Experimentation and the Returns to Entrepreneurship*

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Abstract

Previous studies have argued that entrepreneurs earn less and bear more risk than salaried workers with otherwise similar characteristics. In a simple model of entrepreneurship, I show that estimates of mean and variance of returns to entrepreneurship used by these previous studies are biased, as they fail to account for the option value of experimenting with new ideas. Using longitudinal data, I find patterns that are consistent with entrepreneurship as experimentation and returns to entrepreneurship that are more attractive than established by previous research.

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1 Introduction

Previous research has found that entrepreneurs earn less and bear more risk than salaried workers, raising the question of why people choose to become entrepreneurs (Hamilton 2000, Moskowitz and Vissing-Jorgensen 2002). Prevailing explanations for this puzzle are based on non-standard beliefs or preferences. For example, entrepreneurs may enjoy non-pecuniary benefits (Blanchflower and Oswald 1992), may have a preference for skewness (Kraus and Litzenberger 1976), or may just be overconfident (Cooper, Woo, and Dunkelberg 1988, Arabsheibani, De Meza, Maloney, and Pearson 2000, Bernardo and Welch 2001).

Non-standard beliefs or preferences may not be necessary to justify the decision to become entrepreneur. Studies showing that entrepreneurship does not pay mostly rely on cross-sectional data to compute estimates of the mean and standard deviation of entrepreneurial earnings. I show that such estimates do not reflect the actual risk and return that individuals face when they decide to become entrepreneurs as they fail to account for the option value of experimenting with new ideas.

Using longitudinal data, I find patterns that are consistent with entrepreneurship as experimentation: entrepreneurship spells are short, the probability of abandoning entrepreneurship is higher after bad performance, and failed entrepreneurs are not punished when they return to the salaried workforce.

Lifetime earnings computed from longitudinal data incorporate the value of the options embedded in entrepreneurship. Once the value of these options are taken into account returns to entrepreneurship are more attractive than suggested by previous research. Successful entrepreneurs earn significantly more than salaried workers with similar characteristics, while failed entrepreneurs are able to quickly move back to the salaried workforce limiting their losses. The option to abandon entrepreneurship increases the return and reduces the risk faced by entrepreneurs.

This view of entrepreneurship as experimentation and real options flips the interpretations of some of the previous findings. High variance in cross-sectional self-employed earnings, as found in previous research, is actually valuable for entrepreneurs since such variance increases the value of their real options. Failed entrepreneurs will abandon entrepreneurship quickly and variance in cross-sectional earnings will not get reflected in lifetime earnings.
To study the distribution of entrepreneurial returns, I develop a simple model of entrepreneurship as experimentation with new ideas. In the model, individuals with new ideas may pursue them as self-employed workers, which is the only way to find out whether an idea is good. Alternatively, individuals may remain as salaried workers.

The model reveals how cross-sectional data analysis can introduce different sources of bias in estimating the distribution of entrepreneurial returns. “Survivorship bias” arises because the cross-sectional distribution overweights successful entrepreneurs who survive longer. “Experimentation bias” arises because the cross-sectional distribution neglects the fact that entrepreneurs who fail will not carry on with their bad ideas, but instead will switch back to salaried workers or try new ventures.

These biases affect estimates of the mean and the variance of entrepreneurial returns. Survivorship bias leads to an overstatement of the true lifetime mean of self-employed earnings, while the experimentation bias leads to an understatement of the true lifetime mean of self-employed earnings. Depending on which effect dominates, the cross-sectional mean of self-employed earnings may overstate or understate the lifetime mean of self-employed earnings. On the other hand, since the experimentation bias amplifies entrepreneurial failures and the survivorship bias overweights successful entrepreneurs, the cross-sectional variance of self-employed earnings typically overstates the lifetime variance of self-employed earnings.

An extension of the model studies what happens if previous entrepreneurial experience generates an earnings premium for salaried workers. In such settings, cross-sectional data analysis introduces a new source of bias. “Attribution bias” arises because the cross-sectional distribution of salaried earnings fails to account for the fact that the wage premium earned by salaried workers may be a consequence of previous entrepreneurial experience. Attribution bias will make the cross-sectional mean earnings of salaried workers overstate the lifetime mean earnings of salaried workers, while it will make the cross-sectional mean earnings of self-employed workers understate the cross-sectional mean earnings of self-employed workers.

To test the predictions of the model, I use the National Longitudinal Survey of Youth-1979 (NLSY79). From the NLSY79, I obtain information on demographics, educational attainment, labor market outcomes, and pre labor market traits. The main advantage of the NLSY79 is that
it follows individuals over time, allowing one to compute the lifetime returns to self-employed and salaried workers.

According to the model, self-employed workers experiment with new ideas when they leave the salaried workforce to become self-employed. The value of experimentation arises from the option to abandon bad ideas. For this option to be valuable, self-employment spells must be short, particularly for workers who perform poorly as self-employed. I find that approximately 52% of entrepreneurship spells in NLSY79 lasts less than two years. Moreover, a probit regression estimating how residual earnings affect the probability of abandoning entrepreneurship shows that lower residual earnings while self-employed are associated with a higher probability of abandoning self-employment.

It is also important for experimentation to be valuable that individuals are not penalized for previous entrepreneurial failures. I find that salaried workers earn a premium if they have previously completed a self-employment spell. This shows that the option to abandon self-employment is there and is attractive for the self-employed.

To study lifetime returns to entrepreneurship, I divide the sample into two groups: those who were ever self-employed and those who were never self-employed. Mean lifetime earnings of the ever self-employed are higher than mean lifetime earnings of the never self-employed. More importantly, in contrast to previous studies that rely on cross-sectional data, the risk as measured by the standard deviation of earnings is not substantially greater than the risk of staying as salaried worker.

