BREAKING DOWN BARRIERS TO OPPORTUNITY #2

Entrepreneurship as a Pathway to the American Dream

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PRI PACIFIC RESEARCH INSTITUTE

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Introduction

It is an economic myth that American families have "not had a raise in years". Not only is the average American family wealthier today than years past, so is the average low-income family.

The growth in incomes have not been constant, however. There have been periods where average incomes have stagnated, and periods where average incomes have grown robustly. These alternating periods of growth and stagnation are not random. The average incomes of the lowest-earning families improved during the periods when the policy environment was supportive of economic growth and entrepreneurship, and stagnated during the periods when the environment was less supportive of economic growth and entrepreneurship.

The entrepreneurship part of this connection is important to emphasize. Fostering an environment that supports entrepreneurship is essential for raising the financial well-being of the families with the lowest incomes. Vibrant entrepreneurial sectors benefit the lowest income households both directly and indirectly. The entrepreneurial economy directly benefits low-income families by creating a valuable pathway for these families to obtain a more prosperous future. It indirectly benefits low-income families by promoting an economic environment that creates more job opportunities, increases overall wages, and expands the affordability of goods and services.

> "Fostering an environment that supports entrepreneurship is essential for raising the financial well-being of the families with the lowest incomes.

Due to these benefits, creating a policy environment that supports entrepreneurial innovation, particularly for lower-income households, should be a priority. Fostering such an environment requires reforms that reduce the obstacles, particularly the government-created obstacles, that make it more difficult for low-income individuals to pursue entrepreneurial opportunities. The goal of this second paper in the *Breaking Down Barriers Opportunity* series is to illustrate why empowering lower-income entrepreneurs is an essential tool for reducing poverty in the U.S.

This analysis begins with a review of the income trend data in order to establish the periods when the income for the middle- and lower-income households were growing and when they were stagnating; and to connect the health of the entrepreneurial sector to the economic prospects of lower-income communities. This review shows that lower-income communities thrive the most during the periods when the entrepreneurial sector is healthy.

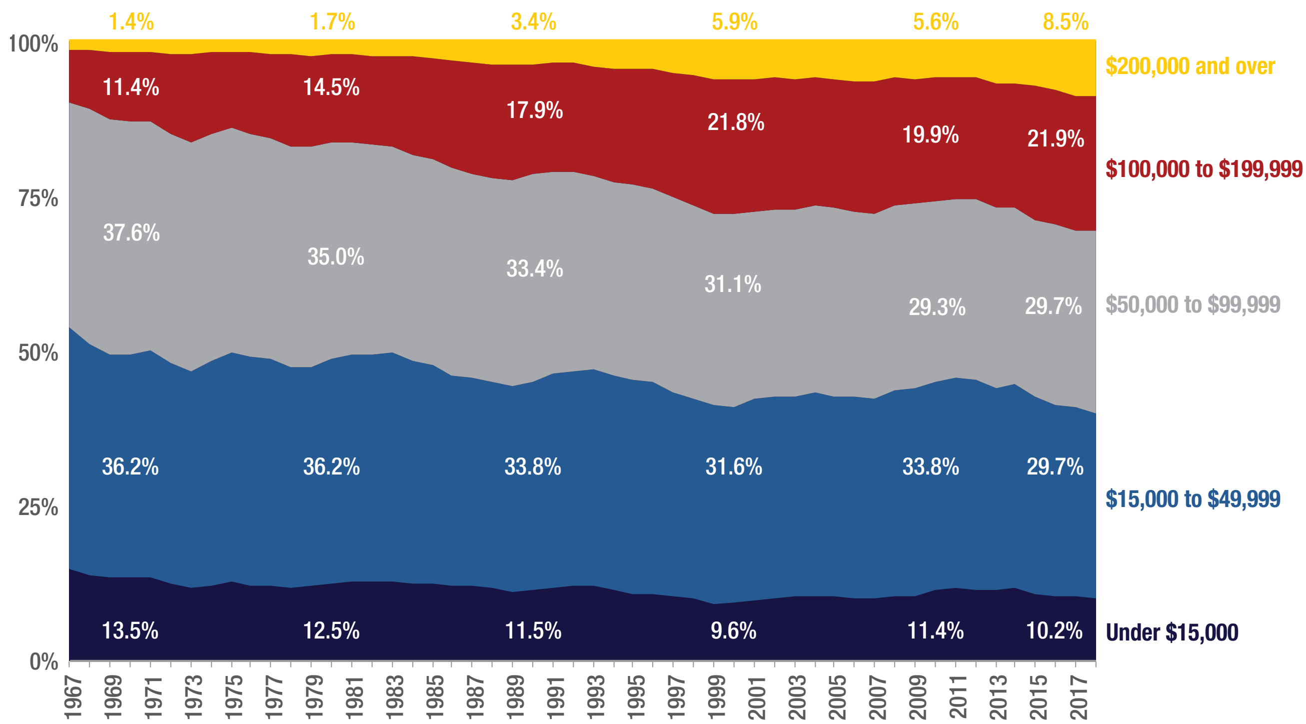
Next, the paper analyzes several disconcerting trends that, if not addressed, threaten the recent economic gains lower-income families have experienced. Among these disconcerting trends are overly burdensome regulations (which were examined in the first paper in the *Breaking Down Barriers to Opportunity* series), a costly (and complicated) tax system, and binding credit constraints.

Finally, beneficial policy reforms are proposed to address the tax and credit constraint obstacles to entrepreneurship (the importance of deregulation with a focus on small businesses was addressed in the first paper in this series, so will only be addressed briefly in this paper).

Incomes for Lower-income Families Are Volatile, but Improving

Before connecting a healthy entrepreneurial sector to improving incomes for lower-income families, it is important to document how these families have fared over time. Despite the rhetoric from the 2020 presidential campaign trail, the income earned by the average American household (for all income groups) has been improving according to the latest inflation adjusted income data from the U.S. Census (i.e. the historical income data were adjusted into 2018 dollars), see Figure 1. Based on these data, nearly 50 percent of all households had an inflation adjusted income that was less than $50,000 back in 1970 (the bottom two areas pictured in Figure 1). As of 2018, the percentage of households with an income less than $50,000 fell to slightly less than 40 percent.

FIGURE 1
SHARE OF HOUSEHOLDS BY ALTERNATIVE INCOME CATEGORIES
1967 THROUGH 2018



Source: Author calculations based on data from the U.S. Census

Put differently, 50.3 percent of all households had an inflation-adjusted income that exceeded $50,000 in 1970, but as of 2018, 60.1 percent of all households did. Families in 2018 are also doing better compared to 2000 (the peak of the Internet bubble) and 2008 (the peak of the housing bubble). In 2000, 58.8 percent of all households had an income that exceeded $50,000; in 2008, 56.2 percent of all households had an income that exceeded $50,000. This is an unequivocal indication that, despite the costs associated with the dotcom bust and the Great Recession, more American households are doing better as of 2018 than ever before.

A similar pattern holds for the poorest families as well. Households earning less than the equivalent of $15,000 today comprised:

- 13.5 percent of all households in 1970,
- 9.6 percent in 2000,
- rose to a recent peak of 11.9 percent in 2011,
- declined to 10.2 percent as of 2018.

While not at its historic low, the percentage of U.S. households in this poorest category has undoubtedly reversed the digression caused by the Great Recession and is now approaching all-time lows.

