

Is there a ‘Penalty’ to Business Ownership? Comparing the Labour Market Status of Paid Employees and Former Business Owners

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Short Abstract: It is expected that those individuals with higher levels of general or specific human capital will be more likely to repeat as entrepreneurs, since they are better equipped to discover and take advantage from new business opportunities. Another possible explanation, however, is that an experience in business ownership may have an adverse effect on the individuals’ earnings when returning to paid employment. If experience as a paid employee is more valuable for an employer than experience as a business owner, than individuals who have just terminated a spell as business owners are at a disadvantage in the labour market and thus may find it more difficult to find a job with an income deemed suitable to their abilities, and are therefore more easily compelled to return to business ownership. The present paper examines whether former business owners who seek paid employment pay a labour market ‘penalty’. In particular, we look at the determinants of income and labour market status for individuals who exit their first entrepreneurial experience and become paid employees, vis-à-vis the determinants of the same variables for individuals who remained in paid employment during the same period. Results suggest that experience acquired as a business owner has little impact in determining labour market status when entering paid employment. In fact, the higher the education level (i.e. general human capital), the greater is the ‘penalty’ paid in terms of wage differential when compared with individuals who remained as paid employees. Hence, individuals may in fact be ‘pushed’ towards serial entrepreneurship due to the lack of rewarding opportunities in paid employment.

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Background and contribution

A considerable amount of theoretical and empirical work on entrepreneurship and self-employment focuses on individual choices between paid employment and business ownership (Parker, 2004). Important theoretical works emphasise the role played by pecuniary rewards, and general and specific human capital in determining such choices (Lucas, 1978; Lazear, 2005). However, empirical evidence with regard to the role played by earnings differentials in the choice between paid employment and self-employment is mixed.

Some studies show that relative earnings do not play a significant role in explaining cross-section labour market status (self-employment vs. paid employment), thus suggesting that pecuniary rewards may not be the primary motive for choosing self-employment. Taylor (1999) suggests that individuals are attracted to self-employment by the freedom from managerial constraints that it offers. Hamilton (2000) argues that non-pecuniary benefits of self-employment are substantial, because entrepreneurs persist in business even when they have both lower initial earnings and lower earnings growth than what they could obtain in paid employment.

If entrepreneurs have higher levels of human capital than paid employees (as suggested by Lucas, 1978; and Carrasco, 1999) than these higher levels of human capital should result in higher wages, thereby facilitating entry into wage employment, and thus reducing the likelihood of entrepreneurship. Lazear (2005) suggests that entrepreneur-specific human capital results from balanced skills, while paid employee-specific human capital results from specialisation, thus providing an different rationale for the low significance of earnings differentials in explaining self-employment choices,

Entrepreneurship research has been shifting attention towards entrepreneurial exit and entrepreneurial careers after business closure (Wennberg and Wiklund, 2006). In particular, the phenomenon of habitual and, in particular, serial entrepreneurship, whereby an individual exits a first business ownership experience and subsequently starts a new one, has been addressed by several works (see, for instance: Westhead and Wright, 1998; Ucbasaran et al., 2003). Habitual entrepreneurs are expected to have better managerial and technical skills, better networks of contacts, access to market-specific information and knowledge, and thus should be better equipped to discover and take advantage from new business opportunities (McGrath and MacMillan, 2000). It is therefore expected that those individuals with higher levels of general or specific human capital will be more likely to repeat as entrepreneurs.

However, recent work by Amaral and Baptista (2006) has unearthed evidence which might suggest a different reality. In separating ‘direct’ serial entrepreneurs (i.e. individuals that enter a second business ownership experience immediately after exiting the first one) from ‘latent’ or ‘nascent’ serial entrepreneurs (i.e. individuals who eventually re-enter business ownership after spending some time in paid employment following exit from their first entrepreneurial experience), the authors found that ‘latent’ or ‘nascent’ serial entrepreneurs are more likely to be better educated than ‘direct’ serial entrepreneurs.

One reason for this result may simply be that more educated individuals benefit more from entrepreneurial experience than less educated ones, thus being more likely to find opportunities and to pursue them, even after spending some time in paid employment. Another possible explanation, however, is that an experience in business ownership (particularly if it was a failed experience) may have an adverse effect on the individuals’ earnings when returning to paid employment. If experience as a paid employee is more valuable for an employer than experience as a business owner, than individuals who have just terminated a spell as business owners are at a disadvantage when competing for a paid employment position with similarly educated professionals who remained as paid employees during the same period of time. The present result seems to indicate that this may be particularly true for more educated individuals, who have higher earnings’ expectations and may find it more difficult to find a job with an income deemed suitable to their abilities, and who are therefore more easily compelled to return to business ownership.