The comparison between lifetime earnings of ever self-employed and never self-employed has important shortcomings. If an individual enters self-employment late in life, she is classified as ever self-employed, even though most of her earnings come from the time she was salaried worker without any entrepreneurial experience.

To address this issue, I use propensity score matching to compare the earnings of an individual who chooses to become self-employed with someone who looks just like this individual in terms of observed characteristics but decides to remain as salaried worker. I find that on average, after becoming self-employed individuals earn approximately 5% less during the first couple of years.

Fairlie (2005) and Levine and Rubinstein (2015) are examples of studies that use this data.
but earn approximately 10% more than their salaried counterparts in the subsequent years.

Conditioning the analysis on the number of years as self-employed, I find that who attempted to be entrepreneurs but abandon self-employment in less than two years are not punished, achieving approximately the same earnings as those who have not attempted to be self-employed. Individuals who stay as self-employed longer than two years experience earn substantially higher earnings than salaried workers with similar characteristics.

The model of entrepreneurship as experimentation used in this paper follows a long tradition in the study of entrepreneurship and innovation. Schumpeter (1934) argues that entrepreneurship is essentially the experimentation with “new combinations” of existing resources. Arrow (1969) associates innovation with the production of knowledge and proposes the use of Bayesian decision models to study innovation. Bandit problems are Bayesian decision models that allow for knowledge acquisition through experimentation. Weitzman (1979) applies a simple bandit problem to study the innovation process. March (1991) uses the terms exploration and exploitation to describe the fundamental tension that arises in learning through experimentation.

Manso (2011) shows that tolerance for early failure and reward for long-term success are optimal to motivate exploration, and consequently entry into entrepreneurship. Manso (2011) argues that debtor-friendly bankruptcy laws encourage entrepreneurship. Other papers have focused on institutional aspects of the labor market that also offer protection against failure and thus motivate entrepreneurship, such as unemployment insurance (Hombert, Schoar, Sraer, and Thesmar 2015) and job-protected leave (Gottlieb, Townsend, and Xu 2016). Along the same lines, the equilibrium in the labor market uncovered here, which has no stigma for failed entrepreneurs, should encourage entrepreneurship.

In this paper, I focus on showing that previous estimates of the returns to entrepreneurship are biased because they fail to take into account the option value of experimenting with new ideas. Other papers try to resolve the puzzle on returns to entrepreneurship by providing behavioral explanations for why entrepreneurs might accept to work for less, such as risk preferences, overconfidence, and non-pecuniary benefits. Astebro, Herz, Nanda, and Weber (2014) provide a survey of this literature and conclude that behavioral research has not yet provided definitive explanations for the puzzling aspects of entrepreneurship.
More closely related, Levine and Rubinstein (2015) argue that the puzzle may be due to mismeasurement because self-employment is not a good measure of entrepreneurship. They show that self-employed workers who incorporate their business earn substantially more than salaried workers and argue that only self-employed workers who incorporate should be called entrepreneurs.

The paper is also related to dynamic models of discrete occupational choices. These models have been successful in explaining issues such as patterns of wealth distribution, the role of financial intermediaries, and the effects of changes in the tax or bankruptcy regulation. Cagetti and De Nardi (2006), Hintermaier and Steinberger (2005), Vereshchagina and Hopenhayn (2009), Campanale (2010), and Poschke (2013) develop dynamic models of occupational choice in which workers can choose to become entrepreneurs and learn about their entrepreneurial skills. However, these models focus on different questions and do not directly compare cross-sectional and lifetime entrepreneurial earnings.

2 A Model of Entrepreneurship as Experimentation

This section introduces a simple overlapping-generations model to study the returns to entrepreneurship. In each period \( t \in \{0,1,\ldots\} \), a unit mass of agents is born. All agents live for two periods and are risk-neutral with zero discounting.

When born, a fraction \( \gamma \) of agents have access to new ideas, which they may pursue as self-employed workers. Alternatively, agents may work as salaried workers. As salaried workers, agents receive a wage \( W \) each period. If an agent has an idea and chooses to pursue it as self-employed, he finds the idea is of high quality with probability \( p \), in which case it pays out \( R \) each period, or low quality with probability \( 1 - p \), in which case it pays out 0. The only way to find out about the quality of a new idea is by trying it out as self-employed.

To capture the exploratory nature of self-employment, I assume that \( R > W \) and \( pR < W \). If successful, self-employed earn more than salaried workers. However, the unconditional mean of self-employed earnings is lower than salaried earnings.

Under these assumptions, there are two strategies that need to be considered. Agents may choose to always remain as salaried workers, earning \( V_{\text{sal}} = W \) per period. Alternatively, agents may become self-employed if they have a new idea. They will remain self-employed if their idea
is of high quality, since it yields $R > W$ in each period. If it turns out that their idea is of low quality, it yields 0, and they will abandon it and return to the salaried workforce. The expected per period earnings $V_{\text{semp}}$ of such strategy are:

$$V_{\text{semp}} = pR + (1 - p)\frac{W}{2}$$ (1)

The intuition for equation (1) is as follows. Self-employed workers have a high quality idea with probability $p$, in which case they earn $R$ each period. With probability $1 - p$ they have a low quality idea, in which case they earn zero for one period and become a salaried worker thereafter, earning $W$ in the second period.

Agents earn more as self-employed than as salaried workers if and only if $V_{\text{semp}} \geq V_{\text{sal}}$, which is equivalent to

$$pR \geq \frac{(1 + p)}{2} W$$ (2)

Otherwise, agents earn more as salaried workers.

The above comparison only takes into account monetary payoffs of workers. To ensure that agents with ideas try them out even if monetary payoffs are not enough to justify becoming self-employed, we assume that self-employed workers enjoy private benefits $\beta$ that are high enough to make entrepreneurship pay off. In the model of this section, this condition holds if $\beta \geq W - 2pR/(1 + p)$. This assumption will play no other role in the analysis as we will focus on monetary payoffs, which are observable.

