



1 Million Missing Entrepreneurs

What Data Reveal About the Lost Class of American Entrepreneurs and Solutions to Bring Them Back

By Jennifer Erickson and Adam Hersh May 2015

New research shows that from 2002 to 2008, the percentage of business-owner households dropped so considerably that the U.S. economy had 1 million fewer entrepreneurs than it would have had if it had kept pace from the 1990s.¹ In the 2000s—as the middle class faced increased pressures and the nation experienced rising inequality²—fewer people took the leap to become entrepreneurs, and more entrepreneurs closed down shop for other forms of employment. Furthermore, in his new paper, World Bank economist Camilo Mondragón-Vélez warns of “entrepreneurship [becoming] a viable option only for those with higher income and wealth levels.”³

Entrepreneurship is a key driver of U.S. economic growth and leadership in the world economy, and economic research shows that the middle class plays a central role in it.⁴ It is also evident that a vast swathe of U.S. society has felt a tightening financial squeeze over the past several decades.⁵ But what is truly striking, and what should give both policymakers and venture capitalists pause, is that these 1 million entrepreneurs—representing more than the population of San Francisco or Boston—were missing even before the full effects of the Great Recession hit. In the wake of the recession, the percentage of business-owned households dropped even further.⁶

To be sure, the mid- to late 1990s was a time when Internet-driven information technology enabled the creation of many new companies that transformed our economy, and we should take care in drawing conclusions from any one set of data or time period. But entrepreneurship covers a vast swathe of businesses—from main street businesses to small startups and solo practitioners operating out of home offices. And the 2000s, with their boom in real estate construction, had no shortage of potential for new small businesses as well.

This issue brief highlights the findings of new research on the pressures facing U.S. entrepreneurship, explaining how the strength of the middle class and entrepreneurship are related and offering policy recommendations that will set the stage for entrepreneurial success.

New research on the middle class and entrepreneurship

A new Center for American Progress report from Mondragón-Vélez analyzes the factors that affected entrepreneurship through 2011. In “How Does Middle-Class Financial Health Affect Entrepreneurship in America?”, Mondragón-Vélez analyzes data from the Panel Study of Income Dynamics and finds that the difficulty middle-class families experienced in financing new business ventures constrained entrepreneurship to older, higher-educated, higher-wealth households.⁷

His analysis details three particularly important points:

- **One million entrepreneurs are missing from the U.S. economy relative to the percentage of business-owner households in the 1990s.** Business creation rates stalled from 2002 to 2008, while business failure rates increased. This occurred even as regulatory and tax policies shifted toward the supply-side economic focus of the 2000s, which professed to be good for business.⁸ Mondragón-Vélez writes:⁹

As middle-class families' incomes stagnated, ... the average percentage of business-owner households dropped to 12.4 percent from 2002 to 2008 and again to 11.8 percent in 2010. The net effect is equivalent to a loss of more than 1 million business-owner households compared to the previous decade.

- **There is now a wider wealth gap between new business owners and their median worker peers.** In the 1980s and 1990s, “new business owners only had 1.7 to 2 times more wealth than their median-wage worker peers.” By the 2000s, this number had jumped to two to three times more wealth. As Mondragón-Vélez notes, “limited wealth accumulation capacity has been gradually making entrepreneurship in America a luxury type of good, mainly available to individuals with high incomes and a high net worth.”¹⁰
- **Entrepreneurs are waiting longer before starting a venture.** New entrepreneurs in the 2000s waited an average of seven years longer than new entrepreneurs in the 1980s to start their own businesses. The median age of a new business-owned household jumped from 38 years old in the 1980s to 45 years old in the 2000s.¹¹

Given that middle-class families account for 60 percent of new business ventures, “their increasing financial stress partly explains the stagnation of business-creation rates in the 2000s compared to the late 1990s.”¹² Mondragón-Vélez argues that the effects of a financial squeeze on the middle class are clear:¹³

Flat income for the majority of families deterred the American middle class from accumulating much in the form of non-real-estate wealth during the 2000s. This ultimately translated into lower possibilities to save and accumulate financial capital in order to overcome potential liquidity and credit constraints for many of those willing to start new businesses.