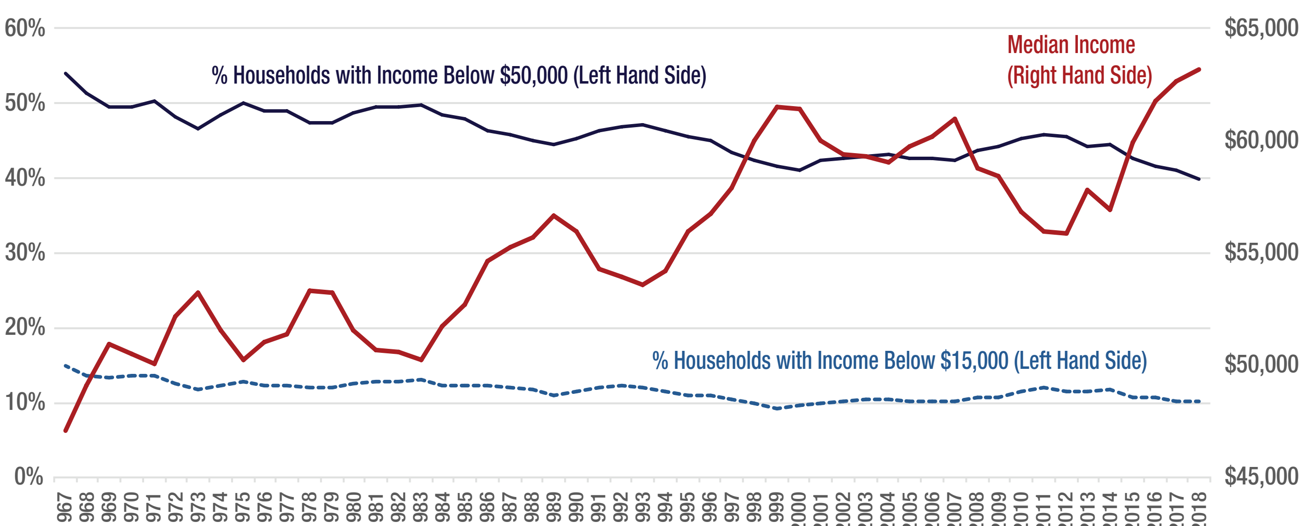
Figure 1 also illustrates that not only are fewer American households poorer, more are wealthier, too. The top shaded area in Figure 1 presents the share of U.S. households earning more than $200,000 annually in 2018 dollars. Back in 1970, only 1.4 percent of households reached this high-income threshold. As of 2018, 8.5 percent of households are part of this top bracket. Therefore, although the middle-income group (between $50,000 and $99,999) has been shrinking, the decline is due to more and more households reaching higher and higher income levels.

While these data illustrate that great progress has been made, it also illustrates that the progress has been inconsistent. There was less progress during the 1970s, an acceleration during the 1980s and 1990s, outright digression during the 2000s, and then a return to progress since 2012.

These fits and starts are easier to picture by examining the trend in median household income (also adjusted for inflation). Figure 2 compares the trend in real median household income to the share of households earning less than $50,000 and the share of households earning less than $15,000 over the same time period.

FIGURE 2

SHARE OF HOUSEHOLDS EARNING LESS THAN $15,000 AND $50,000 COMPARED TO REAL MEDIAN HOUSEHOLD INCOME, 1967 THROUGH 2018



Source: Author calculations based on data from the U.S. Census

Figure 2 connects the improvement in the median household income to the improvements in the income of the lowest-income families (as measured by the number of families living below key income thresholds). While it is theoretically possible that the lowest income groups are being left behind when the welfare of the median household improves, historically this has not been the case. As the real income of the median household has improved, fewer and fewer households have incomes below $15,000 and $50,000 annually.[1] Alternatively, when the real median income was declining, more and more households had incomes below $15,000 and $50,000 annually.

Undoubtedly, further improvements for the lowest-earning families are still necessary. Since the real median income of households in 2018 is at its highest level in over a half-a-century and the number of households living below key income thresholds are at (for the $50,000 threshold) or near (for the $15,000 threshold) all-time lows, undoubtedly, the economic prospects for families of all income levels are improving. These data demonstrate that the oft-repeated mantra that the poorest households in the U.S. are not doing better is clearly wrong. There have been difficult times, but long-term, progress is clearly evident.

The Connection Between a Healthy Entrepreneurial Sector and Upward Economic Mobility for Low-Income Families

The periods of income growth and income stagnation are not random. They are linked to longer-term economic trends. PRI's *Beyond the New Normal* research program analyzed these trends for the broader macroeconomy finding that the periods of income growth and income stagnation are linked to the quality of the economic policies that were implemented during these periods.[2] The data reviewed above illustrates that the same dynamic holds for families with the lowest incomes. It follows that many of the policies necessary to foster robust economic growth in the long-term are also necessary to sustainably improve the economic welfare of the poorest families.

Research also identifies entrepreneurship as an important pathway that helps lower-income households climb the economic ladder. For example, in studying whether microcredit programs (i.e. programs geared toward extending small denomination loans to low-income entrepreneurs) are successful in the U.S., Bhatt et al. (1999) noted that the "…Aspen Institute's study of 405 microentrepreneurs indicates that more than half of the loan recipients escaped poverty within five years. On average, their household assets grew by nearly $16,000 during that period; the group's reliance on public assistance dropped by more than 60%."[3]

A more recent study conducted for the Small Business Administration confirms the higher income potential offered by entrepreneurship.[4] This study evaluated datasets from the U.S. Census (the American Community Survey and County Business Patterns) to gain insights regarding "the characteristics of self-employed workers in low-income areas" compared to workers in higher-income areas.[5]

While the study found lower self-employment rates in low-income areas (9.2 percent) compared to high-income areas (10.9 percent), entrepreneurship offered low-income individuals relatively attractive economic opportunities. Specifically, compared to salaried workers and unemployed workers, the SBA study found that "self-employed workers who own incorporated businesses have much higher earnings than all other worker groups in low-income areas."[6]

Other researchers have also documented the importance of entrepreneurial opportunities relative to salaried employment opportunities. According to Edmiston (2008),

> Evidence suggests that entrepreneurship is a viable alternative to wage and salary employment (or unemployment) for many LMI [low- and moderate-income] people. An analysis of data from the Panel Study of Entrepreneurial Dynamics (PSED) suggests that 38 percent of nascent entrepreneurs, defined as those who are actively involved in the creation of new business ventures, live in LMI households. Of these, about 45 percent live in low-income (LI) households. Roughly 8 percent of nascent entrepreneurs live in households with below-poverty level income.