To understand cross-sectional data generated by the model, we can calculate the distribution of agents in the population at any time $t$. Let $\theta_{\text{sal}}, \theta_{\text{semp,f}},$ and $\theta_{\text{semp,s}}$ be the fractions of salaried workers, successful self-employed workers, and failed self-employed workers in the population at any point in time. These fractions are given by:

$$\theta_{\text{sal}} = (1 - \gamma) + \frac{\gamma(1 - p)}{2}$$
$$\theta_{\text{semp,f}} = \frac{\gamma(1 - p)}{2}$$ (3)
$$\theta_{\text{semp,s}} = \gamma p.$$

The first fraction in (3), $\theta_{\text{sal}}$, consists of $(1 - \gamma)$ young and old individuals who are not born with an idea and $\gamma(1 - p)/2$ old individuals who were born with a bad idea. The second fraction,
θ_{semp,f} consists of γ(1 – p)/2 young individuals who were born with an bad idea. The third fraction, θ_{semp,s}, consists of γp young and old individuals who were born with a good idea.

Using (3), we can compute cross-sectional earnings distributions and compare those with lifetime earnings distributions. Cross-sectional data introduces two sources of bias in estimating lifetime earnings distributions for self-employed workers. Survivorship bias arises because the cross-sectional distribution overweights successful self-employed workers who survive longer as self-employed. Experimentation bias arises because the cross-sectional distribution neglects the fact that self-employed workers who fail will not carry on with their bad ideas, but instead will switch back to salaried workers or try new ideas.

Figure 1 shows the cross-sectional and lifetime distributions of earnings for salaried and self-employed workers for the model with the following parameters: W = 30, R = 60, p = 0.4, γ = 0.05. These distributions illustrate the survivorship and experimentation biases. Due to the survivorship bias, in the cross-sectional earnings distribution, the probability of being successful as a self-employed worker is higher than in the lifetime distribution. At the same time, due to the experimentation bias, in the cross-sectional earnings distribution, the probability of failing and earning 0 is higher than in the lifetime earnings distribution. The lifetime earnings distribution correctly reflects the fact that these failed self-employed workers will earn zero just for one period and will switch back to the salaried workforce earning a lifetime mean payoff that is between zero and W.

[Figure 1 about here.]

The next proposition compares the cross-sectional mean of self-employed earnings with the lifetime mean of self-employed earnings.

**Proposition 1** The cross-sectional mean of self-employed earnings overstates the lifetime mean of self-employed earnings if and only if the lifetime mean of self-employed earnings is higher than salaried workers wage W.

**Proof** The cross-sectional mean of self-employed earnings is:

\[ V_{cs} = \frac{θ_{semp,s}}{θ_{semp,s} + θ_{semp,f}}R = \frac{2p}{1 + p}R, \]  

(4)
which is greater than $V_{\text{semp}}$ if

$$\frac{2p}{1 + p} R \geq pR + \frac{(1 - p)W}{2} \iff pR \geq \frac{(1 + p)}{2} W.$$  \hspace{1cm} (5)

The survivorship bias leads to an overstatement of the true lifetime mean of self-employed earnings. The experimentation bias amplifies entrepreneurial failure leading to an understatement of the true lifetime mean of self-employed earnings. If the lifetime mean of self-employed earnings is higher than the lifetime mean of salaried earnings, then the survivorship bias prevails and the cross-sectional mean of self-employed earnings overstates the lifetime mean of self-employed earnings. Otherwise, the opposite holds.

The next proposition compares the cross-sectional standard deviation of salaried and self-employed earnings with the lifetime standard deviation of salaried and self-employed earnings.

**Proposition 2** The following statements about standard deviations of earnings hold:

1. The cross-sectional standard deviation of salaried earnings is equal to the lifetime standard deviation of salaried earnings.

2. There exists $\lambda \in (1, \infty]$ such that the cross-sectional standard deviation of self-employed earnings overstates the lifetime standard deviation of self-employed earnings if and only if $\lambda \equiv \frac{V_{\text{semp}}}{V_{\text{sal}}} < \lambda$.

**Proof** On point 1), both the cross-section standard deviation of salaried earnings and the lifetime standard deviation of salaried earnings are zero.

On point 2), the cross-sectional variance of self-employed earnings is:

$$\left( \frac{2p}{1 + p} \right) \left( 1 - \frac{2p}{1 + p} \right) R^2 = p(1 - p) \frac{2}{(1 + p)^2} R^2$$  \hspace{1cm} (6)

The lifetime variance of self-employed earnings is:

$$p(1 - p) \left( R - \frac{W}{2} \right)^2 = p(1 - p) \left( \frac{2\lambda - 1}{2\lambda - (1 - p)} \right)^2 R^2$$  \hspace{1cm} (7)

which is increasing in $\lambda$ and lower than (6) if $\lambda = 1$ (or $V_{\text{semp}} = V_{\text{sal}}$).
Salaried work is always rewarded with $W$, and is thus risk free. Both the cross-sectional and lifetime standard deviation of earnings reflect that and are equal to zero.

The second statement is more subtle. The experimentation bias amplifies entrepreneurial failures, while the survivorship bias overweights successful entrepreneurs, both in principle contributing to an overstatement of the variance of self-employed earnings. It is only for extreme cases, when lifetime self-employment payoff is substantially higher than salaried payoff that the cross-sectional variance understates the lifetime variance of self-employed earnings. Such situations are unlikely to arise since in a general equilibrium model, these payoffs are likely to be close to each other as any substantial difference between the payoffs would attract more people to entrepreneurship.

