that high and low rates of unemployment can be incentives for self-employment the question is what are the main incentives for self-employment? Like the results further above show, economic reasons often play a big role in the decision of becoming self-employed. However, those economic reasons vary throughout time and also in different countries.

What remains interesting as well, is the question why in different countries the opposite effects are incentives for self-employment. Meaning why is low unemployment in one country an

incentive for self-employment and in another country a high unemployment rate seems to be the incentive. Of course, the effects can be linked to other reasons. However, many examples show that the both rates do correlate throughout many years.

To sum up, this states that the unemployment rate and the self-employment rate do influence each other. And although other reasons might have an impact as well and as we learnt that the rates do influence each other in different, not to say opposite, ways, the influence is in many cases constant.

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