Self-Employment an Option for Workers Who Lose Jobs in Economic Slowdowns

By Anil Kumar and Michael Weiss

Because of the significance of self-employment, understanding its relationship to the business cycle is especially useful during periods of financial stress.

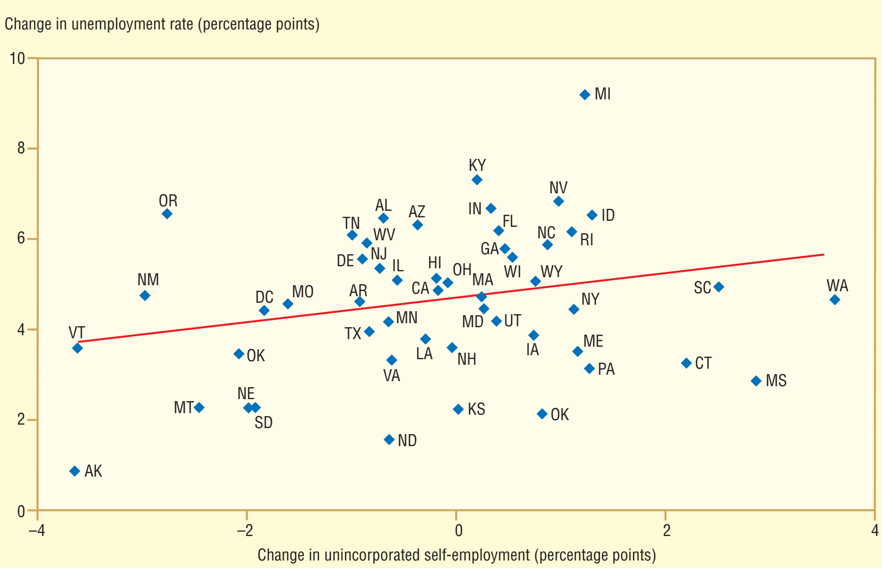
The American worker has been buffeted in recent years, first during the Great Recession and again during the weak recovery that followed. The Federal Reserve has contemplated further monetary measures to support hiring as the jobless rate settles in the low-to-mid 8 percent range nationally, down from a seasonally adjusted 10.1 percent peak in September 2009.

Displaced individuals who are unable to find a new employer may opt to seek unemployment benefits or leave the labor force. But often they choose a different path: self-employment. The self-employed can form an incorporated entity—doctors, lawyers and other professionals often do so for legal and tax considerations, in essence working for the business they created.

Alternatively, they can start unincorporated businesses, working for themselves in such disparate professions as laborer, business analyst, writer and performer.[1]

The transition from employee to self-employment provides an informative economic indicator. Changes in a state's unincorporated self-employment rate during the U.S. recession, for example, appear positively correlated with the severity of the downturn as reflected in state unemployment-rate changes—a relationship captured in the upward-sloping line in Chart 1.[2]

Chart 1
Self-Employment Correlates Positively with Severity of Great Recession



NOTE: The National Bureau of Economic Research dates the most recent recession as December 2007 to June 2009.
SOURCES: Bureau of Labor Statistics; Haver Analytics; authors' calculations.

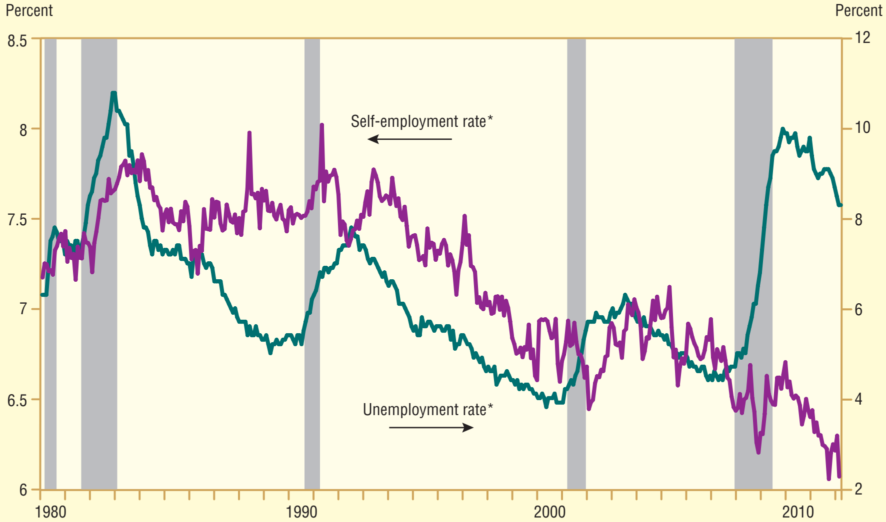
Recessions and Self-Employment

About one in 10 U.S. workers was self-employed during 2011. Within the group, 60 percent were in unincorporated endeavors. It is widely believed that small and relatively new firms, many of which are established by the self-employed, account for the bulk of new jobs created in the economy.[3] Because of the significance of self-employment, understanding its relationship to the business cycle is especially useful during periods of financial stress, when even the largest businesses turn cautious in hiring and retention.