3 Prior Entrepreneurial Experience

In this section we consider the same model as in the previous section, except that after experiencing an entrepreneurial failure, salaried workers earn $\kappa W$. When $\kappa > 1$, failed self-employed workers earn a premium in the job market. When $\kappa < 1$ failed self-employed workers earn a discount in the job market. When $\kappa = 1$ we are back to the setup studied in the previous section.

Self-employed lifetime mean earnings are:

$$V_{\text{semp}} = pR + (1 - p)\frac{\kappa W}{2}$$

while salaried workers lifetime mean earnings are $V_{\text{sal}} = W$.

The cross-sectional distribution needs to account for fractions of successful self-employed, failed self-employed, as well as salaried workers with and without a previous entrepreneurial failure. The cross-sectional distribution is given by:

$$\theta_{\text{semp},s} = \gamma p$$
$$\theta_{\text{semp},f} = \frac{\gamma(1 - p)}{2}$$
$$\theta_{\text{sal}(1)} = \frac{\gamma(1 - p)}{2}$$
$$\theta_{\text{sal}(0)} = (1 - \gamma)$$
**Proposition 3** The cross-sectional mean of salaried workers earnings overstates the lifetime mean of salaried workers earnings if and only if previous entrepreneurial failures improve salaried worker earnings.

**Proof** The cross-sectional mean of salaried workers earnings is given by:

\[
\frac{\theta_{\text{sal}}(0)W + \theta_{\text{sal}}(1)(\kappa W)}{\theta_{\text{sal}}(0) + \theta_{\text{sal}}(1)} = \frac{2(1 - \gamma) + \gamma(1 - p)\kappa}{2(1 - \gamma) + \gamma(1 - p)} W
\]

which is greater than \( W \) iff \( \kappa > 1 \).

If previous entrepreneurial failures improve salaried worker earnings (\( \kappa > 1 \)), it means that salaried workers will only have access to this wage premium if they were previously self-employed. However, this wage premium is reflected in the cross-sectional distribution of salaried earnings, as no distinction is made whether the worker has formerly been self-employed or not. Due to such attribution bias, the cross-sectional mean earnings of salaried workers overstates the lifetime mean of salaried workers earnings.

**Proposition 4** There exists \( \kappa \) such that for \( \kappa > \kappa_0 \) the cross-sectional mean of self-employed earnings understates the lifetime mean of self-employed earnings.

**Proof** The cross-sectional mean of self-employed earnings is:

\[
V_{\text{CS}} = \frac{\theta_{\text{semp},s}}{\theta_{\text{semp},s} + \theta_{\text{semp},f}} R = \frac{2p}{1 + p} R,
\]

which is independent of \( \kappa \). However, it is clear from equation (5) that \( V_{\text{semp}} \) is increasing in \( \kappa \) and goes to infinity as \( \kappa \) goes to infinity.

The cross-sectional distribution of self-employed earnings does not take into account the salaried wage premium \( \kappa \) that only accrues to the worker if he has previous experience as self-employed. For high enough \( \kappa \), this attribution bias becomes dominant and the cross-sectional mean of self-employed earnings understates the lifetime mean of self-employed earnings.

Another form of attribution bias can arise if successful self-employed become salaried workers (managers) in their own firms. In this case, cross-sectional studies would count them as salaried workers, but their high earnings are there only because they were entrepreneurs in the first place. Our empirical approach, using longitudinal data will deal with this issue.
We now turn to the standard deviation of salaried and self-employed earnings in the presence of attribution bias.

**Proposition 5** The following statements about standard deviations of earnings hold:

1. The cross-sectional standard deviation of salaried earnings overstates the lifetime standard deviation of salaried earnings if and only if $\kappa \neq 1$.

2. For $\kappa$ close to 1, there exists $\lambda \in (1, \infty]$ such that the cross-sectional standard deviation of self-employed earnings overstates the lifetime standard deviation of self-employed earnings if and only if $\lambda \equiv \frac{V_{\text{semp}}}{V_{\text{sal}}} < \overline{\lambda}$.

**Proof** On point 1), the lifetime standard deviation of salaried earnings is zero. The cross-sectional standard deviation of salaried earnings is greater than zero if and only if $\kappa \neq 1$ as the cross-sectional distribution of salaried earnings include previously failed entrepreneurs making $\kappa W$.

On point 2), the cross-sectional variance of self-employed earnings is:

$$\left(\frac{2p}{1 + p}\right) \left(1 - \frac{2p}{1 + p}\right) R^2 = p(1 - p) \frac{2}{(1 + p)^2} R^2$$

(12)

The lifetime variance of self-employed earnings is:

$$p(1 - p)(R - \frac{W}{2})^2 = p(1 - p) \left(\frac{2\lambda - \kappa}{2\lambda - (1 - p)\kappa}\right)^2 R^2$$

(13)

which is increasing in $\lambda$ and lower than (12) if $\lambda = 1$ (or $V_{\text{semp}} = V_{\text{sal}}$) and $\kappa$ is close to 1.

With the attribution bias, the cross-sectional standard deviation of salaried earnings is greater than zero and thus overestimate the lifetime standard deviation of earnings. As before, the cross-sectional standard deviation of self-employed earnings typically overestimate the lifetime standard deviation of self-employed earnings.

4 The Returns to Self-Employment: Evidence from the NLSY79

This section examines the returns to salaried and self-employed workers using the National Longitudinal Survey of Youth-1979 (NLSY79). The main advantage of the NLSY79 is that it follows individuals over time, allowing one to compute the lifetime returns to self-employment.
4.1 Data

The NLSY79 is a survey of 12,686 individuals who were 15-22 years old when they were first surveyed in 1979. The same individuals were then surveyed annually through 1994 and every two years thereafter. The last survey year in my sample is 2012. To keep the frequency of observations constant throughout the sample period, I drop odd years from the sample. I also drop from the sample observations in which an individual has missed the survey.

