

Originally presented at the Conference *Self-Employment and Entrepreneurship* organized by
The Economic Council of Sweden, Stockholm, March 22, 2004.

Is More Self-Employment Good or Bad? Comment on David Blanchflower

by

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August 18, 2004

Summary: This comment provides a critical evaluation of Blanchflower's (2004) survey of various aspects of self-employment and his overall normative conclusion that "more may not be better". In order to draw normative conclusions regarding the optimal level of self-employment a number of issues ignored by Blanchflower need to be addressed. First, self-employment may or may not be entrepreneurial. Second, it could be a second-best solution to institutional deficiencies at either the firm or the social level. Third, one should distinguish between rent seeking and productive activities. Fourth, over time and across industries the optimal level of self-employment is likely to vary for structural and technological reasons. Fifth, questionnaire evidence on self-reported relative satisfaction should be interpreted with caution. After all, by volitionally choosing self-employment the individual in question has revealed her preferences.

JEL Classification: M13; J20; H30; O12.

Keywords: Economic growth; Entrepreneurship; Innovation; Self-employment.

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* The author gratefully acknowledges useful comments and suggestions from Jesper Roine and financial support from the Jan Wallander and Tom Hedelius Research Foundation.

1. Introduction

David Blanchflower (2004) provides an extraordinarily rich and comprehensive survey of an enormous body of research on self-employment. The survey mostly focuses on the level of the individual and deals with issues such as perceived impediments to self-employment, cultural differences in the propensity to be self-employed, whether people maintain that they would like to be self-employed and how the self-employed feel relative to wage-earners.

The survey is highly useful in many respects, but what are the implications? For specific individuals? For society? Can we draw any normative conclusions from David Blanchflower's extensive survey? In particular, is it possible to conclude that "[m]ore doesn't seem to be better."

The purpose of this comment is to critically evaluate this bottom-line conclusion drawn by David Blanchflower. This will be done by looking more closely at the concept of self-employment. Both the individual and the social level will be dealt with.

2. Why is there any self-employment at all?

In the empirical literature on the determinants of the supply of self-employment a distinction is often made between *pull* and *push* factors (Storey 1994). An individual can either be pulled into self-employment in order to pursue a business opportunity (rather than having a regular job) or he/she can be pushed into it because there is no better choice for work or for making a living. Reynolds *et al.* (2002) explicitly distinguish between "opportunity-based" and "necessity" entrepreneurship in their annual effort (*Global Entrepreneurship Monitor*) to measure the rate of entrepreneurial activity across countries.

Reynolds *et al.* somewhat misleadingly use the term entrepreneurship rather than self-employment. Entrepreneurship has a more specific connotation. A useful definition could be the following (Wennekers and Thurik 1999): the ability and willingness of individuals, both on their own and within organizations to: (i) perceive and create new economic opportunities; (ii) introduce their ideas in the market, in the face of uncertainty and other obstacles, by making decisions on location, form and the use of resources and institutions; and (iii) compete with others for a share of that market.

Thus, in order for an activity to be defined as entrepreneurial it needs to be novel at least in some sense, but whether it is novel because it applies new knowledge or uses existing knowledge in new ways does not matter. But there must also be an ambition to grow. As a result, one cannot define entrepreneurship as self-employment or firm formation *per se*. A person may be entrepreneurial both in his/her role as business owner/self-employed or as an employee (intrapreneur) – see Table 1.

Table 1 Entrepreneurs, intrapreneurs and managers.

	Business owner	Employee
Entrepreneurial	Innovator, risk taker	Intrapreneur
Managerial	Lacks ambition to grow and/or change	Manager

Source: Adapted from Wennekers and Thurik (1999).