Additional gains also may arise from increased entrepreneurship. Self-employed people on average have higher incomes than wage and salary workers (Fronczek, 2005), and self-employment may be an important component of upward mobility. Further, many report nonpecuniary benefits.[7]

Perhaps no group has leveraged entrepreneurial opportunities as a pathway to the middle-class (or even higher income groups) as effectively as immigrants. According to data from the Kauffman Foundation,

> the rate of new entrepreneurs was 0.56 percent for immigrants in 2017, which means they are twice as likely to start businesses as native-born Americans (0.28 percent). Both groups started businesses at slightly higher rates than they did in 2016 and 2007. Immigrants now comprise nearly 30 percent of all new entrepreneurs, a substantial increase from 2007, when 24.6 percent of new entrepreneurs were immigrants.[8]

As the Center for an Urban Future has noted, this trend is not new; immigrants have been benefiting from entrepreneurial opportunities for more than a century. According to the report, "in every U.S. Census since 1880, immigrants have been more likely to be self-employed than the native-born population."[9] What is even more exciting, the Center for an Urban Future further notes that immigrant entrepreneurs create broad-based economic benefits. Noting the contribution of immigrant entrepreneurs in New York City, the report states that,

> Over the past 10 to 15 years, immigrant entrepreneurs fueled much of the overall growth in new businesses across the city and triggered dramatic turnarounds in neighborhoods all over the five boroughs. The number of self-employed foreign-born individuals in the city increased by 53 percent during the 1990s, while the number of native-born self-employed people declined by 7 percent. Over the same period, neighborhoods where immigrants own the lion's share of businesses — including Jackson Heights, Sunset Park, Flushing, Sheepshead Bay, Brighton Beach and Elmhurst — created jobs at a significantly faster rate than the city as a whole. Several of these communities even added jobs in the two years after September 11th, a time when the city's overall economy was shedding massive numbers of jobs.[10]

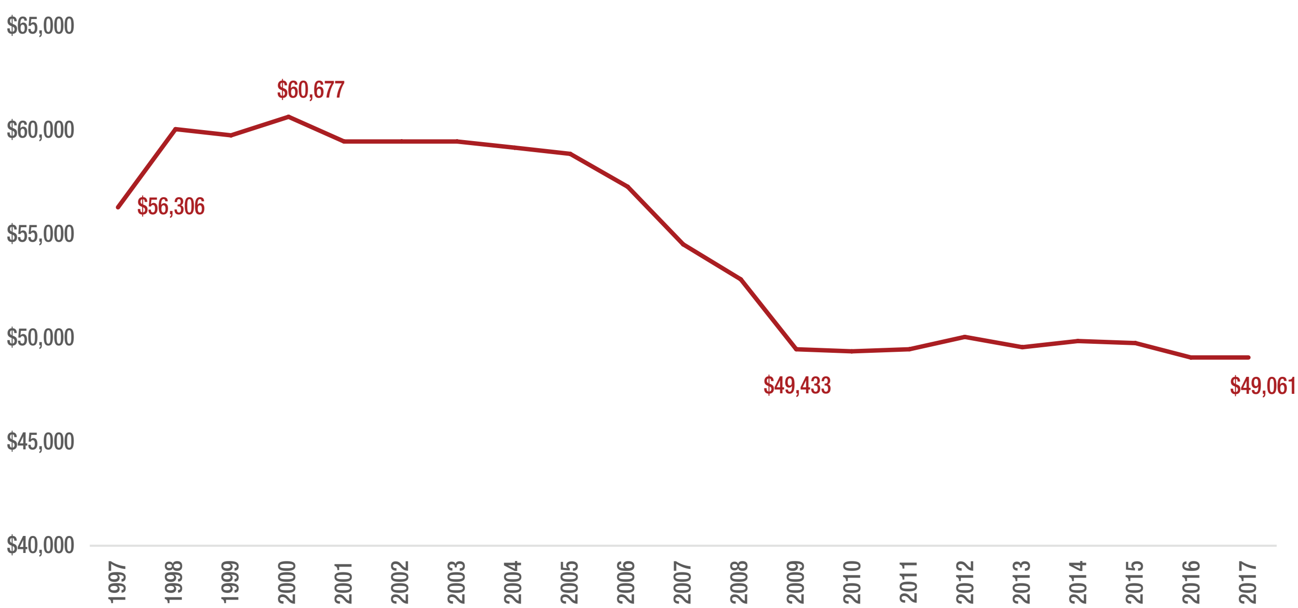
The benefits are not confined to New York City either. According to the report, first-generation immigrants "created at least 22 of [Los Angeles'] 100 fastest growing companies in 2005"; immigrant entrepreneurs are credited with revitalizing the Boston neighborhoods of Fields Corner, East Boston, Allston Village and Jamaica Plain; and Houston's economy has benefited from being "home to 16 of the largest 500 Hispanic-owned firms in the country".[11]

Research has also linked entrepreneurship to improving the economic well-being for communities of color. For instance, according to Hamilton (2019)

> Black entrepreneurs have 12 times more net worth than their peers who work for an employer, and their donations of time, money, and services to their communities further strengthen their neighborhoods. Entrepreneurship also has risen to unprecedented levels among women of color over the past two decades, driven largely by necessity and a lack of employment opportunities. People of color own nearly 50 percent of women-owned businesses, and the number of firms owned by women of color has grown four times faster than women-owned businesses overall, with black and Hispanic women leading the way.[12]

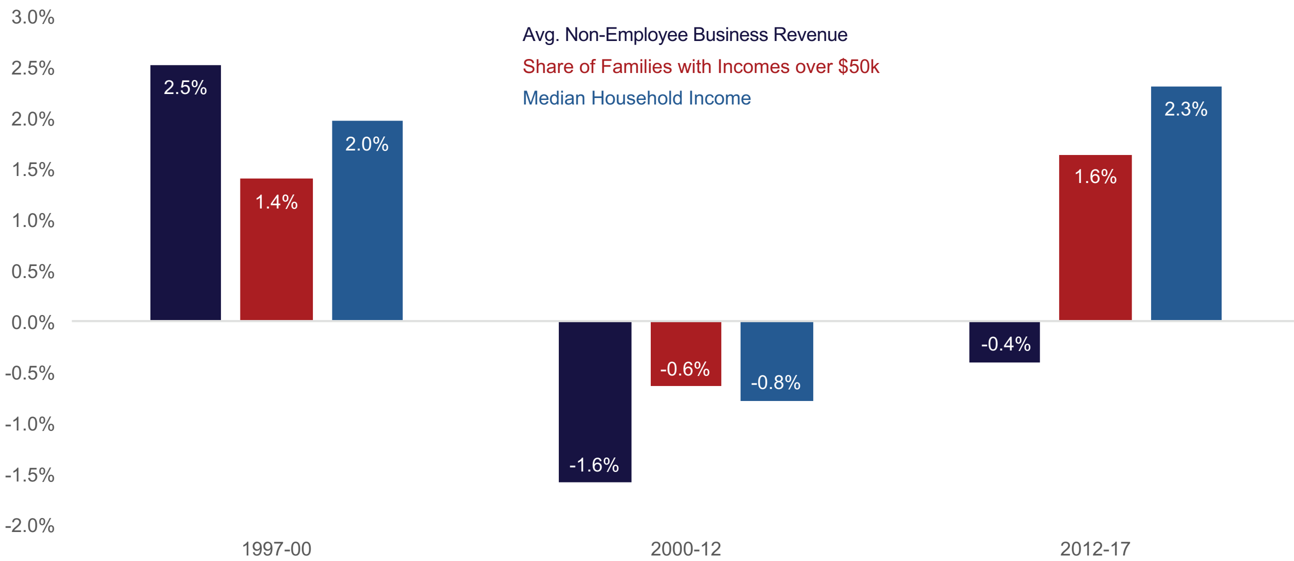
The correlation between small business revenue and the share of households living below the key income thresholds are consistent with the results of these studies. Small business revenue for non-employee firms (as a proxy for the smallest small businesses) is available from the U.S. Census between 1997 and 2017. The total inflation-adjusted revenues per non-employee firm shows that, over the past 20 years, small business revenues were growing through 2000, fell until 2009, and have been flat through 2017, see Figure 3. Figures 1 and 2 illustrated a similar pattern. Using the peak and troughs in Figure 3, Figure 4 compares the average annual change in small business revenue to the average annual change in the real median household income and the average annual change in the number of households living above $50,000 (adjusted for inflation).