The NLSY79 cohort is comprised of three subsamples. For this study, I drop the military and representative minorities subsamples to restrict the analysis to the nationally representative subsample of 6,111 individuals. I also dropped from the sample all observations corresponding to individuals who were never a worker during the period 1979-2012. The final sample contains observations on 5,415 individuals.

From the NLSY79, I obtain information on demographics, educational attainment, labor market outcomes, and pre labor market traits. The demographic variables are age, gender, and race. For educational attainment, I construct dummy variables for six education categories based on years of schooling. Labor market outcomes include earnings, hours worked, weeks worked, and industry.

Pre-labor-market traits include three different measures. To measure cognitive ability, I use the Armed Forces Qualifications Test (AFQT) score, which measures the aptitude and trainability of each individual. Collected during the 1980 NLSY79 survey, the AFQT score is based on information concerning arithmetic reasoning, world knowledge, paragraph comprehension, and numerical operations. It is frequently employed as a general indicator of cognitive skills and learning aptitude. The AFQT score is measured as a percentile of the NLSY79 survey, with a median value of 50.

To measure self-esteem, I use the Rosenberg Self-Esteem score, which is based on a ten-part questionnaire given to all NLSY79 participants in 1980. It measures the degree of approval or disapproval of oneself. The values range from six to 30, with higher values associated with greater self-approval.

I also use information on the degree to which individuals believe they have internal control of their lives through self-determination relative to the degree that external factors, such as chance,
fate, and luck, shape their lives. This is measured by the Rotter Locus of Control, which was collected as part of a psychometric test in the 1979 NLSY79 survey. The Rotter Locus of Control ranges from four to 16, where higher values signify less internal control and more external control.

All earnings variables are adjusted for inflation using the Consumer Price Index (CPI). Earnings are expressed in 2012 dollars.

4.2 Pooled Data

In this subsection, I take individual-year observations as the basic unit of analysis, to provide summary statistics and also reproduce results obtained in previous studies using cross-sectional data.

Table 1 shows summary statistics from NLSY79 data. Self-employed workers are similar to salaried workers in most characteristics, but typically there is a higher proportion of white and males among the self-employed. Mean annual earnings of self-employed workers are higher than those of salaried workers. However, median annual earnings of self-employed workers are lower than those of salaried workers. Moreover, the standard deviation of self-employed earnings is substantially higher than that of salaried workers earnings. These are in line with previous studies which conclude that the median self-employed individual earn less and bear significantly more risk than salaried workers.\footnote{See for example, Table 3 in Hamilton (2000) or Figure 2 of Moskowitz and Vissing-Jorgensen (2002).} Even though mean self-employed earnings are higher than salaried workers earnings, it is hard to justify selection into entrepreneurship given the difference in risk between the two career choices as captured by the standard deviation of earnings. Entrepreneurship seems too risky as the standard deviation of self-employed earnings is substantially higher than the standard deviation of salaried earnings.

[Table 1 about here.]

4.3 Lifetime Earnings

This subsection exploits the longitudinal dimension of the data to compute unbiased estimates of the returns to self-employment.
According to the model in Section 2, self-employed workers are engaging in experimentation when they choose self-employment. As such, the average self-employment spell should be short. If it takes too long to learn about the quality of an idea there is little value in experimentation. Moreover, self-employed workers should be more likely to leave self-employment after lower earnings as self-employed.

Figure 2 shows a histogram with the duration of self-employment spells that start between 1979 and 2002. Approximately 52% of self-employment spells last less than 2 years. This is consistent with the view that self-employed experiment with new ideas and learn quickly about the quality of their ideas. Therefore, the losses due to an entrepreneurial failure do not impose a large penalty on lifetime earnings.

![Figure 2 about here.]

Table 2 presents coefficient estimates for a probit model estimating how residual earnings affect the probability of abandoning self-employment. Residual earnings are the residuals of the OLS regression that controls for demographics, educational attainment, work experience, industry, and pre labor market traits. According to Table 2 lower residual earnings while self-employed are associated with a higher probability of abandoning self-employment. When evaluated at the means, a one-standard-deviation increase in residual earnings raises the probability of abandoning entrepreneurship from 30.4% to 35.8% while a one-standard-deviation decrease in residual earnings reduces the probability of abandoning entrepreneurship from 30.4% to 25.5%.

![Table 2 about here.]

The basic model of Section 2 also predicts that self-employed workers are not penalized if they decide to go back to the salaried workforce. Table 3 presents results of an OLS model estimating how a previously completed self-employment spell affects annual earnings for individuals between 25 and 55 years old working full-time, full-year. These regressions control for work experience as well as year and individual fixed effects. Salaried workers with previous self-employment experience earn a premium of $5,161 per year when compared to similar workers.
without self-employment experience. Self-employed workers who have previously completed a self-employment spell earn a negative (but not statistically significant) premium.

These findings are consistent with the extension of the basic model considered in Section 3 with a premium for salaried workers with previous self-employment experience ($\kappa > 1$). They also suggest we should be specially careful when using cross-sectional data to measure returns to entrepreneurship since in the cross-section this self-employment premium would be attributed to salary workers, but is only attainable by entrepreneurs.

[Table 3 about here.]

Using NLSY79, we can compute lifetime mean earnings for different employment types. Table 4 provides summary statistics and is the analogous of Table 1 for longitudinal data. To study whether it pays off to be an entrepreneur, I classify individuals into two groups: those who have never been self-employed and those who have ever been self-employed. Summary statistics in Table 4 show a much more balance picture of the choice between self-employment or salaried work than those in Table 1. The mean lifetime earnings ($42,770$) of those who were ever self-employed are slightly higher than the mean lifetime earnings ($40,460$) of those who were never self-employed. The median lifetime earnings ($34,670$) of those who were ever self-employed are slightly lower than the median lifetime earnings ($36,110$) of those who were never self-employed. The risk dimension is the main departure from the statistics in Table 1. Different from the results of the pooled data analysis, the standard deviation of lifetime earnings of workers who were ever self-employed is only slightly higher than the standard deviation of lifetime earnings of workers who have never been self-employed.