Put simply, anyone concerned about the importance of entrepreneurship for the American economy should also be concerned about the strength of the nation's middle class.

The relationship of the middle class to entrepreneurship

Research shows that the majority of American entrepreneurs come from middle-class families.¹⁴ Beyond the statistics, economists Heather Boushey and Adam Hersh outline why the middle class is particularly important to entrepreneurship:¹⁵

- A strong middle class promotes broader access to the education, skills, and experience needed to start a successful business.
- A strong middle class provides fertile ground for would-be entrepreneurs and allows them reasonable expectations of success by creating strong and stable demand in the overall economy.
- A strong middle class ensures that families can sustain the financial risks associated with starting a new business while their dreams take shape.

Promoting broad access to the education and skills necessary for entrepreneurship

In his report, Mondragón-Vélez shows that approximately two-thirds of new U.S. entrepreneurs have some college education. This is significantly higher than educational attainment of the U.S. population overall.¹⁶ In fact, the probability is significantly higher that more educated workers—independent from their level of wealth—will become entrepreneurs. According to a separate study by Mondragón-Vélez, “the transition probability for the college educated is 50-100% higher than that of the non-college educated for most of the wealth distribution.”¹⁷

The connection between education and entrepreneurship is evident, but what about the connection between education and the strength of the middle class? In the United States, the data indicate that opportunities for people to accumulate human capital—and the higher incomes that come with it—are increasingly being passed from parents to children through social channels, as opposed to biologically inherited traits.¹⁸ The failure of the U.S. education system to provide broad access to quality, affordable education means that individuals are economically rewarded by their socioeconomic statuses, not just their skills and productivity. This constrains the less privileged from creating and contributing their own entrepreneurial initiatives to the U.S. economy.

Supporting strong and stable demand, which supports entrepreneurship

Demand is critical to the success of any business, whether existing or new. As the past generation has seen a dramatic rise in inequality and increased pressures on the middle class, new questions have been raised about the stability of demand.

As Boushey and Hersh pointed out, the health of the middle class affects aggregate demand:¹⁹

- Different tendencies to spend—the “marginal propensity to consume”—at varying levels of income and wealth mean that high inequality weakens aggregate demand.
- Changes in the distribution of income—across households, and between profits and worker wages—affect the stability of aggregate demand.
- Having a large middle-class markets create business synergies and spillovers that benefit economic growth.

All of these economic points can be summarized simply: To be successful, entrepreneurs need consumers who are able to buy what they are selling. As venture capitalist Nick Hanauer wrote in Bloomberg Businessweek, “only consumers can set in motion a virtuous cycle that allows companies to survive and thrive and business owners to hire.”²⁰ To have a vibrant environment where entrepreneurs can build successful businesses, we need a vibrant middle class.

Ensuring that families have access to resources to sustain entrepreneurs

Risk is inherent in entrepreneurship; policy cannot and should not seek to eliminate it. But there are economic risks associated with becoming an entrepreneur that are independent from a venture’s business risk and an entrepreneur’s ability. Entrepreneurs face greater risks of inconsistent income flows and substantial wealth losses, as well as less access to affordable health care. As Nobel Prize-winning economist Robert Shiller points out, market institutions typically do not provide entrepreneurs with ways to self-insure against such risks,²¹ which undeniably deters some prospective entrepreneurs with otherwise economically sound business ventures.

The effects of health care access provide a clear example of how mitigating certain risks can encourage entrepreneurship. Individuals with access to employer-provided health insurance through a spouse—a situation much more common in middle-class families than in low-income families—are significantly more likely to become self-employed; husbands are 14 percent more likely, while wives are 7 percent more likely.²² A study by econ-

omist Robert Fairlie and his co-authors found that accessing Medicare at age 65 made men more likely to own a business than men just younger than age 65.²³ In other words, changing just one risk—health care access—led to an increase in entrepreneurship.