FIGURE 3
INFLATION-ADJUSTED NON-EMPLOYEE SMALL BUSINESS REVENUE PER FIRM
1997–2017



Source: Author calculations based on U.S. Census data

FIGURE 4
SMALL BUSINESS REVENUE PER FIRM COMPARED TO MEDIAN HOUSEHOLD INCOME AND THE CHANGE IN SHARE OF FAMILIES WITH INCOMES EXCEEDING $50,000 ANNUALLY (ALL DATA ADJUSTED FOR INFLATION), 1997–2017



Source: Author calculations based on U.S. Census data

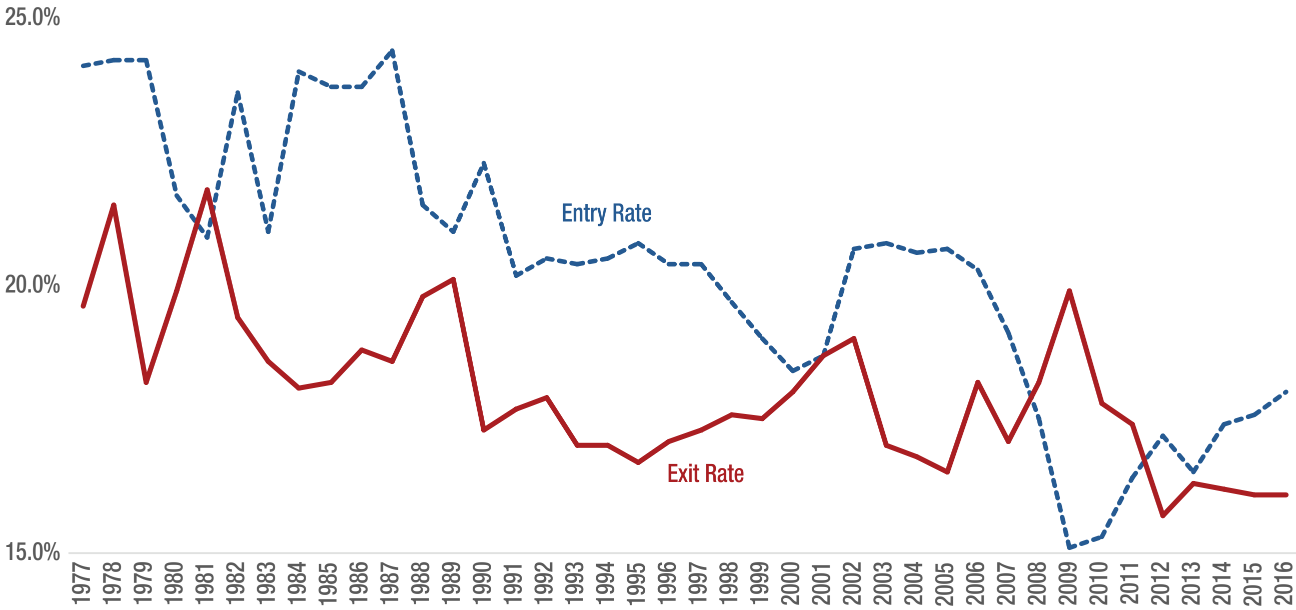
While this correlation does not mean causation, and undoubtedly all of these trends are inter-related with broader economic growth trends, these data appear to be connected. The period 1997 to 2000 was the peak of the dot.com bubble. Not only was the economy experiencing strong growth, average incomes were rising, and this growth benefited families across the income spectrum. As part of this environment of shared prosperity, small business growth was robust.

The next decade experienced economic growth as well, although it was volatile as evidenced by the housing boom and bust of the middle- to late-2000s. Average inflation-adjusted revenues for the smallest businesses declined throughout this entire decade as well. This decline is noteworthy because this was also the period when the income for the average household declined, as did the share of the households with an annual income exceeding $50,000. These data demonstrate that average incomes declined when small business growth prospects suffered, despite the overall economy growing throughout the 2000s.

Beginning sometime around 2012 the trends have appeared to change. Economic growth has strengthened, but perhaps more important, the decline in small business revenues have abated. Along with this abatement, average income growth and the share of families earning more than $50,000 have both improved. Should these trends continue, then this is a bullish sign for continued opportunity growth for the lowest income earning families in the future.

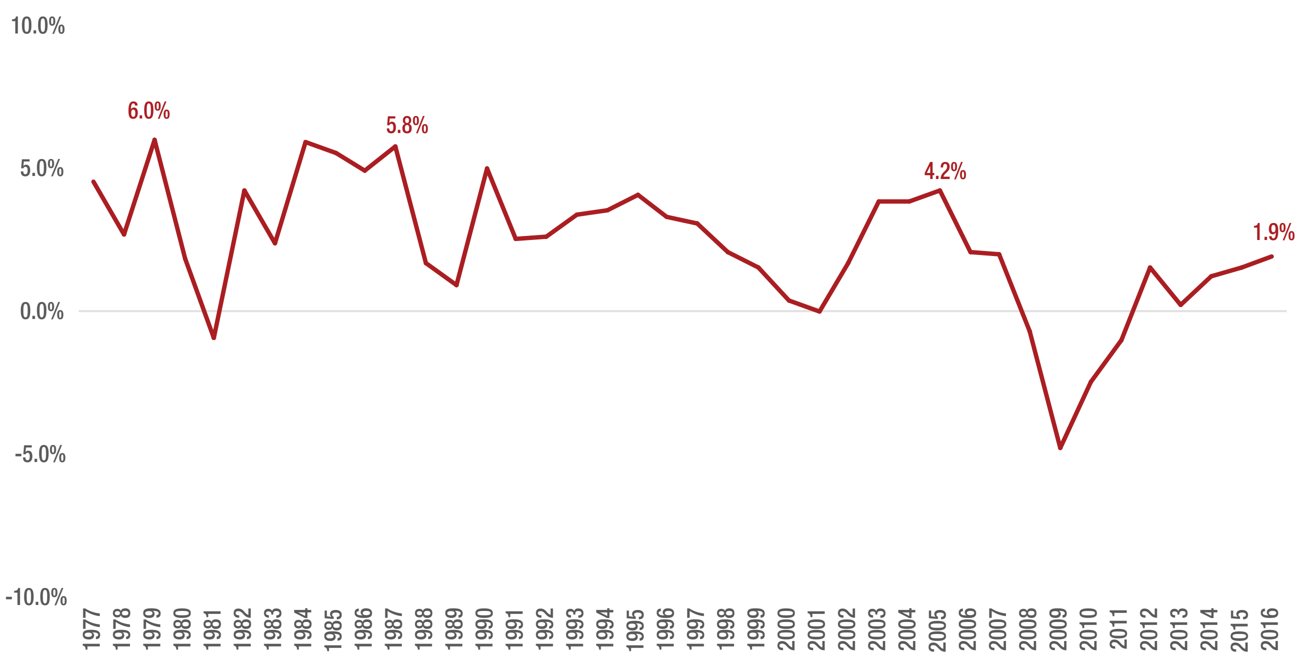
There are several disappointing long-term trends with respect to the rate of entrepreneurship in the U.S., however, that diminish this positive outlook, see Figures 5 and 6. Figure 5 presents the percentage of new firms and the percentage of exiting firms for small businesses with one to four employees between 1977 and 2016 (the latest data available). Focusing first on the entry rates, while the impact from economic booms and busts are evident, there is a clear long-term decline in the growth rate of new small firms. While the exit rate for these small firms has also declined, the decline is less than the entry rate, indicating that the net growth in small businesses, while up from the lows caused by the Great Recession, has been generally declining for many years, see Figure 6.