Although recent research shows a positive relationship between local unemployment rates and the transition into self-employment, the overall impact of recessions on unincorporated self-employment is far from clear.[4] Self-employment can rise or fall.

Theoretically, workers choose to invest part of their personal wealth and become self-employed if potential returns from their own business exceed the sum of likely earnings from a job and investing their assets elsewhere. Potential new entrants to self-employment often find it difficult to raise required capital during tough times, when personal wealth is frequently diminished as asset prices fall. Those seeking to borrow may encounter

Chart 2
Self-Employment–Unemployment Relationship Weakens in Last Two Slumps



* Seasonally adjusted.
NOTE: Shaded areas indicate recessions.
SOURCES: Bureau of Labor Statistics; Haver Analytics.

banks that do not want to lend. Individuals already self-employed struggle with the same conditions afflicting the broader economy, including difficulty achieving profitability because of declining aggregate demand.

Even so, a sizable number of individuals confronting joblessness may turn to self-employment when facing the prospects of a difficult job search, reduced job hours or lower potential earnings. During a downturn, the cost of starting a business typically declines due to lower labor costs (including forgone wages) and other expenses.

The unincorporated self-employment rate rose in three of the previous five downturns (*Chart 2*). While self-employment was strongly countercyclical—increasing in 1980, 1982 and 1991—it declined in 2001. During the Great Recession, self-employment fluctuated, with an initial increase, followed by a sharp drop amid unprecedented turmoil in the financial markets. Self-employment strongly rebounded when the Federal Reserve's monetary stimulus measures to ease financial stress took hold (*Chart 3*). As the economy recovered, the self-employment rate returned to near prerecession levels.

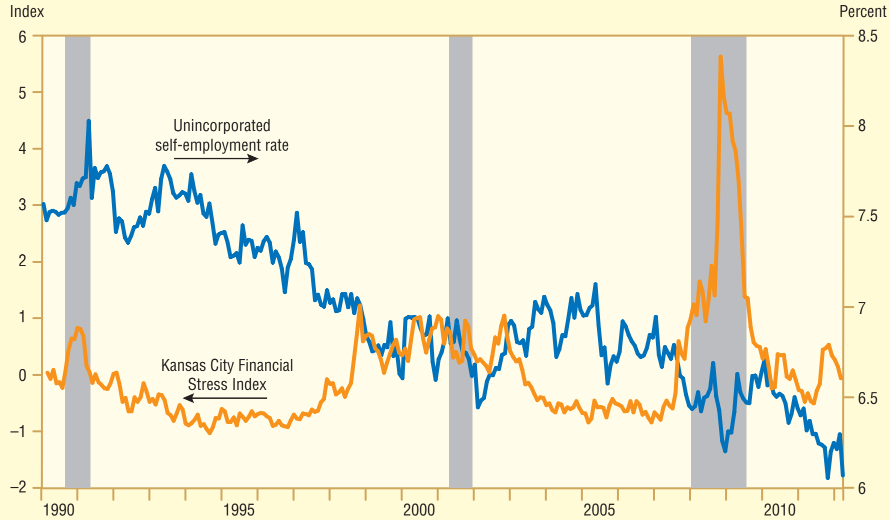
Demand for self-employed workers may be countercyclical—another reason self-employment may vary across the business cycle. For example, in times of uncertainty, established businesses ambivalent about long-term economic prospects may be hesitant to hire permanent workers. They may, instead, make a hedged bet on an upturn by temporarily hiring the self-employed.[5]

Gauging Labor Market Impact

An increase in self-employment has clear economic benefits, damping unemployment and aiding job growth through entrepreneurial activity. The implications for labor market slack are somewhat less

In times of uncertainty, established businesses ambivalent about long-term economic prospects may be hesitant to hire permanent workers. They may, instead, make a hedged bet on an upturn by temporarily hiring the self-employed.

