Center for American Progress

How Does Middle-Class Financial Health Affect Entrepreneurship in America?

By Camilo Mondragón-Vélez,
International Finance Corporation, World Bank Group

May 2015

Introduction and summary

Entrepreneurs play a critical role in the U.S. economy, and America's middle class plays a critical role in nurturing the people and social environment that create successful entrepreneurs. In other words, the dynamics of business creation and consolidation are interlinked with those of overall economic growth and the financial health of middle-class families.

This report analyzes data from the Panel Study of Income Dynamics to understand the effects of inequality and the financial health of the middle class on the dynamics of business creation by entrepreneurs in the United States.[1] For the purposes of analysis in this report, "middle class" is defined as households with total family income between $41,000 and $151,000, or between the 40th percentile and 90th percentile of the income distribution.[2]

To become an entrepreneur, after all, is often a family decision—weighing the potential risks against the probable rewards and dedicating significant portions of a family's income, wealth, human capital, and effort into a business venture. Analysis in this report shows that middle-class families account for 60 percent of new business ventures. According to the U.S. Small Business Administration, small firms—defined as those with up to 500 employees—represent more than 99 percent of employer firms, generate half of non-farm private goods and services in the U.S. economy, employ about half of all private-sector workers, and have created around two-thirds of net new jobs in the past two decades.[3]

It is worth noting, however, that there is an active debate about the relationship between job creation and firm size. Professor John Haltiwanger and the coauthors of the 2013 study "Who Creates Jobs? Small vs. Large vs. Young" show that when firm age is included in the analysis of job creation and firm size, it is not possible to draw any definite conclusion about the relationship between firm size and employment growth. More importantly for the purpose of this study, their findings suggest that "business startups contribute substantially to both gross and net job creation," and they find "an 'up or out' dynamic of young firms"—that is, young firms either grow to survive or are out of business.[4]

Increased financial stress on middle-class families—related to rising income and wealth inequality—is unfortunately constraining the creation of new businesses in the U.S. economy and therefore hurting overall economic growth and job creation. Economic expansion in the medium and long run should be reflected in increasing numbers of consolidated and growing private-sector firms, which is supported by a dynamic process of business creation.[5] This was the case for the U.S. economy from the 1970s through the 1990s, a period when gross domestic product—the measure of all goods and services produced by an economy's workers and equipment—grew by more than 80 percent in real terms, while the percentage of business-owner families—defined as those where at least one family member is a business owner—increased from less than 10 percent to about 13.5 percent, according to analysis presented in this report.[6] But as middle-class families' income stagnated, especially in the business-cycle expansion of the 2000s, 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 in the United States compared to the previous decade.[7]

The decline in business ownership from 2002 to the financial crisis in 2010 resulted from stalling business creation rates—the percentage of households becoming business owners within one data collection period—and increasing rates of business failure.[8] The rate of new business ownership among American families increased from 3 percent in the 1970s to 5 percent in the late 1990s but remained below this level in the 2000s. In contrast, business failure—that is, the rate at which business-owner families close their businesses within one data collection period—inched toward 30 percent since the late 1990s after fluctuating between 20 percent and 25 percent for most of the previous three decades, according to data presented in this report.

A more qualitative view of the middle class includes those with sufficient incomes and insulation from economic risks and the ability and means to make long-sighted decisions to invest in opportunities for themselves and for the next generation. Regardless of how one delineates "middle class," the evidence indicates that as the United States has grown more unequal, the opportunity to become an entrepreneur has moved farther out of reach for many people. The analysis presented in this report finds:

- Middle-class families account for 60 percent of new business-owner households in the United States in the past four decades, and their increasing financial stress partly explains the stagnation of business-creation rates in the 2000s compared to the late 1990s.

- Before starting their businesses, new business owners in the 2000s had two to three times more wealth than their median worker peers. In the 1980s and 1990s, however, new business owners only had 1.7 to 2 times more wealth than their median worker peers.

- New entrepreneurs in the 2000s on average waited an additional seven years before becoming business owners, compared to the 1980s.

Moreover, through the well-known effects of inequality on opportunities for quality education in the United States, the abilities and talents of many potential entrepreneurs remain undeveloped. Education not only plays a critical role in the development of productive people—workers and entrepreneurs alike—but also plays a role in reducing the inequality of income and opportunities, which can be transmitted through time to subsequent generations of descendants.[9] In fact, this report shows that the fraction of new business owners with more than a high school education increased from 50 percent in the 1970s to 67 percent in the 2000s and 75 percent in 2010. Overall, about two-thirds of new business owners in the past decade have some college education, relative to less than 60 percent between the 1970s and the mid-1980s and around 60 percent during the 1990s and the early 2000s.

The link between entrepreneurship and education implies that the opportunity of entrepreneurship has become more concentrated among those with higher education at a time when rising inequality tightens educational constraints, thereby putting the choice of entrepreneurship out of some people's reach. Furthermore, restricted access to entrepreneurship constrains upward social mobility opportunities for middle-class families across the United States.[10]

Business creation is therefore closely related to the financial health of the middle class. In this regard, the facts documented in this report suggest that the structural policies that have led to unequal economic outcomes and opportunities for American families over the past decades are in fact inhibiting the development of the critical entrepreneurial sector of the U.S. economy. Furthermore, the evidence presented below suggests that macroeconomic and structural policies directed toward increasing education opportunities, as well as income adjusted for inflation, to broaden and strengthen the U.S. middle class will allow these households to make better choices about starting new businesses. This will result in a more efficient and innovative population of entrepreneurs. In sum, policies focused on strengthening the financial health of the middle class will ultimately foster a vibrant and dynamic entrepreneurial economy in the United States.[11]

Our Mission

The Center for American Progress is an independent, nonpartisan policy institute that is dedicated to improving the lives of all Americans, through bold, progressive ideas, as well as strong leadership and concerted action. Our aim is not just to change the conversation, but to change the country.

Our Values

As progressives, we believe America should be a land of boundless opportunity, where people can climb the ladder of economic mobility. We believe we owe it to future generations to protect the planet and promote peace and shared global prosperity.

And we believe an effective government can earn the trust of the American people, champion the common good over narrow self-interest, and harness the strength of our diversity.

Our Approach

We develop new policy ideas, challenge the media to cover the issues that truly matter, and shape the national debate. With policy teams in major issue areas, American Progress can think creatively at the cross-section of traditional boundaries to develop ideas for policymakers that lead to real change. By employing an extensive communications and outreach effort that we adapt to a rapidly changing media landscape, we move our ideas aggressively in the national policy debate.

Center for American Progress

1333 H STREET, NW, 10TH FLOOR, WASHINGTON, DC 20005 • TEL: 202-682-1611 • FAX: 202-682-1867 • WWW.AMERICANPROGRESS.ORG