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Why are some people more likely to become small-businesses owners than others: Entrepreneurship entry and industry-specific barriers

Magnus Lofstrom [a,d], Timothy Bates [b,*], Simon C. Parker [c,d]

[a] Public Policy Institute of California and IZA, 500 Washington Street, San Francisco, CA 94111, United States
[b] Wayne State University, 204 Cherokee Road, Asheville, NC 28804, United States
[c] University of Western Ontario, Canada
[d] IZA, Germany

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ABSTRACT

Why are some individuals more likely to become owners of small businesses than others? We classify industries using measures of entry barriers and proceed to investigate how determinants of entry vary in high- as opposed to low-barrier fields. Claims that neither financial-capital constraints nor the educational backgrounds of aspiring small-business owners predict the likelihood of small-business entry are investigated in this context. These claims of irrelevance, we find, are inconsistent with the facts. The wealth and educational background characteristics potential entrepreneurs possess predispose them to make distinctly different industry choices, both because of the differing rewards available to them and the very different entry barriers they face. The characteristics of potential entrants, in other words, draw them toward some industries and away from others.

1. Executive summary

Why are some individuals more likely to become small business owners than others?

Both theory (Aghion and Bolton, 1997; Evans and Jovanovic, 1989; Parker, 2009) and some empirical studies (Bates, 1997; Parker and van Praag, 2006) suggest that those most likely to enter into small-firm ownership have higher personal net worth and stronger human-capital credentials than non-entrants. Wealthier people can invest more in a new venture and borrow from financial institutions by posting their assets as collateral, thereby avoiding borrowing constraints (Berger and Udell, 1990; Coco, 1999). Advanced education often facilitates entrepreneurial entry by providing needed skills for successful business operation (Shane, 2003).

Yet an impressive body of evidence indicates that neither the wealth holdings nor the educational credentials of aspiring entrepreneurs are causally related to the likelihood of small-business formation. Thus, an influential article by Hurst and Lusardi (2004) found that the relationship between entrant wealth and actual entry into business was flat throughout most of the wealth distribution: only at the top was a positive relationship found. Since the wealthy were least likely to have their entrepreneurial ambitions thwarted by borrowing constraints, the positive relationship observed between entry and abundant household wealth was not due to borrowing constraints. The evidence suggested, instead, that wealthier people simply had a greater preference for

* Corresponding author. Tel.: +1 8283501959.
E-mail addresses: lofstrom@ppic.org (M. Lofstrom), Tbates7893@gmail.com (T. Bates), sparker@ivey.uwo.ca (S.C. Parker).

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becoming entrepreneurs than the less wealthy. Likewise, causal impacts of education upon entry into firm ownership are unclear. Greater education increases one's options in salaried employment, thereby increasing the opportunity costs of entrepreneurship, which discourages entry (Gimeno et al., 1997). On the positive side, formal education often enhances one's analytical abilities and provides specific skills needed to run certain types of ventures (Casson, 1995). Educational credentials therefore impact the likelihood of entry into entrepreneurship in offsetting ways.

Building on previous research, this study investigates causal relationships between the financial- and human-capital resources of potential entrepreneurs and their likelihood of new-venture entry. Most previous studies of entry have implicitly assumed homogeneity of the entrepreneurial occupation, despite the fact that small-firm owners are an unusually diverse group, ranging from casual laborers to specialized professionals. Past studies have also treated entry itself as a homogeneous outcome, even though it is more difficult to enter some industries than others. *The novelty of the present article is to analyze the effects of educational background and personal wealth on entry while distinguishing between entry into "low" and "high" barrier industries*. Our guiding hypothesis is that industry context shapes impacts of entrant resource endowments on small-firm entry patterns. It turns out that this distinction possesses considerable empirical heft, revealing relationships between wealth holdings, educational credentials and entry disguised by conventional, aggregated analyses across different industry types.