Hence, there are several reasons for self-employment in the literature, and it is driven by necessity, by entrepreneurial ambition or by a strive for personal independence. At the same time, one of the most clearly documented facts in labor economics is that wages and other benefits rise with the age, capital intensity and – especially – the size of employers (e.g., Brown and Medoff 1989, and Davis, Haltiwanger and Schuh 1996). Researchers have managed to show that part of this size-wage effect can be attributable to observable characteristics of workers. Still, one may ask why is not everybody employed in large firms? There must be some snag? One possibility is that at the individual level the measurable, largely monetary, advantages cannot compensate for unmeasurable factors such as independence, flexibility and so on. Based on numerous surveys David Blanchflower also asserts that there are allegedly advantages at the individual level to be self-employed, but at the same time the self-employed claim that they are less satisfied with the hours they have to work, they find their work stressful, they come home exhausted, they have too little time with their family, they sleep too little, they often feel unhappy and depressed, their partner/family gets fed up with the pressure of their job and a host of other unpleasant things.

David Blanchflower intimates that the self-employed may not be doing the right thing, and by implication the strong wish expressed by so many to be in charge of their own company – 71 percent in the U.S., 64 percent in West Germany and 39 percent in Sweden and so on – could

be based on misjudgment and wishful thinking. Still, hinting that people are not the best judges of their own true preferences is rather unusual in mainstream economics. I will revert to the individual level in section 4.

More importantly, from a societal perspective the aggregate level of self-employment, measured as self-employment as a share of total employment, is not necessarily a meaningful measure. In order to evaluate whether there is too much or too little self-employment one needs to decompose the aggregate.

3. Fundamental reasons for self-employment

From the discussion in section 2 one may infer that there are fundamental reasons for a person to choose self-employment rather than salaried employment. It may be useful to distinguish between first-best and second-best solutions, as well as whether the self-employed is entrepreneurial or non-entrepreneurial. A further important distinction is whether the self-employed pursue productive or rent-seeking activities (Murphy, Shleifer and Vishny 1991). The various combinations are exemplified in Table 2.

Table 2 Self-employment – a typography.

	Entrepreneurial	Non-entrepreneurial
First best	Pursue a business opportunity most suitably pursued in a new firm	1. Seeking independence, a certain life style etc. 2. Local service production; working in networks in temporary projects
Second best	1. Necessity entrepreneurship 2. Inferior management by current employer bars efficient intrapreneurship 3. Mechanism to escape effect of discrimination or lack of social capital for marginal groups	1. Safety valve to circumvent excessive labor market regulations 2. Means to achieve flexibility hindered by other regulations 3. Mechanism to escape effect of discrimination or lack of social capital for marginal groups
Rent seeking	Set up a business to exploit subsidies and tax breaks rather than create value for customers	1. Transform consumption expenditure into deductible business costs 2. Fraudulence, where revenue is partly unreported etc.

Note: The table lists the major motives for self-employment. Entrepreneurial self-employment may be partly pursued in search for independence, and fraudulent rent-seeking may also be entrepreneurial (Baumol 1990).

In a world where institutions were such that there were no rent-seeking opportunities and where productive entrepreneurship could always be pursued efficiently within existing firms, the only reason to be self-employed would be the personal quest for independence. However, this (ideal?) state of affairs is far from reality. In fact, the long period during which large firms had predominated while small firms had been increasingly marginalized came to an end in the 1970s. Entrepreneurship and small firms experienced a global resurgence (Brock and Evans 1986; Loveman and Sengenberger 1991). Scholars have suggested several reasons why this occurred:

- (i) Technological change in recent decades has resulted in a dramatic reduction in transaction costs in the market, which has led to increased specialization across firms and sharper focus on each firm's core activity. Outsourcing and corporate downsizing are concrete manifestations of this change (Carlsson 1999; Piore and Sabel 1984). Hence, the Coasian demarcation line between hierarchy and market (Coase 1937) has shifted towards a greater use of markets.
- (ii) Since the 1960s, there has been a sizeable shift away from industries characterized by large firms and establishments (manufacturing, extraction, construction) towards service industries where firms and establishments tend to be smaller (see, e.g., Davis, Haltiwanger and Schuh 1996).
- (iii) In tandem with increased incomes, consumers have come to demand more differentiated products rather than standardized products suitable for large-scale production and distribution (Piore and Sabel 1984; Carree and Thurik 1999).
- (iv) In many cases, large, mature firms cannot introduce genuinely new products and production methods efficiently. In the long run, radically new technology is required to sustain a high growth rate, since firms in other countries at lower income levels will sooner or later imitate current technologies. Large firms often excel in increasing productivity in the manufacture of existing products, while totally new products are often produced more efficiently in newly established firms, which have been started with the purpose of producing these very products (Baldwin and Johnson 1999; Audretsch 1995; Baumol 2002).
- (v) Small entrepreneurial firms can often act as crucial *agents of change*. Such firms are also motivated to grow and, hence, they are likely to play a particularly important role in the growth process (Audretsch 1995).
- (vi) The small-business sector can function as an inexpensive mechanism for identifying and developing entrepreneurial and managerial talent (Lucas 1978).