The following policies address how to strengthen the middle class and, with it, the next generation of entrepreneurs.

Policy recommendations for entrepreneurial success

Given the importance of the middle class in feeding America’s entrepreneur pipeline, policies that strengthen and expand it should be at the top of the economic agenda. Some of the policies that follow will have an effect on the pipeline of entrepreneurs over the longer term, such as investments in education, while others will have a more immediate effect, such as fixing our immigration system and welcoming new entrepreneurs. Many of the policies described below are part of CAP’s long-term growth plan, as described in *300 Million Engines of Growth*.²⁴

Access to high-quality education

Ensuring that students with interest and ability are able to access the higher-education system is central to building America’s pipeline of future entrepreneurs. Over the past generation, the inflation-adjusted cost of a public four-year college degree has increased by 250 percent.²⁵ In order to remain economically competitive, the United States needs to boost its postsecondary education attainment by ensuring that all American students can pursue a college education. This plan—which CAP calls College for All—will guarantee that every high school graduate receives the financial support needed to attend college.²⁶ To make college more affordable, states need to reinvest in higher education through the enactment of a Public College Quality Compact.²⁷ To provide access to high-quality higher education, policymakers need to expand and improve the U.S. Department of Education’s College Scorecard, so that it is a central repository of easy-to-read information on average net price, graduation rates, and earnings after graduation.

Colleges should also be required to use understandable, standardized financial aid letters.²⁸ New mechanisms need to be created that support students’ transition from high school to college, including expanding college-ambassador programs based on the National College Advising Corps. This will allow college seniors to receive federal work-study funding by working as trained counselors for low-income, first-generation high school students.

And when we think about the longer-term pipeline of entrepreneurs, it is difficult to dispute that having only about one-third of eighth-grade students proficient in math and reading²⁹ is a problem for the future. If American lawmakers are truly interested in the future of U.S. entrepreneurship, then they should ensure that access to high quality education begins in early childhood.³⁰

Access to capital

Entrepreneurs need more than ideas to innovate; they need capital as well. Even in the United States' well-developed financial system, many people remain excluded from credit markets or cannot receive the amount of credit they desire. Would-be entrepreneurs often must rely on self-financing, at least initially, and regularly draw on their own savings to finance a new venture.

A Cleveland Federal Reserve Paper shows that one in four small-business owners used home equity to finance their businesses, by either pledging their homes as collateral or borrowing against them.³¹ A 2013 Small Business Administration report shows that “personal wealth, primarily through home ownership, decreases the probability of loan denials among existing business owners,” noting that personal wealth “may be even more important for entrepreneurs in acquiring startup loans.”³² Considering between 11 percent and 17 percent of homeowners now have mortgages higher than their homes are worth,³³ this is undoubtedly having an effect on some entrepreneurs' ability to start or grow their businesses.

The 2012 Jumpstart Our Business Startups, or JOBS, Act was designed in part to offer new funding streams for entrepreneurs and small businesses. How successful it will be in this endeavor depends on how regulations are written and how capital markets adjust to this new legislation. Unquestionably, however, there is more that can be done to assist entrepreneurs. Particularly, policymakers can work to repair the damage to the housing market.

Much more needs to be done to repair this damage, and policymakers can aid potential entrepreneurs by taking the following steps:

- Assisting current homeowners by requiring lenders to forgive the underwater portion of mortgage balances if it would return more value to investors than foreclosure
- Require Fannie Mae and Freddie Mac to support a healthier and more equitable housing market by increasing access to and affordability of mortgages, providing struggling borrowers with better loan modifications that include principal reductions, and capitalizing the National Housing Trust Fund and Capital Magnet Fund³⁴