Because individuals choose their industry sector jointly with their decision to enter, we adopt a multi-pronged empirical strategy. First, we analyze entry into small-business ownership using a conventional aggregated analysis of entry; we then estimate a multinomial probit model with 3 outcomes: 1) entry into low-barrier industries; 2) entry into high-barrier industries; 3) no entry. Next, we analyze entry choices of high- or low-barrier industries in a bivariate sample selection model. Our findings exhibit a high degree of consistency, indicating that potential entrepreneurs tend to self-select into certain industries, depending upon their initial resource endowments. These facts suggest that the conventional approach of conflating different industry types in empirical analyses of transitions to entrepreneurship generates misleading findings about determinants of entry.

It might seem somewhat surprising that readily available resources like wealth and education can overcome entry barriers established by more powerful incumbents, who may adopt Porter cost leadership or product differentiation strategies. Yet that is exactly what we find, with wealth holdings positively predicting entry into high-barrier industries but not significantly impacting the likelihood of entry into low-barrier fields. The top 2 quintiles of the personal wealth distribution consistently predict entry into high-barrier industries. Thus, across a wide range of the distribution, wealth appears to alleviate borrowing constraints, facilitating entrepreneurial entry in high-barrier lines of business. Educational levels, similarly, are found to predict entry differently in differing contexts. College-education level strongly predicts entry into high-barrier fields, yet the opposite outcome describes low-barrier industry entry. College graduates positively select into industries where entry barriers elevate the expected earnings of firm ownership, while steering clear of low-remuneration fields like personal services. We conclude that industry context heavily shapes impacts of entrant resource endowments on entrepreneurial entry choices.

2. Introduction

The multiple circumstances that may either promote or inhibit new-firm formation have for decades attracted the attention of researchers interested in understanding the determinants of entrepreneurial entry. New venture creation appears to enhance an economy's productivity, intensify market competition, and promote economic growth (Audretsch et al., 2006; Foster et al., 2008). A large literature now explains why some individuals are more likely than others to become entrepreneurs (Parker, 2009). The evidence base is largely derived from econometric models of discrete occupational choice, where self employment or business ownership is identified with the entrepreneurial occupation.

It is often argued that the individuals most likely to become entrepreneurs have higher personal net worth and stronger human-capital credentials than non-entrants (Shane, 2003). Personal wealth serves as equity capital and facilitates borrowing to finance small-business start-up; advanced education provides needed skills. Similarly, increased success and survival odds typify well-capitalized small firms run by owners having the appropriate human capital for operating viable ventures (see, for example, Bates, 1997; Cooper et al., 1994; Dunn and Holtz-Eakin, 2000; Fairlie and Robb, 2008; Hout and Rosen, 2000; Parker, 2009). It is tempting to label this characterization as the prevailing conventional wisdom regarding determinants of entrepreneurial entry, yet substantial controversy remains.

A large body of evidence suggests that neither household net-worth levels nor the educational credentials of aspiring entrepreneurs are causally related to the likelihood of small-business formation. Regarding wealth, Hurst and Lusardi (2004) suggest reverse causality: non-pecuniary benefits of being entrepreneurs attract the wealthy to the entrepreneurial occupation. The positive empirical relationship between entry and personal net worth levels may therefore be unrelated to surmounting capital constraints that might otherwise preclude new venture creation. Causal links between the educational backgrounds of potential entrepreneurs and entry into firm ownership are disputed as well. Advanced educational credentials both encourage and discourage entrepreneurial entry. On the negative side, greater education increases options in salaried employment, thereby increasing the opportunity costs of pursuing entrepreneurship (Gimeno et al., 1997; Le, 1999). On the positive side, formal education often enhances one's analytical abilities, communication skills, and provides specific skills useful in business operation (Casson, 1995). Net effects are thus unclear. Turning to the evidence, a recent meta-analysis by van der Sluis et al. (2008) failed to uncover a clear, positive relationship between entry and the educational backgrounds of potential entrepreneurs.

The present article is premised on the perspective that greater empirical clarity can be gained by distinguishing carefully between entries into different industries, since they impose different entry barriers and entail different rewards, which predispose different aspiring entrepreneurs to make systematically different entry choices. While prior researchers have also recognized the importance of