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THE EARNINGS IMPACT OF BECOMING AN ENTREPRENEUR (SUMMARY)

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SUMMARY

THE EARNINGS IMPACT OF BECOMING AN ENTREPRENEUR

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Principal Topic

It is expected that individuals are attracted to business ownership because of higher expected earnings relative to paid employment; earnings in paid employment can thus be viewed as an opportunity cost of entrepreneurship. In fact, several studies have found that individuals with relatively low wages are the ones more likely to become self-employed. However there may be a mismatch between latent entrepreneurs' expected utility from business ownership and their effective earnings once they become business owners. Some explanations for this mismatch are provided by the literature, including unrealistic optimism in anticipating earnings growth (Lowe and Ziedonis, 2006); non-pecuniary benefits of self-employment (Hurst and Lusardi, 2004); and matching skills/human capital (Lazear, 2005). Our aim is to examine the impact on individuals' incomes of switching from paid employment to business ownership.

Methodology

We examine whether individuals who became business owners earn less than comparable individuals who did not. The study makes use of a Portuguese longitudinal matched employer-employee data set including extensive information on the mobility of workers and business owners for the period 1995-2003. There are over two million individuals in each annual survey who can be traced through time using a unique identification number. We concentrate on earnings differentials between individuals who become business owners, employees who change firms, and employees who continue in the same firm. We account for multiple determinants of wage earnings, such as individual attributes (age, education, and labor market experience); employer characteristics (firm size, economic sector, and administrative region); and individuals' careers.

Results

Results show that there is a short term earnings penalty for those who enter self-employment. We also find that this penalty is relatively larger for smaller start-ups. The earnings penalty fades away for individuals who switch from paid employment to business ownership directly while being especially significant for those who become business owners after a stretch in unemployment. This suggests that necessity-based entrepreneurs are more likely to face/accept earnings losses (when compared with their last paid employment) than opportunity-based ones.

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