FIGURE 5
ESTABLISHMENT ENTRY AND EXIT RATES FOR SMALL BUSINESSES WITH 1 TO 4 EMPLOYEES
1977–2016



Source: U.S. Census, Business Dynamic Statistics

FIGURE 6
NET ESTABLISHMENT ENTRY RATES FOR SMALL BUSINESSES WITH 1 TO 4 EMPLOYEES
1977–2016



Source: U.S. Census, Business Dynamic Statistics

Noting this decline, Keating (2016) concluded that "the entrepreneurship or business activity gap over the past decade or so has led to an estimated shortfall of anywhere from 867,000 to 4.8 million businesses, with an assessment of 3.7 million missing businesses being quite reasonable based on a combination of the most often cited self-employed and employer firms data."[13]

In light of the large benefits entrepreneurship enables for lower- and middle-income families, this long-term declining rate of new business creation is disconcerting. Policies should, consequently, focus on minimizing any unnecessary obstacles that inhibit the entrepreneurial opportunities for lower- and middle-income families.

The Unique Barriers Facing Low-Income Entrepreneurs

While the potential benefits to lower-income families from entrepreneurial opportunities are well documented, so are the unique barriers these potential low-income entrepreneurs face. There are many obstacles raised in the literature, and it is not possible for specific policy changes to address all of these obstacles. Instead, beneficial reforms should identify specific obstacles and devise policy reforms that can effectively reduce or minimize these impediments. Below, two obstacles commonly referenced in the literature are reviewed: the costs of complying with overly burdensome tax and regulatory codes, and the binding credit constraints that often prevent low-income entrepreneurs from establishing viable businesses.

Obstacles Created by the Anti-Small Business Regulatory and Tax Systems

The idea that actions often have unintended consequences can be traced all the way back to Adam Smith. In this case, the unintended consequence is positive – by promoting their own self-interest, the butcher and the baker enable the entire community to enjoy a higher standard of living (an unintended consequence). More often, unintended consequences refer to a negative, however. Take rent control as an example. Proponents of rent control do not intend to create housing shortages and lower quality housing, presumably. Yet, this is the well documented consequence of rent control policies. As Diamond (2018) summarizes the evidence:

> Rent control appears to help affordability in the short run for current tenants, but in the long-run decreases affordability, fuels gentrification, and creates negative externalities on the surrounding neighborhood. These results highlight that forcing landlords to provide insurance to tenants against rent increases can ultimately be counterproductive.[14]

The same negative unintended consequence also applies to the current federal tax and regulatory systems. It is difficult, time consuming, and costly for most small businesses (particularly start-ups) to comply with the complex array of federal and state regulations and file federal income taxes. In fact, small businesses regularly complain about the onerous burden created by regulations and the tax system.

Citing the August 2019 National Federation of Independent Business (an association of small businesses) monthly survey of the single most important problem facing small businesses, the burden from government taxes and the burden from regulations and red tape, while down from survey highs, are each tied for the second largest concern of small businesses. Overall, 14 percent of firms listed taxes as their single largest challenge, and 14 percent listed regulations and red tape (quality of labor was the largest challenge).[15] A large number of academic studies confirm that these concerns are well founded.

Starting with the regulatory studies, which were reviewed in the first study in this series, and are only summarized here, with respect to overall economic growth,

- Dawson and Seater (2013) found that the growth in federal regulations between 1949 and 2005 was responsible for a 2.0 percentage point decline in the average annual growth rate in the U.S. economy.[16] The study also found a significant link between the rising regulatory state and declining productivity growth, which is directly linked to the problem of stagnating wages.
- Coffey, McLaughlin, and Peretto (2016) found "…that economic growth has been dampened by approximately 0.8 percent per annum since 1980. Had regulation been held constant at levels observed in 1980, our model predicts that the economy would have been nearly 25 percent larger by 2012 (i.e., regulatory growth since 1980 cost GDP $4 trillion in 2012, or about $13,000 per capita)."[17]
- Brannon and Batkins found that the rising regulatory burden on labor regulations in the final year of the Obama Administration, over the next 10 years, would have cost the economy $80 billion, added an additional 400 million hours of compliance efforts, and led to 155,000 lost jobs.[18]

Beyond the broad economic impacts, studies have also explicitly examined the impacts on small businesses finding that they are disproportionately harmed by regulations:

- Sobel, Clark, and Lee (2007) found that regulatory barriers to competition "have a strong negative impact on entrepreneurial activity in an economy."[19]
- Calcagno and Sobel (2014) found "that regulation decreases the proportion of zero employee and 1 – 4 employee establishments. The proportion of establishments in the 5–9 employee range generally increases with the level of regulation. Thus, regulation appears to operate as a fixed cost causing establishments to be larger."[20]
- Bailey and Thomas (2015) confirm the hypothesis that regulation inhibits business growth and job creation while protecting larger, existing businesses.[21] Specifically, a 10% increase in the intensity of regulation leads to a statistically significant 0.5% decrease in firm births, driven by a decline in small firms, and a 0.5% decrease in hiring by small firms.[22]
- Crain and Crain (2014) estimated the average regulatory cost per employee in 2012 (measured in 2014 dollars) was $9,991, but the cost per employee for firms with fewer than 50 employees was $11,724, or 29 percent higher.[23]
- The U.S. Chamber (2017) found that federal regulations cost the American economy as much as $1.9 trillion a year in direct costs, lost productivity, and higher prices. The costs to businesses with 50 or fewer employees are nearly 20% higher than average.[24]

The same evidence exists with respect to the federal tax system. According to the NFIB, "tax compliance costs are 67% higher for small businesses than for big businesses. Compliance costs small-business owners $18-$19 billion per year. Paperwork costs come to $74.24 per hour."[25] Citing the chairman of the House Subcommittee on Economic Growth, Tax and Capital Access, Maloney (2016) claimed that complying with the U.S. tax code "for an employer with 1–5 employees range[s] from $4,308 to $4,276 per employee".[26]

McKay et al. (2014) similarly noted that

> One of the greatest burdens placed on microbusiness owners is the complexity of the tax system itself; 27% of microbusiness owners say that they need additional help with tax issues. The self-employed not only must file and pay income taxes, but also are responsible for paying both the employer and employee shares of FICA. A wage worker will pay 7.65% of her salary in FICA taxes (on the first $113,700 in earnings), while her employer will pay an additional 7.65%. The worker does not have to take action to pay this tax as it is automatically deducted from her paychecks. In contrast, a self-employed person is responsible for paying the full 15.3 percent tax on her own. Additional complexity for self-employed taxpayers stems from the quarterly filing requirement—rather than dealing with taxes once a year, as most workers do, they must estimate their earnings in advance and pay taxes on them four times a year.
>
> Tax compliance burdens on microbusiness owners are significant even when analyzed from several different viewpoints, including as a percentage of total receipts, as a percentage of total assets, and as a cost per employee. Time burden is mainly a result of recordkeeping; cost burden is mainly due to securing commercial tax preparers. Tax policy experts with whom we spoke cautioned that creating new tax preferences for LMI microbusinesses will have limited impact if they are difficult to claim or if few eligible entrepreneurs are aware of them. To ensure that microbusiness-targeted reforms have a net positive impact, they should reduce this burden of complexity, not add to it.[27]

"Similar unintended consequences arise from the large number of regulations small businesses must comply with, such as workers compensation and occupational licensing laws.