The first three factors indicate that more goods and services than previously are produced more efficiently in smaller firms and establishments – for structural as well as technological reasons. The last three factors are more dynamic. They imply that to a greater extent than before, small and new firms are better suited for contributing to technological and organizational renewal. As a result, growth is profoundly manifested by the expansion of

small entrepreneurial firms with viable business concepts (Birch and Medoff 1994).¹ In particular, it has been stressed by many (e.g., Holmström 1989) that it is likely that small firms have a comparative advantage in innovative activity.²

Hence, a willingness to become self-employed is likely to be more important today than in the 1950s and 1960s in order for society to reap the full benefits of available business opportunities. Moreover, labor markets are highly regulated in many western countries, which tends to increase the value of a wage contract. In fact, it may be so attractive that few employers are prepared to offer such contracts. Examples of industries where this is common is hairdressing, entertainment, writing and taxi driving. Self-employment in effect implies a labor contract where hourly pay and working hours are totally unregulated and where there are no job security mandates, while a permanent employment contract in countries like Sweden, Germany and France is at the opposite end of the spectrum.

The conclusion from the discussion in this section is straightforward. The aggregate level of self-employment in a country is the result of a number of effects. Due to heavy labor market regulations people who would prefer a salaried job may be forced into self-employment. Rigid management practices may discourage productive intrapreneurship, and as a consequence force entrepreneurial individuals into self-employment. Or, effective labor taxation may be high on wages relative to business income, where there may be opportunities to evade taxation, encouraging individuals to be self-employed to a degree that is socially excessive. At the same time, self-employment provides a second-best solution that spurs economic activity that would not have materialized otherwise. Moreover, given the changes in structural conditions since the 1970s noted above, society needs to benefit from the entrepreneurial talent and insights that resides in some people. In many cases this is best done within a new firm founded by somebody who is currently an employee.

¹ Blanchflower (2004) refers to Davis, Haltiwanger and Schuh (1996) to make the case that new and small firms may not contribute disproportionately to employment growth. However, the validity of this result has been questioned by many – in particular, see Davidsson, Lindmark and Olofsson (1998).

² Holmström (1989) notes that agency costs associated with innovation are likely to be high, since innovation projects are: (i) risky (high risk for failure, but also unusually large prospects for extraordinary returns); (ii) unpredictable (many contingencies are impossible to foresee); (iii) long-term and multi-stage; (iv) labor intensive (effort/motivation of specific individuals is crucial); (v) idiosyncratic (comparability with other projects is low).

In short, from a social perspective it is hard to claim that there is an optimal rate of self-employment. A certain institutional structure, like the one in Italy, appears to demand a larger rate of self-employment rate than the more deregulated structure in the UK, for instance, in order to produce similar average income levels.³ A shortage of entrepreneurship, given the institutional structure is also likely to have harmful effects in that it may be expected to diminish competition with detrimental effects on static efficiency and competitiveness of the economy and diminish variety, learning and selection and thereby harm dynamic efficiency/innovation (Carree *et al.* 2002). At the same time, it is always true that excessive self-employment results in scales of operation that are too small from an efficiency perspective.

