

# Excessive Firm Turnover in the Shadow of Unemployment

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Job Market Paper

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## Abstract

This paper studies how pecuniary self-employment affects business cycle dynamics, macroeconomic efficiency, and the outcomes of structural reforms. I employ a two-sector dynamic general equilibrium model with endogenous producer entry. One sector (the “hiring sector”) is populated by monopolistically competitive firms that employ workers subject to search-and-matching frictions in order to produce output. The other sector consists of self-employment firms that use the output of the first sector as input. Self-employment is introduced as a possible occupational choice for the unemployed. This feature relates firm creation more directly to the state of the labor market and to workers’ opportunity costs. Consistent with the U.S. data, the model shows that self-employment represents 7.4% of employment and is procyclical. The procyclicality of self-employment arises because positive productivity shocks in the hiring sector cause profits for the self-employed to rise strongly enough that additional unemployed workers are drawn into self-employment, despite tighter labor market conditions and a competing incentive to seek traditional employment. Novel sources of inefficiency exist since neither workers nor firms internalize the consequences of self-employment. As a result, the number of firms is more volatile and welfare costs of business cycles are higher in the presence of self-employment dynamics. Furthermore, I show that reforms facilitating entry in one or the other sector are more effective when the self-employed are relatively less productive or have greater monopoly power.

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