Chart 3
Self-Employment Correlates with Financial Stress Index



NOTE: Shaded areas indicate recessions.
SOURCES: Bureau of Labor Statistics; Haver Analytics; Federal Reserve Bank of Kansas City.

What Makes Texas Different?

Texas has consistently recorded a higher annual average unincorporated self-employment rate relative to the nation—a difference that persists even when accounting for demographic characteristics such as age, sex, race and education (*Chart A*). The Texas workforce has more men, fewer people who are college educated and more people who are foreign born, all pointing to a higher self-employment rate. Texas' long international frontier also contributes to higher self-employment. Mexican immigrants along the border are significantly more likely to be self-employed than those inland.[1]

Alternatively, Texas' younger and less-white population predicts a lower self-employment rate. The state's industrial structure also significantly influences the broader trend, with its relatively larger construction sector encouraging higher unincorporated self-employment rates while its smaller manufacturing sector suggests less-prevalent self-employment.

On net, however, differences in demographics and industrial structure predict a slightly lower self-employment rate for Texas, not higher. The fact that the state's unincorporated self-employment rate is higher suggests that other factors—such as a favorable regulatory and business climate—likely play an expanded role in explaining the state's unincorporated higher self-employment rate.

By contrast, the state lags behind the nation in incorporated self-employment (*Chart B*). Texas' lower incorporated self-employment is partly explained by differences in race, age and educational attainment. However, variations in demographics and industrial structure explain no more than half of that difference.[2]

Notes

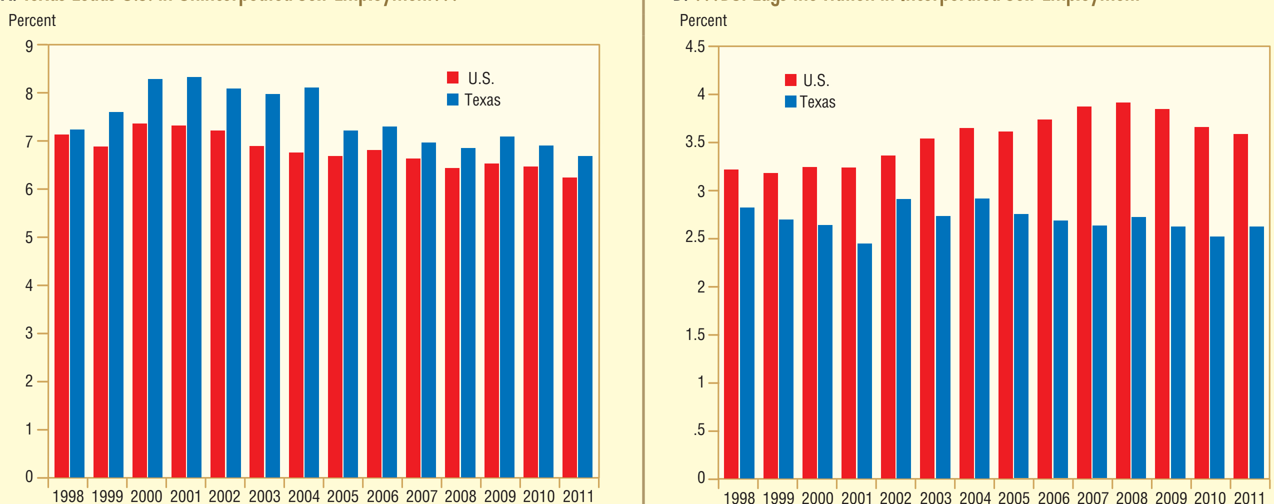
[1] See "Mexican Immigrant Self-Employment Along the U.S.-Mexico Border: An Analysis of 2000 Census Data," by Marie T. Mora and Alberto Dávila, *Social Science Quarterly*, vol. 87, no. 1, 2006, pp. 91–109.

[2] Analysis of the sources of the difference between self-employment rates in Texas and the U.S. is carried out using Oaxaca decomposition.

Self-Employment Trends in Texas Differ by Type of Entity

A. Texas Leads U.S. in Unincorpoated Self-Employment…

B. …But Lags the Nation in Incorporated Self-Employment



SOURCES: Bureau of Labor Statistics' Current Population Survey; authors' calculations.

upbeat if the self-employed struggle to find buyers for their products or services.

The unincorporated self-employed face greater labor market stress than the average worker; they have a higher incidence of part-time employment for economic reasons and lower average weekly hours, according to Bureau of Labor Statistics data from its Current Population Survey (CPS). Structural differences among states affect the prospects of individuals who go it alone. For example, the regulatory and business climate in Texas makes unincorporated self-employment more inviting than might be expected given its demographics and industrial structure (*see the box "What Makes Texas Different?"*).