[Table 4 about here.]

The results in Table 4 call into question previous findings which claim that entrepreneurs earn less and bear significantly more risk than salaried workers (Hamilton 2000, Moskowitz and Vissing-Jorgensen 2002). Once lifetime earnings are taken into account, returns of entrepreneurs appear to be higher than those of salaried workers, while entrepreneurs bear only a little more risk than salaried workers.

Hamilton (2000) presents similar findings.
4.4 Propensity Score Matching

The comparison in the previous section was between never self-employed and ever self-employed individuals. Such analysis has important shortcomings. For example, people who become entrepreneurs late in life have earnings that are counted for the ever self-employed, while most of their earnings are coming before they became self-employed.

A more precise exercise is to compare earnings of an individual who chooses to become self-employed for the first time in year $t$ with someone who has never been self-employed and looks just like this individual in terms of observed characteristics but decides to remain as salaried worker.

An individual is considered a match to the individual that chooses self-employment if: (i) their earnings in year $t - 1$ are in the same percentile; (ii) their earnings growth between year $t - 2$ and $t - 1$ are in the same decile; (iii) their propensity scores in year $t - 1$ based on work experience, demographics, educational attainment, pre-labor market traits, industry, and year are in the same decile. If more than one individual is considered a match I use the mean of their earnings for the analysis.

Table 5 shows treatment and control groups means after matching. Two-sided t-tests indicate no significant differences at the 95% confidence level for each variable, highlighting the quality of the match.

![Table 5 about here.]

Figure 3 compares outcomes between treatment and control groups. As shown in the left graph, after becoming self-employed, individuals go through a couple of years with lower earnings but then in the subsequent years they earn on average approximately $4,000 more per year than similar individuals who decided to remain as salaried workers. The right graph shows that these differences are statistically significant in many of the years.

![Figure 3 about here.]

Figure 4 compares treatment and control groups conditional on the duration of entrepreneurship span. The upper-left graph shows the results for individuals whose self-employment spans

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*Results are robust to restricting matching to individuals who never become self-employed in their lifetime.*
last less than 2 years, while the upper-right graph shows the results for individuals whose self-
employment spans last more than 2 years. Individuals who attempt to be entrepreneurs but
abandon entrepreneurship in less than two years, are not punished, achieving approximately the
same earnings as similar individuals who have not attempted to be entrepreneurs. At the same
time, entrepreneurs who stay longer than two years, make substantially more than similar salaried
workers.

The lower graphs in Figure 4 show the difference between mean earnings of individuals in
the treatment and control groups around the decision to become entrepreneurs (time 0). In
the lower-left graph, the solid line shows mean difference earnings between individuals in the
treatment group who stay as entrepreneurs for less than two years and their pairs. The dashed
line represents 95%-confidence intervals. The lower-right figure is analogous for individuals in the
treatment group who stay as entrepreneurs for more than two years.

Figure 4 illustrates well the dynamic aspects of the gamble entrepreneurs face. If they fail
as entrepreneurs, they can always abandon entrepreneurship without significant costs. If they
succeed, they earn substantially more. As the figure shows, entrepreneurs who abandon self-
employment in less than two years have low earnings at time 0 relative to their matched pairs
who stayed as salaried workers. At subsequent times, after abandoning entrepreneurship, the
performance of these individuals is not significantly different from their matched pairs who were
never an entrepreneur. Entrepreneurs who decide to stay longer than two years, do not suffer as
much at time 0 and perform significantly better than their matched pairs

[Figure 4 about here.]

5 Additional Discussion

The model proposed in Sections 2 and 3 is a stylized model. There are several ways to enrich
the model, some of which could make the biases described here less severe. However, there are
also natural extensions that would make the biases more severe. For example, allowing agents
to live more than two periods would exacerbate the experimentation bias as agents that fail as
entrepreneur suffer only one period and have several periods ahead as salaried worker to recover
from this failure. The empirical implementation tests the main insights of the model but does not depend on its specific formulation.

Previous studies reached the conclusion that entrepreneurs earn less and bear substantially more risk than salaried workers relying at least in part on cross-sectional data analysis. However, they have attempted to mitigate some of the concerns raised in this paper. For example, Hamilton (2000) uses the 1984 Survey of Income and Program Participation (SIPP) which contains tenure in a particular job or business. He is thus able to estimate earnings profile as a function of tenure in a job or business. However, this still fails to correct for the attribution bias described in the current paper since it does not capture earnings after transitioning from self-employment to salaried work.

It might be possible to correct for some of the biases pointed out in this paper using cross-sectional data. However, in order to correct for all potential biases, cross-sectional surveys would need to ask more questions than typically available in such surveys. For example, one would need to ask whether and for how long an individual was an entrepreneur in the past to correct for the attribution bias. To get around this issue, this paper proposes correcting for these biases using longitudinal data. By following individuals over time, we can see whether they are experimenting and when they exercise their options, being thus able to value those.

One potential issue when comparing earnings of self-employed and salaried workers is the treatment of returns to capital. In the NLSY, respondents are likely to interpret the question on income as including both returns to labor as well as returns to capital. This is unlikely to pose a substantial problem, however, as most entrepreneurs do not invest large amounts of capital. In the 1992 Characteristics of Business Owners survey, 57% of small business require less than $5,000 of startup capital (U.S. Bureau of the Census, 1997).