According to the American Action Forum, based on data from the Office of Information and Regulatory Affairs, "the estimated aggregate time burden required to complete IRS forms, when rounded, decreased slightly from 2018 to an even 8 billion hours. This figure breaks down to 52 hours per taxpayer."[28] As the McKay et. al. (2014) analysis indicates, small business owners will typically have more complex income tax returns, indicating that they are likely to spend more than this average amount of hours complying with the tax code. Time is valuable for small businesses, particularly small businesses just starting out. Spending the equivalent of at least one full workweek simply complying with the tax code is a luxury many can ill afford.

Beyond the issues of cost and complexity, the Tax Foundation noted in testimony to the Committee on Small Business that the U.S. tax code also harms small businesses because it "tends to impose higher burdens on businesses that run losses for many years, businesses that are risky investments, and businesses undergoing rapid expansion – all of which are typical characteristics of entrepreneurial ventures."[29]

These studies confirm that, just like the overly burdensome regulatory structure, the current U.S. tax code contains anti-growth biases that increase the hurdles for small businesses, particularly small businesses owned by low-income individuals. Many of these hurdles are the unintended consequences from other policies. Take tax preferences as an example. Tax preferences are implemented to lessen the tax burden, and some of these preferences are justified as a means of helping small businesses. But, this help comes at the cost of excessive tax complexity. This complexity is now an obstacle to small business growth – particularly small businesses owned by low-income households. Similar unintended consequences arise from the large number of regulations small businesses must comply with, such as workers compensation and occupational licensing laws.

Credit Constraints

As documented by the Milken Institute, the "empirical research consistently suggests that liquidity constraints—arbitrary limits on the amount an entrepreneur can borrow — inhibit the rate and growth of business formation" particularly for low-income entrepreneurs.[30] Further, the Milken Institute analysis found "that even when accounting for income disparity, the business communities in many LI [low-income] and LMI [low- to moderate income] areas obtain far less capital than should be expected, hampering their ability to grow."[31]

The annual *Small Business Credit Survey* conducted by the Federal Reserve similarly noted that many small businesses continue to face constrained credit opportunities:

> Nearly half of applicants (47%) received the full amount of funding sought, similar to the 2017 survey. Of those that did not apply, roughly half reported they had sufficient financing.
>
> Financing shortfalls were particularly pronounced among firms with weak credit profiles, unprofitable firms, younger firms, and firms in urban areas. Funding gaps were most acute for firms seeking $100–$250K.[32]

The fact that funding gaps "were most acute for firms seeking $100,000 to $250,000" is an indication that the credit constraints impacted the smallest small businesses the most, which will often include the businesses owned by low-income entrepreneurs.

For potential low-income entrepreneurs, the credit restrictions often thwart any hope that they will ever get their business operational. Consider that, according to the Center for an Urban Future "starting a business takes an estimated 4.4 times the median net worth of the average African American household ($5,677) and four times the median net worth of the average Latino household ($6,325)".[33] When coupled with binding credit constraints, such high costs relative to their net worth creates a large barrier preventing many would-be entrepreneurs from ever getting started.

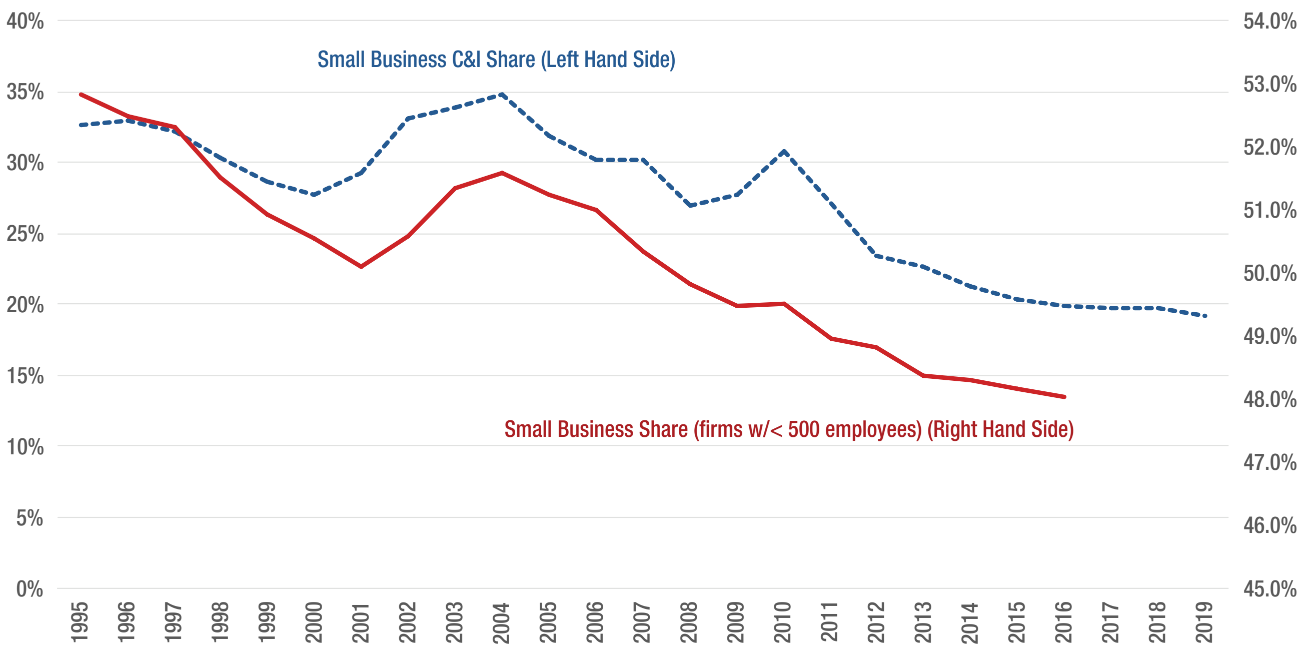
Credit constraints do not simply constrain low-income entrepreneurs from starting a business either. Credit constraints often inhibit a low-income entrepreneur from growing his/her business, and could be the difference between staying in business or closing down. Exemplifying the impact that these liquidity constraints have on the ability for small businesses to grow and thrive, in California,

> Latinos are starting businesses at a faster rate than other groups in the country. But their ventures have higher failure rates or grow at a slower pace partly because they have less capital, said Robert Fairlie, an economist at UC Santa Cruz.
>
> "They're less likely to get bank loans. They're less likely to be able to tap into family and friends' wealth or neighborhood wealth. So, all those things kind of work against them," said Fairlie, who has researched minority-owned enterprises for two decades.
>
> That unequal access to credit, said Fairlie, contributes to the massive wealth gap in this country because small businesses generate jobs and wealth for their communities.[34]

Data trends indicate that the relative availability of small businesses loans is getting worse over time, particularly since the Great Recession. Based on data from the Federal Deposit Insurance Corporation (FDIC), the commercial and industrial (C&I) loans that the FDIC categorizes as small business loans have been declining as a share of total C&I loans for more than a decade. Further, the declining credit availability is consistent with the declines in the small business sector, see Figures 7 (small businesses with less than 500 employees) and Figure 8 (small businesses with 1 to 4 employees). Therefore, small businesses are clearly receiving a declining share of total bank loans, and that declining share is associated with small businesses' declining prospects.