Demographic characteristics and behaviors of the self-employed also factor into labor market impact.

Although the unincorporated self-employed are classified among the employed, they differ from wage and salary personnel. At an average age of 48 years in 2011, these self-employed tend to be six years older than other workers. This reflects two factors likely contributing to greater self-employment among longstanding workforce participants. First, older workers have more work experience, greater wealth and access to credit. Thus, it is not surprising that 15 percent of workers 65 and older were self-employed in 2011—more than twice the rate for workers 35 to 55.

Also, older workers confronting personal or financial imperatives are increasingly unwilling to retire. Baby boomers, whose anticipated retirement income increasingly shifted to defined contribution plans such as 401(k)s from traditional annuity-like defined benefit programs, appear particularly compelled to remain working. Retirement assets, which become a backup source of support during prolonged unemployment, are often diminished. Additionally, the lump-sum 401(k) distribution provided immediately upon leaving an employer becomes an attractive funding source for starting self-employment.[6] Among the employed 55-to-64 demographic, 22 percent were self-employed in 2011, up from 15 percent in 2000, CPS data show.

At the same time, self-employment decreases with education. The unincorporated self-employment rate among college degree holders is 6 percent—2 percentage points lower than for those without a high school diploma. Given the ability of the highly educated self-employed to raise capital, many choose to incorporate their businesses.

Moreover, males are more likely to be self-employed than females, and whites have a higher self-employment rate than other racial groups.

Many of the differences among demographic groups can be explained by workforce characteristics such as occupational category and industry—construction workers, for example, are much more likely to be self-employed than those in manufacturing.

Rethinking Programs

Should heightened self-employment—particularly among older workers—become an enduring feature of the postrecession economy, programs based on traditional employer–employee relationships will remain relevant but may need to be redrawn to accommodate the new realities that are emerging.[7]

Kumar is a senior research economist and advisor and Weiss is the economic writer/editor in the Research Department at the Federal Reserve Bank of Dallas.

Notes

[1] Internal Revenue Service (IRS) tax-return data provide an alternative to the Current Population Survey for measuring self-employment. The IRS defines unincorporated self-employed workers as those who carry on a trade or business as sole proprietor/independent contractor/member of a partnership or who are in business for themselves (including a part-time business).

[2] The unemployment rate change is an imperfect measure of recession severity because it is a lagging indicator of recessions. Recession severity accounts for a recession's depth as well as duration and, in the most recent downturn, is measured as the absolute sum of changes in the unemployment rate from December 2007 to June 2009. This is similar in spirit to "Real-Time Macroeconomic Monitoring: Real Activity, Inflation and Interactions," by S. Borağan Aruoba and Francis X. Diebold, *American Economic Review*, vol. 100, no. 2, 2010, pp. 20–24.

[3] For example, see "Who Creates Jobs? Small vs. Large vs. Young," by John C. Haltiwanger, Ron S. Jarmin and Javier Miranda, National Bureau of Economic Research, NBER Working Paper no. 16300, August 2010, and "Do Small Businesses Create More Jobs? New Evidence for the United States from the National Establishment Time Series," by David Neumark, Brandon Wall and Junfu Zhang, *The Review of Economics and Statistics*, vol. 93, no. 1, 2011, pp. 16–29.

[4] From "Entrepreneurship, Economic Conditions and the Great Recession," by Robert Fairlie, *Journal of Economics and Management Strategy*, forthcoming.

[5] See "Assessing the Jobless Recovery," by Daniel Aaronson, Ellen R. Rissman and Daniel G. Sullivan, Federal Reserve Bank of Chicago *Economic Perspectives*, Second Quarter 2004.

[6] See *Self-Employment Among Older Workers: Assistance Programs, Liquidity Constraints and Employment Patterns*, by Qian Gu, Santa Monica, Calif.: RAND Corp., 2009.

[7] See *An Economy that Works: Job Creation and America's Future*, by James Manyika, Susan Lund, Byron Auguste, Lenny Mendonca, Tim Welsh and Sreenivas Ramaswamy, New York: McKinsey Global Institute, June 2011.

Should heightened self-employment—particularly among older workers—become an enduring feature of the postrecession economy, programs based on traditional employer–employee relationships will remain relevant but may need to be redrawn to accommodate the new realities that are emerging.