The main objective of the present paper is therefore to examine whether former business owners who seek paid employment pay a labour market ‘penalty’, i.e., whether individuals who pursue an entrepreneurial experience and exit their first business, choosing to become paid employees, receive lower wages than individuals of similar age and education levels who chose to remain as paid employees during the same period. In particular, we look at the determinants of income and labour market status for individuals who exit their first entrepreneurial experience and become paid employees, vis-à-vis the determinants of the same variables for individuals who remained in paid employment during the same period.

Methodology

The study follows individuals who exit their first business ownership experience and choose to become paid employees. We contrast those transitions with a control group of non-entrepreneurs, i.e. individuals of comparable age who entered the labour market at a similar point in time and who remain as paid employees since they enter the labour market. The objective is to ascertain whether past experience as a business owner has a specific value in the labour market or, on the contrary, if it is associated with a stigma of failure which leads to a negative wage premium.

The study uses the “*Quadros de Pessoal*” (QP) Micro Data, a longitudinal matched employer-employee data set including extensive information on the mobility of workers and business-owners for the period 1984-2003. QP include yearly data from all private establishments with at least one wage-earner in the Portuguese economy. There are over two million workers in each annual survey that can be tracked over time through a unique identification number associated with the Portuguese social security system. Data relative to business owners and employees for each firm and establishment include income, gender, occupation, tenure, schooling and hierarchical levels. For both business-owners and employees, records of paid employment and entrepreneurial experience can be collected, as well as information concerning their labour market experiences following business ownership. The longitudinal and often all-inclusive nature of large surveys can be used to answer research questions where interrelated heterogeneous factors concerning firms and individuals require large, unbiased samples with the possibility to simultaneously investigate a variety of factors (Wennberg, 2005).

The focus group of the study, includes those individuals who, having entered the labour market sometime between 1985 and 1988, become business owners at some point in time, exiting entrepreneurship and moving to paid employment in the period between 1995 and 1998. For these individuals, data are collected on their professional experience (entrepreneurial or otherwise) before exiting business ownership, and on their new position as paid employees. In order to assess the differences in labour market status between former business owners and those who remained in paid employment, the ideal situation would be to have the same individual in both statuses at the same time – i.e. as paid employee and as business owner – which is impossible by definition. It is therefore necessary to select a proper control group with whom the group under study can be compared. The best candidate is the group of individuals with similar attributes which enter the labour market in the same 1985-1988 period as paid employees and remain so ever after. With the proper selection of both groups, with regard to age, gender and education levels, heterogeneity and issues associated with initial conditions are mitigated.

The study then compares the two career paths: individuals who remained as paid employees – eventually moving between employers – with individuals who became business owners at a certain point after their entry in the labour market and remained so until the 1995-98 period, at which point they exited entrepreneurship, becoming paid employees. The comparison is made using wages after the transition to paid employment as the variable of interest, given that the objective is to determine whether the skills necessary to start a business, together with the skills acquired while being an entrepreneur have a significant impact on the individuals’ labour market performance as a paid employee.

Individual wage equations are defined for the years after the transition, i.e. from 1995-1998 until 2003. Past experience as business owners (and as paid employees, in case the individual entered the labour market as such, before entering business ownership), is included among the covariates. Since the data allow us to distinguish between types of exit – firm dissolution or sale – which may serve as an indicator of success in business ownership, this variables can also be also accounted for when explaining wage performance as a paid employee. We also control for hierarchical level, education, gender, age, past promotions, and firm characteristics not only in the present job but also for the period prior to the transition. The same exercise is conducted for the control group. If past experience as a business owner as a significant value in the labour market, then the associated coefficient should be higher than the coefficient associated with past experience as paid employee (for the control group).

The longitudinal nature of the data set allows us to control for individual heterogeneity not captured by the explanatory variable. When defining a fixed effect specific to each individual, the possible causes of selection between the two groups are partially accounted for. However, we also consider an alternative approach by using instrumental variables for the initial business owner status. Overall, we compare the wage path of the two groups – former business owners with individuals who are always paid employees – in order to gauge the market value of the skills – innate or acquired – of the first group.

Results

Results suggest that experience acquired as a business owner has little impact in determining labour market status when entering paid employment. In fact, the higher the education level (i.e. general human capital), the greater is the ‘penalty’ paid in terms of wage differential when compared with individuals who remained as paid employees. Mode of exit from the first business ownership experience does not seem to play a significant role in determining wage performance as a paid employee after entrepreneurial exit. Results therefore suggest that, in the Portuguese case, the pursuit of an entrepreneurial career puts an individual at a disadvantage when seeking paid employment following entrepreneurial exit. Hence, individuals may in fact be ‘pushed’ towards serial entrepreneurship due to the lack of rewarding opportunities in paid employment.

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