4. Human choice is context-dependent

Economists usually focus on the study of people's actual choices rather than what they say they would do. Many self-employed apparently say that they feel stressed and would like to work less in order to spend more time with their family, take more active interest in what is going on in their home etc. But are these answers credulous, or are they largely the result of what others expect them to say? Would it be welfare-improving if the self-employed were forbidden to work long hours, just like trade unions forbid overtime exceeding certain limits for workers? Analogously, would it be a good solution to force highly prolific professors at American top universities to work no more than (say) 45 hours a week and force them to take at least four weeks off per year? That would certainly release a great deal of time that could be spent with the family, but would they be their agreeable self or would they be fuming about all the embryonic papers in their head that they are not allowed to develop?

Economists are becoming increasingly aware that human choice is often context-dependent. Choice that trained economists deem equivalent may be treated far from equivalently by agents in the real world. Thaler and Sunstein (2003) exemplifies this by pointing out that considerably more people choose to join a pension plan when it is presented as an opt-out choice rather than an opt-in choice, and people are more likely to refrain from adding a dessert to their meal in a cafeteria if it is placed after the main dishes.

³ Blanchflower (2004) reports that education is positively correlated with self-employment in the U.S., while the opposite pattern is found in Europe. This provides indirect evidence in support of this institutional hypothesis. It may be noted that one reason why there are so few female top executives in large U.S. firms is that "the lure of entrepreneurship" provides an attractive alternative career for high-achieving women (Wells 2001).

David Blanchflower’s questionnaire evidence is also likely to be highly context-dependent, the context varying across countries and over time. Let me illustrate this by taking a striking example from Sweden. Table 3 reports the results from a questionnaire where a representative sample of individuals were asked about their attitudes towards entrepreneurship and business conditions. In 1978 only 30 percent of the respondents believed that it was important to encourage entrepreneurship and firm formation. In the 1980s people’s attitude on this issue changed dramatically and by the mid 1980s approximately four quarters thought this was important. There was also a brief period in Sweden, during the IT-boom in the mid to late 1990s, when self-employment was in vogue, in particular with the young. Puranen (2000) reports that among young people the attitudes towards self-employment and private industry were extremely favorable around 1997 – 77 percent of young women and 84 percent of young men could consider starting their own firm. In a 1998 opinion poll, the TEMO institute found that 78 per cent of males and 67 per cent of females aged 20–24 could consider starting up their own business.⁴

Table 3 Results from a longitudinal study of attitudes towards entrepreneurship.

Question: Is it important to encourage entrepreneurship and firm formation? Share of respondents believing that it is important:

Year	1963	1967	1978	1981	1985	1997
Share (%)	50	41	30	72	74	88

Source: Henrekson and Jakobsson (2001).

Given time and place it is still true that attitudes to entrepreneurship can vary across ethnic groups. A great deal of evidence to this effect is also reported by David Blanchflower. The variation across ethnic groups is enormous also in Sweden – see Figure 1, which demonstrates remarkable differences across different ethnic groups in entrepreneurial inclination. This high variation makes it difficult to invoke discrimination across the board as an explanation.

Apparently, informal learning and support (including financial support from parents, relatives and friends) is important to become a successful entrepreneur (Matthews and Moser 1995; de Wit and van Winden 1989). Likewise, it further illustrates the point that alleged preferences

⁴ Reported in *Dagens Nyheter* May 30, 1998 in an article entitled “Många redo för ett liv utan fast jobb“ written by Bosse Andersson.

are context-dependent. The attractiveness of becoming self-employed varies greatly across groups, and this variation may be difficult to attribute to differences in standard explanatory variables such as the degree of discrimination in the labor market.

Figure 1 Number of firms per 1000 inhabitants in Sweden among people born outside Sweden, 1991.

Enclosed

Source: SOU 1996:55.

In short, given external and internal institutions, people choose to become self-employed and I believe we need quite strong evidence in addition to their own assertions before we draw normative conclusions about the appropriateness of their choice. Moreover, one can always assert that the very choice to become self-employed – in particular in countries with generous welfare systems – reveals that person's preferences, and the fact that they say that their choice prevents them from having and doing other things is a tenuous basis for suggesting that life as a wage-earner would be better for them.