Moreover, for the years of 1985 to 1990 and 1992 to 1998, the NLSY contains variables that allows one to calculate the owner’s equity value in the business. I follow the procedure described in Fairlie (2005) to calculate adjusted self-employed earnings by subtracting opportunity cost of equity. As in Fairlie (2005), this adjustment does not affect results significantly and, therefore, I use total earnings in my analysis.

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5See, for example, Figure 1 and Table 3 of Hamilton (2000) and Figure 2 of Moskowitz and Vissing-Jorgensen (2002).
We acknowledge that our matching approach of Section 4.4 has an important limitation since the choice to become entrepreneur is not an exogenous event. For instance, individuals with better future earnings potential may be more likely to become entrepreneur. Matching on a long list of individual characteristics, as we do in the paper, helps making this concern less stringent. The fact that entrepreneurs do poorly initially, as predicted by the model of entrepreneurship as experimentation is also comforting. Yet, in the absence of a proper source of exogenous variation in the probability to become an entrepreneur, our results may be subject to an endogeneity bias and should therefore be interpreted as descriptive more than causal.

The NLSY79 data used in the current paper is a household survey with no tax implications for respondents. In spite of that, Hurst, Li, and Pugsley (2014) argue that self-employed under-report their income by 25% in household surveys. Correcting for this under-reporting would make entrepreneurship even more attractive.

6 Conclusion

Previous studies showing that entrepreneurship does not pay fail to account for the option value of experimenting with new ideas. Using longitudinal data, I show that entrepreneurship is more attractive than suggested by such studies. Most entrepreneurs fail quickly and are able to limit their losses by moving back to the salaried workforce. Few entrepreneurs succeed but these earn significantly more than salaried workers with similar characteristics. Overall, I find that entrepreneurs earn approximately 10% more than salaried workers with similar characteristics.

Entrepreneurs in this paper are the ones who declared themselves as self-employed in NLSY. This definition is similar to previous studies of the returns to entrepreneurship. However, Hurst and Pugsley (2011) argue that these individuals are not necessarily the entrepreneurs that economic models and policy makers have in mind in that they have little desire to grow big or innovate in any observable way. For example, they may be small shopkeepers or restaurant owners. To the extent that even these shopkeepers and restaurant owners need to experiment with their business ideas, and have the option to abandon in case of failure, the results of the paper go through. Arguably, there is even more experimentation going on in more innovative startups. This would in principle only make results stronger. A study that looked at data restricted to these more
innovative startups would be an interesting avenue for further research.

The results of the paper are obtained for a particular cohort: individuals who were 14-22 years old in 1979. It is possible that for different datasets or cohorts results will be different. The National Longitudinal Survey of the Youth is following a new cohort whose respondents were 12-17 when first interviewed in 1997. It is too early to compute lifetime earnings for these individuals though.

However, Kerr, Nanda, and Rhoder-Kropf (2014) document a trend towards lower costs of experimentation in different industries. As argued here, the value of entrepreneurship arises from the real options that are available when experimenting with new ideas. A trend towards lower costs of experimentation is thus likely to make these options more valuable for more recent cohorts.

Another interesting topic for future research is that of serial entrepreneurs, i.e. workers with more than one self-employment spell. Serial entrepreneurs represent approximately 4% of the sample in this paper, and thus there is not enough statistical power to study them.

References


6See, for example, Astebro (2012) for a discussion of different datasets to study returns to entrepreneurship.


Figure 1: Comparing Cross-Sectional and Lifetime Earnings Distributions by Employment Type

The figure presents cross-sectional and lifetime earnings distributions for self-employed and salaried workers. The parameters of the model used to generate these distributions are: $W = 30$, $R = 60$, $p = 0.4$, $\gamma = 0.05$. The figures show that the cross-sectional self-employed earnings distribution is very different from the lifetime self-employed earnings distribution.
Figure 2: Duration of self-employment spells that start between 1979-2002

The figure presents the histogram of the distribution of the duration of self-employment spells that start between 1979-2002. Approximately 52% of self-employment spells last less than two years.
Figure 3: Using propensity score methods, individuals who choose to become self-employed (treatment group) are matched with individuals who stay as salaried workers (control group) based on earnings path before treatment, work experience, demographics, educational attainment, pre-labor market traits, industry, and year. The left graph shows mean earnings for treatment group (solid line) and control group (dashed line) around the decision to become self-employed (time 0). The right graph shows the mean difference between earnings of treatment and control groups (solid line) around the decision to become self-employed (time 0) and the corresponding 95%-confidence interval (dashed line).
Figure 4: Using propensity score methods, individuals who choose to become self-employed (treatment group) are matched with individuals who stay as salaried workers (control group) based on earnings path before treatment, work experience, demographics, educational attainment, pre-labor market traits, industry, and year. In the upper-left figure, the solid line shows mean earnings of individuals in the treatment group who stay as entrepreneurs for less than 2 years and the dash line shows mean earnings of the corresponding control group. In the upper-right figure, the solid line shows mean earnings of individuals in the treatment group who stay as entrepreneurs for more than 2 years and the dash line shows mean earnings of the corresponding control group. The lower graphs show corresponding mean differences between earnings of treatment and control groups (solid lines) around the decision to become self-employed (time 0) and the 95%-confidence intervals (dashed lines).
<table>
<thead>
<tr>
<th></th>
<th>Salaried</th>
<th>Self-Employed</th>
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<tbody>
<tr>
<td># of Observations</td>
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<td>5470</td>
<td>57773</td>
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<tr>
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<tr>
<td>White</td>
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<td>0.872</td>
<td>0.818</td>
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<tr>
<td>Female</td>
<td>0.510</td>
<td>0.385</td>
<td>0.498</td>
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<tr>
<td>Years of Schooling</td>
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<td>13.88</td>
<td>14.03</td>
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<tr>
<td>Weeks Worked</td>
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<td>46.65</td>
<td>46.39</td>
</tr>
<tr>
<td>Hours Worked</td>
<td>1964.0</td>
<td>2101.6</td>
<td>1977.1</td>
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<td>AFQT</td>
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<td>51.01</td>
<td>49.52</td>
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<td>Rotter Locus of Control</td>
<td>8.515</td>
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<td>Rosenberg Self-Esteem</td>
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<td>22.70</td>
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<td>Mean Annual Earnings</td>
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<td>Median Annual Earnings</td>
<td>37.36</td>
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<td>36.87</td>
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<tr>
<td>SD Annual Earnings</td>
<td>45.75</td>
<td>73.12</td>
<td>48.25</td>
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Table 1: Summary Statistics (Pooled Data)