FIGURE 7

SMALL BUSINESS LOANS SHARE OF TOTAL COMMERCIAL AND INDUSTRIAL (C&I) LOANS COMPARED TO SHARE OF EMPLOYMENT FOR SMALL BUSINESSES WITH 500 EMPLOYEES OR LESS 1995–2019*

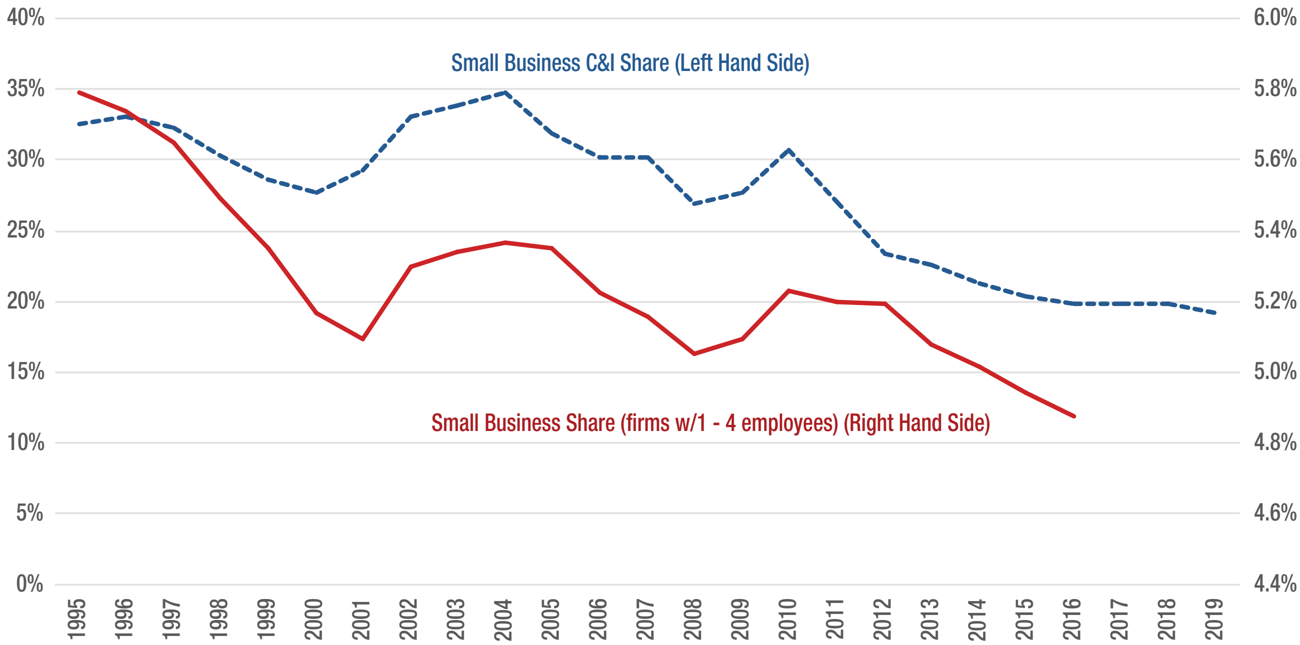


* 2019 share of C&I loans as of 2019Q2

Source: FDIC and U.S. Census

FIGURE 8

SMALL BUSINESS LOANS SHARE OF TOTAL COMMERCIAL AND INDUSTRIAL (C&I) LOANS COMPARED TO SHARE OF EMPLOYMENT FOR SMALL BUSINESSES WITH 1 - 4 EMPLOYEES 1995–2019*



* 2019 share of C&I loans as of 2019Q2

Source: FDIC and U.S. Census

Since credit constraints are more problematic for lower-income entrepreneurs, alleviating these constraints are an important strategy for promoting more low-income entrepreneurship.

Policy Reforms to Alleviate the Barriers to Low-Income Entrepreneurship

Overly complex government regulations are a common cause behind the barriers to low-income entrepreneurship raised in the previous section. It is useful to frame the over-regulation problem with respect to the Hippocratic Oath that all doctors must take: *primum non nocere*, or first do no harm. Current government policies are violating this principle by raising the costs of starting and running a small business and making it more difficult to pursue entrepreneurial ventures. Therefore, reforms should start by eliminating the harms that overly complex government policies are inflicting on current and potential low-income entrepreneurs.

Starting with the tax code, reforms that promote tax simplification are key, particularly with respect to retirement accounts and health insurance. The research above documented how the costs of complying with the tax code are a large obstacle for small businesses, which is even more burdensome for low-income entrepreneurs who may not have the resources to effectively manage these costs. Lowering these costs is an important policy goal that can decrease the costs associated with pursuing entrepreneurial opportunities, particularly for low-income entrepreneurs.

Raising Thresholds for Small Business Payroll Taxes

One straightforward reform that would provide immediate benefits to entrepreneurs who are just starting out is updating the outdated self-employment tax threshold. Currently, the 15.3 percent payroll tax—the tax levied to fund Social Security and Medicare—is evenly split between the employer and employee. Self-employed people are responsible for paying the entire 15.3 percent payroll tax themselves, but only on the income earned above $400. This income level was established by the Self-Employment Contributions Act (SECA) of 1954, but a lot has changed since 1954. To keep the purchasing power of this threshold constant (based on the growth in the consumer price index, CPI), the amount of income exempt from the payroll tax should be raised to the first $3,734 of income.

> "One straightforward reform that would provide immediate benefits to entrepreneurs who are just starting out is updating the outdated self-employment tax threshold.

However, even greater increases in this deduction can be justified. The standard deduction was transformed from a percentage of taxable income to a fixed amount in 1964 in order to explicitly remove specific low-income earners from the tax rolls—a rationale that is directly applicable to the policy of exempting the first $400 of income earned by the self-employed from the payroll tax. However, the standard deduction has increased by more than just the increase in the cost of living. If the self-employment threshold grew at the same rate as the value of the standard deduction for married couples since 1970, then the small business tax threshold would exempt the first $8,727 in self-employment income from the payroll tax. Raising the threshold to this amount would put up to $1,335 directly into the pockets of entrepreneurs, which would be particularly valuable for low-income entrepreneurs who are attempting to get their new business off the ground.

Reforming Tax Laws to Lower Small Business Retirement and Health Care Costs

Tax-free retirement and health care accounts are important investment options that the government has created to help Americans meet their financial goals, or amass sufficient financial resources to pay for necessary expenses. For many small businesses, these accounts are also restrictive, costly to administer, and complicated to manage. Reforms that simplify and consolidate the number of tax-free accounts can make it easier for low-income entrepreneurs to start and manage their own business.