Portable benefits that prevent job lock

While grappling with a degree of financial uncertainty is inevitable for potential entrepreneurs, concern over loss of benefits can be a significant deterrent from leaving a job. This phenomenon is known as job lock. Given the daunting cost of health care and the fact that the majority of Americans have health care through employer-based systems,³⁵ health care is one of the most critical benefits to make portable. More specifically, research shows “evidence that ‘entrepreneurship lock’ exists, which raises concerns that the bundling of health insurance and employment may create an inefficient level of business creation.”³⁶

A 2009 Council of Economic Advisers report noted that health care reforms that expand available coverage “could help spur entrepreneurial activity by increasing the incentives for talented Americans to launch their own companies, and could increase the pool of workers willing to work at small firms.”³⁷ Effective and timely implementation of the Affordable Care Act could play a significant role in removing this barrier to entrepreneurship.³⁸ Additionally, by offering more universal and portable retirement benefits through hybrid retirement plans—such as CAP’s Secure, Accessible, Flexible, and Efficient, or SAFE, Retirement Plan—policymakers could do even more to ensure that workers and their families have more security as they start new ventures.³⁹

Fixing the immigration system and welcoming aspiring Americans

Immigration has been a huge boon to America’s entrepreneurialism. Immigrants are twice as likely as native-born Americans to start a new business.⁴⁰ They or their children have also founded 40 percent of the country’s Fortune 500 companies, from Ford to Google.⁴¹ Immigration is a powerful force in today’s job market, with immigrant-owned businesses employing 1 in 10 American workers in the private sector. Furthermore, immigrants founded 28 percent of all new U.S. companies in 2011.⁴² Creating an immigration system that is safer and more easily understood is central to U.S. entrepreneurial prospects. The United States must offer a fair, navigable pathway to citizenship for aspiring Americans already in the country; support family reunification by clearing system backlogs; improve access to permanent visas for foreign graduates of U.S. universities with science, technology, engineering and math, or STEM, degrees; and create a discretionary pool of visas that can be flexibly allocated based on broadly defined national interest. The recent executive actions could also promote entrepreneurship by enhancing the utility of the national interest waiver for legal permanent resident applicants of exceptional ability and by authorizing inventors, researchers, and start-up founders to receive parole status on a case-by-case basis in order to pursue their research and development here in the United States.⁴³

Investments in science and technology

Advancements in science and technology account for roughly half of the increase in the U.S. economy since World War II.⁴⁴ As huge as this innovation boon has been to overall gross domestic product, it has also significantly affected entrepreneurs. For example, National Science Foundation grants helped in the founding of companies such as Google, and government-funded research led to successful commercial applications, such as the 1,500 NASA success stories,⁴⁵ or whole new industries—including the Defense Advanced Research Projects Agency, or DARPA; the Internet; national labs; and optical digital recording technology. Investments in U.S. science are often investments in future U.S. entrepreneurs.

With this kind of return on investment, there is a huge economic cost to the failure to fund the appropriations for the National Science Foundation, the National Institute of Standards and Technology, and the Department of Energy Office of Science that were authorized under the COMPETES Reauthorization Act of 2010. This \$6 billion gap in funding, which CAP researchers termed “Science Gap 1.0,” cannot be repeated as Congress considers several proposals to again reauthorize the COMPETES Act.⁴⁶ Replicating that mistake could lead to Science Gap 2.0—or a dearth of more than \$13 billion in funding for these agencies—is a cost too high to bear to seriously promote innovation and entrepreneurship.⁴⁷

Conclusion

Amid the many interesting findings in Mondragón-Vélez’s research, is his discovery that:⁴⁸

Not only do middle-class families account for 60 percent of business creation in the United States, but they also explain the stagnation of business-ownership growth rates in the 2000s compared to the late 1990s.

From Henry Ford to Steve Jobs, many of America’s most transformative entrepreneurs have come from the middle class. If policymakers do not act to strengthen the middle class and reverse the trends that caused the nation to miss out on 1 million potential entrepreneurs in the 2000s, then they risk sacrificing tremendous competitive advantages and future economic growth.

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