Chapter 14
Labour Market Institutions and Entrepreneurship

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Abstract The impact of labour market institutions on both labour supply and job search rates has been exhaustively analysed in Labour Economics from theoretical as well as empirical approaches. However, research on the impact of this regulation on self-employment and its composition is limited, that is, the impact of labour market institutions on occupational choice and labour demand. In this context, the aim of this study is to revise the effects of certain labour market institutions on self-employment rates, defining the key dimensions and revising those indicators that could be used for capturing these effects, making an abstraction of the tax system effects.

14.1 Introduction

The impact of labour market institutions on both labour supply and job search rates has been exhaustively analysed in Labour Economics from theoretical as well as empirical approaches. Thus, labour market regulations may have significant effects on employment turnover (Bertola 1992, Bentolila and Bertola 1990, Layard and Nickell 1999, Millard and Mortensen 1997, Millard 1996, Nickell 1982), on the levels of employment (Scarpetta 1996, Layard and Nickell 1999) and unemployment (Kugler and Pica 2004), on productivity (Akerlof 1984; Piore 1986), on wages and benefits (Bentolila and Dolado 1994), and on the degree of protection that workers may benefit from (Lindbeck and Snower 1988), as well as the level of self-employment and its composition.

However, research on the impact of this regulation on self-employment and its composition is limited, that is, the impact of labour market institutions on occupational choice and labour demand. The decision to become self-employed is

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1 In this sense, the consequences of the duration and quantity of unemployment benefit on the inflow, or the effects of long-term contracts and the dismissal costs on the outflow, are other institutions comprehensively surveyed.
usually the result of an occupational choice problem in which the risks associated
to other employment possibilities are weighed. In this sense, the assessment of risk
can be determined by the existence of certain labour market institutions. Hence,
the existence of such institutions as severance pay, long-term contracts or, even,
unemployment benefits, may change the individual’s perception of the degree of
risk associated to a certain job. This is the reason why the regulation of the labour
market and, more specifically, the design of unemployment benefits, severance pay,
long-term hiring procedures, or the tax incentives associated to certain types of
work, can be determining in solving this problem, as well as for self-employment
rates.

Therefore, labour market institutions with disparate purposes may become a hin-
drance for self-employment, as they can be misleading when choosing an occupa-
tion. In the first place, the security that some labour market institutions bestow on
paid-employment or wage-work increase the value of uncertainty, which rise the
opportunity cost of self-employment.

When the laws that protect employment are very rigid, the risks run by paid-
employees are very low. Therefore, labour market regulations can be a handicap
for self-employment. We shall pursue this line of thinking in terms of the tran-
sition to employment from unemployment. When labour legislation is very pro-
tective towards paid-employment, where permanent contracts have prevail, where
unemployment compensations and severance pay exist, and there are high salary
prospects, the opportunity cost of self-employment increases, bringing about at
the same time a higher perception of risk. On the contrary, in the context of a
completely flexible labour market, with no elements to safeguard against non-
payment, nor unemployment compensation or severance pay, the perception of
risk and reward associated to self-employment improves in relation to that of
paid-employment. Over the last years, the deregularization of labour markets has
made paid-employment more insecure, thus becoming an unexpected stimulus to
entrepreneurship.

Secondly, we may consider how the decision of becoming an employer is affected
by the existence of adjustment costs. When hiring regulations are too stringent and
hefty dismissal costs are imposed, the employer’s risk increases, because the cost
of workforce reduction adds up to the market fluctuations. Therefore, the existence
of long-term contracts and costs of dismissal are constraints that prevent compa-
nies from adjusting to demand fluctuations. These adjustment costs can make own-
account workers to reject a profit opportunity brought about in a positive demand
shock, not because of its feasibility, but because of its possible after effects in case
that shock is not steadfast. To illustrate this, let’s imagine a self-employed worker
considering the idea of becoming an employer. In this decision, this person will
have to take into account these adjusting costs, especially if he or she is uncer-
tain as to the permanent or transitory nature of the shock moving them to this
transition.

But labour market institutions may also generate distortions in the opposite
direction, that is, the transition to self-employment from paid-employment could
occur as a way to avoid the most unfavourable constituents of legislation. If we