For example, health reimbursement arrangements (HRAs) allow employers to fund accounts for their employees to cover the costs of health care, including the costs of paying for health insurance. The expenses are deductible for the employers, and are tax free income for the employees. There are many restrictions on HRAs. These include restricting only employers to funding these accounts, and the fact that the accounts are not portable when the employee leaves the company. But, what if these restrictions were removed, and the accounts expanded to allow for long-term savings, including saving for retirement?

Ideally, such tax-free accounts would allow both employers and employees to contribute a set amount of money each year. The contribution caps should approximate the total amount of spending on health insurance, health care costs, and recommended retirement savings for individuals. All health care expenditures not spent in a given year should roll over to cover either future health care costs or, if never spent, used for retirement. There should also be allowances for individuals to use the assets in these accounts to cover specified family emergencies.

These types of flexible, easy to use, tax-free savings accounts could meaningfully improve the current problems that afflict the health care system and strengthen people's retirement nest eggs. With respect to this paper, the core benefit is creating a less complex, lower cost health insurance plan and retirement program that small businesses (particularly small businesses that are newly formed by low-income entrepreneurs) can leverage. The accounts would provide many benefits for low-income entrepreneurs including:

- Lowered costs of running a small business;
- Improved financial welfare for the small business owner; and,
- Improved competitiveness of a small business' compensation package vis-à-vis larger competitors.

Regulatory Reforms to Lower Costs for Small Businesses

Beyond tax simplification, regulatory reforms could further reduce the costs for low-income entrepreneurs and improve their viability. These issues were addressed in the first study in this series, all of which are particularly burdensome on low-income entrepreneurs, and include:

- Defeating ill-considered proposals such as the $15 minimum wage;
- Reforming occupational licensing laws that increase the costs of becoming an entrepreneur and hiring workers; and,
- Lowering excessive workers compensation costs.

Removing Policy Barriers Limiting Access to Credit for Small Businesses

Along with tax simplification and regulatory reforms, policy changes should directly remove the barriers that unnecessarily create additional credit constraints for low-income entrepreneurs. Toward this goal, there have actually been positive changes. The Dodd-Frank Act, which was passed in the aftermath of the 2008 financial crisis, significantly handicapped small community banks that have traditionally been a major credit provider for small businesses. An analysis by Lux and Greene (2015) linked the Dodd-Frank regulations to an accelerated decline in the community banking sector.[35] Summarizing their findings,

> Our assessment of Federal Deposit Insurance Corporation data finds that community banks service a disproportionately large amount of key segments of the U.S. commercial bank lending market – specifically, agricultural, residential mortgage, and small business loans. However, community banks' share of U.S. banking assets and lending markets has fallen from over 40 percent in 1994 to around 20 percent today [2015]. Interestingly, we find that community banks emerged from the financial crisis with a market share 6 percent lower, but since the second quarter of 2010 – around the time of the passage of the Dodd-Frank Act – their share of U.S. commercial banking assets has declined at a rate almost double that between the second quarters of 2006 and 2010. Particularly troubling is community banks' declining market share in several key lending markets, their decline in small business lending volume, and the disproportionate losses being realized by particularly small community banks.

Lux and Greene (2015) also noted that community banks provide over 50 percent of the small business loans.[36] Several trade publications have also linked the Dodd-Frank regulations and the decline in the community banking sector to the declining availability of credit to small businesses.[37] It logically follows that when the vibrancy of the major lender to small businesses declines, the credit constraints for small businesses will tighten.

The good news is that a bi-partisan regulatory reform bill was signed into law in 2018 that exempted small banks from several of the more onerous regulations imposed by the Dodd-Frank Act. These were important reforms that should increase the vibrancy of small business lending.[38]

However, as the Federal Reserve's *Small Business Credit Survey* indicated, smaller businesses seeking smaller loans still face significant credit constraints. Mills and McCarthy (2016) documented that there is a "gap in access" to small business loans for less than $250,000 which "is the level of loan that most small businesses want; more than 70 percent of small businesses seek loans in amounts under $250,000, and more than 60 percent want loans under $100,000."[39]

Microlenders have arisen to fill this microcredit niche. While many microlenders are non-profit organizations that simply distribute federal money, there are also a growing number of entrepreneurial firms that now provide microcredit to small businesses (mostly leveraging online platforms). To ensure sustainability, government supported microlenders should be phased out in favor of the private firms that have a better track record of serving the needs of their customers.[40]

Then there is the question of regulations. Many of the private microfinance lenders do not fit into the current regulatory structure, and are typically less regulated than traditional lenders.[41] The growth in microlending has highlighted this reality, which has led to a growing push to regulate these firms. It is imperative that regulators recognize that they will threaten the ability of the microfinance industry to serve these small businesses if they impose overly burdensome and costly regulations. Consequently, the efforts to regulate the microfinance space should be guided by the following principles:

- The regulations should be streamlined so as to minimize their complexity and cost of compliance;
- The regulations should be as transparent as possible for both the microlender and small business borrower; and,
- Instead of subjecting the microfinance industry to an array of regulators, oversight for the industry should be provided by one national regulator.

Conclusion

Milton Friedman famously noted "one of the great mistakes is to judge policies and programs by their intentions rather than their results." Judged by their results, policies that focus on redistributing income pale in comparison to policies that incent vibrant entrepreneurial sectors. Not only does a vibrant entrepreneurial sector contribute to the "rising tide that lifts all boats" that President Kennedy spoke of, entrepreneurial opportunities are a pathway that low-income people have been able to use for more than a century to build a more prosperous future for themselves and their children.

As this study has demonstrated, there is a strong connection between a healthy entrepreneurial sector and an improvement in the incomes for the lowest-income households in the country. When policies increase the barriers to entrepreneurship, the health of the small business sector worsens, and the economic improvements for the lowest-income households stagnates. The opposite is the case when policies decrease the barriers to entrepreneurship.

Due to this connection, creating an entrepreneurially friendly policy environment should be a top economic policy priority. Fostering such an environment requires tax and regulatory reforms, as well as reforms that improve the availability of credit to small businesses.

> "As this study has demonstrated, there is a strong connection between a healthy entrepreneurial sector and an improvement in the incomes for the lowest-income households in the country.

Tax and regulatory reforms should reduce the costs of complying with the tax code and decrease the costs of overly burdensome regulations. These reforms should include increasing the amount of income not subject to the employer tax and creating a simple new tax-free savings account that would make it easier for entrepreneurs to provide health insurance and retirement benefits for themselves and their employees.

Recent regulatory reforms have helped by reducing the burden from the Dodd-Frank Act on small community banks. By reducing the regulatory costs for community banks, which have been the traditional source of loans for small businesses, these reforms should increase the availability of credit for small businesses. These efforts should be enhanced by promoting a market-based microlending industry that is not subject to excessive or complex regulations that would eliminate their ability to profitably serve small businesses.

The reforms suggested here are not a panacea, but they will meaningfully lower current barriers inhibiting low-income entrepreneurs. And, by lowering these barriers, the reforms will empower aspiring low-income entrepreneurs to start a business. The historical record shows that empowering low-income entrepreneurs is an effective means for improving the financial well-being of the lowest income families.

Endnotes

1 It is important to note that these income levels do not include the value of income support benefits. Therefore, the actual purchasing power of these households is higher than the income thresholds would imply.

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