5. Concluding remarks

David Blanchflower has presented an extensive survey of the enormous literature on micro evidence of determinants of self-employment as well as questionnaire evidence of the reported well-being of self-employed relative to wage-earners. He also reports evidence suggesting that there is no positive link between rates of self-employment and aggregate growth rates or average income.⁵ Taken together, this leads him to the conclusion that more self-employment may not be better. In this comment I have made other distinctions and drawn on other types of research that provides a complementary picture. This boiled down to the overall conclusion that in order to draw any normative conclusions regarding the optimal level

⁵ Carree *et al.* (2002) arrive at the opposite conclusion, or rather they find a U-shaped relation between the rate of self-employment and the level of income per capita. The negative correlation reported by David Blanchflower may be spurious. Assume that inappropriate institutions in a country increases transaction costs by impeding efficient contracting in the labor market, this may lower growth and increase self-employment at the same time. The slow growth rate may then erroneously be attributed to excessive self-employment rather than to institutional deficiencies. Given this caveat, Blanchflower's (2004) categorical conclusion regarding the macroeconomic effects of a high level of self-employment ("More is not better.") should be called into question.

of self-employment one needs to look deeper into the specific institutional and/or situational context.

Let me round off by some concluding remarks regarding some important issues that are relevant when discussing the role of self-employment in the economy. Most fundamentally, can we imagine a dynamic society consisting (almost) exclusively of wage-earners? I find this highly unlikely, and in this comment a broad body of literature has been invoked to make this point.

In the static view of the economy that has been predominant in neoclassical models, firms exist exogenously and no attempt is made to explain why they came into existence (Barreto 1989; Bianchi and Henrekson 2004). In this setting suboptimally large firms at a given point in time appears very costly in terms of social welfare. But in an entrepreneurial society where value is often appropriated outside the boundary of existing firms, new startups are necessary. Entrepreneurial selection needs to take place in the market due to both uncertainty regarding the viability of the idea and the competence of the entrepreneur given the idea (Audretsch 1995, 2002). If some firms are going to reach the minimum efficient scale, both high birth and death rates of firms may be necessary.

Already Hayek (1945) forcibly argued that information/knowledge is incomplete and highly decentralized. Moreover, knowledge is not just *codifiable* knowledge. The knowledge that is tied to a certain individual, location, point in time and/or specific circumstance is crucial. But how should knowledge be utilized if it is not given to anyone in its totality?⁶ Virtually every individual has some advantage relative to other individuals in that this individual has some unique information that can be used in an advantageous/profitable way (Kirzner 1997; Martens 2004). However, this can only take place if the decisions that depend on this information are given to that person or are taken in close cooperation with that person. As a result, entrepreneurial opportunities tend to appear within the context of a specific time and place. Thus, “a decentralized economy” that allows individuals to act on their entrepreneurial insights, and rewards them for doing so, produces an environment where additional entrepreneurial insights are likely to be produced. Entrepreneurship then becomes the foundation for growth and renewal since entrepreneurial insights lay the foundation for

⁶ See Rosen (2002) for a modern formulation of this problem.

further such insights, which drive the growth process. These effects should therefore, in this view, be weighed against the scale economies traditionally emphasized in economics.

In short, the economy may have to be studied through an evolutionary lens to detect important dynamic aspects of production and growth. Some of the small, “suboptimal” firms of today will become the large and optimally-sized firms of tomorrow, capable of paying high wages and offering attractive benefit packages.

In the best of worlds, with a whole range of streamlined institutions that minimize transaction costs by facilitating all types of contracting on mutually beneficial terms, minimize principal-agent problems in existing firms and strongly deter all kinds of opportunistic behavior on the part of economic and political agents, the optimal rate of self-employment may be very low. However, the world is replete with institutional inefficiencies and self-employment is often the best available means to deal with these imperfections. After all, in order to be a wage-earner it is necessary to find an employer who is willing to hire you, and the terms for this hiring are subject to a great many restrictions in most countries.

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Figure 1. Number of Firms per 1000 Inhabitants in Sweden among People not Born in Sweden, 1991