The table presents summary statistics of 57,773 individual-year observations from 1980 to 2012 from the Bureau Labor of Statistics’ National Longitudinal Survey of the Youth 1979 (NLSY79). The sample excludes earnings from people who are less than 25 years old as well as earnings from people who do not work either as salaried or self-employed.
<table>
<thead>
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<th>Different Models</th>
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<tr>
<td></td>
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<tr>
<td>b/se</td>
<td>b/se</td>
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<tr>
<td>Residual Self-Employed Earnings</td>
<td>-0.002*** (-0.000)</td>
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<tr>
<td>AFQT</td>
<td>-0.002** (0.001)</td>
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<tr>
<td>Rotter Locus of Control</td>
<td>0.019** (0.008)</td>
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<tr>
<td>Rosenberg Self-Esteem</td>
<td>-0.000 (0.005)</td>
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<td>Pseudo R-squared</td>
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<tr>
<td>Observations</td>
<td>4785 4785</td>
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Table 2: Effects of residual earnings on transition away from self-employment
This table presents coefficient estimates for a probit model estimating how residual earnings affect the probability of abandoning self-employment. The sample is restricted to self-employed workers over 25 years old. Residual earnings are obtained from an OLS regression that controls for demographics, educational attainment, work experience, industry, and pre labor market traits. Heteroskedasticity robust standard errors clustered at the year level are reported and the symbols *, **, *** represent significance at the 10%, 5%, and 1% level respectively.
Table 3: Effects of previous self-employment experience on earnings
This table presents coefficient estimates for an OLS model estimating how a previous completed self-employment spell affects annual earnings for individuals between 25 and 55 years old working full-time, full-year. These regressions control for work experience as well as year and individual fixed effects. Heteroskedasticity robust standard errors clustered at the year level are reported and the symbols *, **, *** represent significance at the 10%, 5%, and 1% level respectively.

<table>
<thead>
<tr>
<th></th>
<th>Full Sample</th>
<th>Sub-Samples</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Currently Salaried</td>
</tr>
<tr>
<td></td>
<td>b/se</td>
<td>b/se</td>
</tr>
<tr>
<td>Previously Self-Employed</td>
<td>-0.286</td>
<td>5.161**</td>
</tr>
<tr>
<td></td>
<td>(1.505)</td>
<td>(2.181)</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.651</td>
<td>0.703</td>
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<tr>
<td>Observations</td>
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<td>33581</td>
</tr>
<tr>
<td></td>
<td>Never Self-Employed</td>
<td>Ever Self-Employed</td>
</tr>
<tr>
<td>--------------------------------</td>
<td>---------------------</td>
<td>--------------------</td>
</tr>
<tr>
<td># of Observations</td>
<td>3863</td>
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</tr>
<tr>
<td>White</td>
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<td>0.843</td>
</tr>
<tr>
<td>Female</td>
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<td>0.452</td>
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<tr>
<td>AFQT</td>
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<td>49.62</td>
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<td>Rotter Locus of Control</td>
<td>8.614</td>
<td>8.331</td>
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<tr>
<td>Rosenberg Self-Esteem</td>
<td>22.39</td>
<td>22.69</td>
</tr>
<tr>
<td>Mean Annual Earnings</td>
<td>40.46</td>
<td>42.77</td>
</tr>
<tr>
<td>Median Annual Earnings</td>
<td>36.11</td>
<td>34.67</td>
</tr>
<tr>
<td>SD Annual Earnings</td>
<td>34.48</td>
<td>41.79</td>
</tr>
</tbody>
</table>

Table 4: Summary Statistics (Lifetime)

The table presents summary statistics of 5,415 individuals from 1980 to 2012 from the Bureau Labor of Statistics’ National Longitudinal Survey of the Youth 1979 (NLSY79). The sample excludes earnings from people who are less than 25 years old.
<table>
<thead>
<tr>
<th></th>
<th>Treatment</th>
<th>Control</th>
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<tbody>
<tr>
<td>Age</td>
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<td>30.08</td>
</tr>
<tr>
<td>White</td>
<td>0.90</td>
<td>0.89</td>
</tr>
<tr>
<td>Female</td>
<td>0.49</td>
<td>0.51</td>
</tr>
<tr>
<td>Year of Schooling</td>
<td>14.30</td>
<td>14.26</td>
</tr>
<tr>
<td>Work Experience</td>
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<tr>
<td>AFQT</td>
<td>55.24</td>
<td>55.01</td>
</tr>
<tr>
<td>Rotter Locus of Control</td>
<td>8.26</td>
<td>8.28</td>
</tr>
<tr>
<td>Rosenberg Self-Esteem</td>
<td>22.77</td>
<td>22.69</td>
</tr>
<tr>
<td>Previous Period Earnings</td>
<td>29.80</td>
<td>29.81</td>
</tr>
<tr>
<td>Previous Earnings Growth</td>
<td>1.51</td>
<td>1.53</td>
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</tbody>
</table>

Table 5: Matching quality
This table reports mean values of treatment and control observable characteristics used in the matching procedure. Two-sided t-tests on the difference between mean values between treatment and control groups indicate no significant differences at the 95% confidence level for each variable.