

CHAPTER 5

Household Income and Net Worth

Phillip H. Kim

Howard E. Aldrich

Lisa A. Keister

Entrepreneurship is central to the evolution of organizations, industries, and economies (Aldrich, 1999). Entrepreneurial activity encourages innovation, fosters job creation, and improves global competitiveness for firms, regions, and entire countries (Bednarzik, 2000). New business formation also shapes the nature of social and economic stratification in an economy, and it is a critical component of social mobility (Keister, 2000b). Organizations play an important role in distributing life chances and determining individuals' social standing and chances for upward mobility (Haveman & Cohen, 1994). Self-employment facilitates wealth accumulation, increases social contacts, and improves social and economic standing for entrepreneurs and their families (Bates, 1997; Fischer & Massey, 2000; Nee & Sanders, 1985). Many business owners, particularly those who create large firms, employ family members in their business ventures, and some pass on their businesses to their families, either during their lives or as part of an inheritance (Keister, 2000b). Successful entrepreneurs may also be able to expand their children's human capital, social connections, and occupational opportunities (Nee & Sanders, 1985).

Although entrepreneurship clearly has important social and economic consequences, we have few well-grounded empirical generalizations about the specific factors that lead to the creation of new businesses. One potentially important factor that has attracted little attention is household net worth. Wealth, or net worth, is

the value of a household's assets less their liabilities. Like income, net worth is a measure of the financial resources available to the entrepreneur. Net worth, the total value of financial resources currently available, may be a more critical component of family finances than income, for a number of reasons. For instance, financial assets can be used directly as start-up capital or for later investment or indirectly for securing loans. In this chapter, we explain why household income and net worth variables are central to understanding entrepreneurship, and we explore briefly how the Panel Study of Entrepreneurial Dynamics (PSED) is uniquely designed to facilitate empirical study of this relationship.

The Importance of Income

Because accurate data on wages and salaries are widely available, income is perhaps the most commonly studied indicator of financial well-being. Several developments have made longitudinal data on income widely available: the advent of the income tax, increasingly comprehensive census data, and advances in survey data collection (Winnick, 1989, p. 160). Perhaps because income data has been fairly easy to obtain, entrepreneurship researchers have tended to focus on it.

In their study of survival prospects of new business ventures, Boden and Nucci (2000) described how individuals might weigh their participation in a start-up venture in terms of *opportunity costs* of their present income from employment. This opportunity cost approach clarifies the concept of utility that researchers use in their models to predict an individual's preference for pursuing self-employment (Blanchflower & Oswald, 1998). An entrepreneur makes two evaluations: prospects for additional income from a start-up relative to present income, as well as perceived future income from the current place of employment. At lower income levels, individuals may find that the opportunity cost is low enough to pursue the uncertainties of income from a new venture. For example, if a venture fails, an individual may be able to find wage employment elsewhere at a similar income level. Or, the projected minimal income stream from a new venture may be similar, in the short term, to an individual's current income stream. In such cases, an individual would pursue a new venture, given a higher projected long-term income stream.

However, in higher income brackets, individuals may find that the prospective gains from an entrepreneurial venture are outweighed by the loss of present and future income from their current place of employment. Furthermore, future employment prospects associated with their present occupation may be perceived more favorably than the uncertain outcome from an entrepreneurial venture. Individuals at higher income levels may perceive income streams from wage and salary employment to be more predictable and thus be reluctant to pursue a start-up venture.

In another argument for a potential negative association between income and the likelihood of becoming an entrepreneur, Evans and Leighton (1989) argued that

low-wage workers are forced to pursue self-employment when they are excluded from the traditional wage labor market. Such “necessity entrepreneurship” can be contrasted with “opportunity based entrepreneurship,” which would occur independently of someone’s current income level (Reynolds, Camp, Bygrave, Autio, & Hay, 2001). To the extent that opportunity-based entrepreneurship dominates over necessity-based entrepreneurship, the association between income and becoming an entrepreneur will weaken.

The Importance of Net Worth

Using income alone to indicate the financial well-being of families would be adequate if income and wealth were highly correlated. However, the correlation between the two indicators is relatively low. Estimates from survey data suggest that the correlation between income and wealth is about 0.50 and that much of this already weak correlation is attributable to the inclusion of asset income (income generated by wealth) in the definition of total income. When asset income is removed from total income, the correlation between income and net worth drops to below 0.30 (Keister, 2000b). This suggests that using income alone captures only part of a household’s financial picture.

There are several reasons why wealth and income are not more highly correlated. Many of the truly wealthy have rather low earnings because they are able to support current consumption with income derived from assets (Wolff, 1995). In addition, retired persons often have low incomes but substantial net worth because their wealth continues to accumulate after retirement even though earnings have ceased (Radner, 1989b). Racial differences in savings and asset accumulation also account for some of the weak correlation between wealth and income (Brimmer, 1988). In fact, many families, particularly non-White families, have zero or negative net worth regardless of income (Radner, 1989a; Winnick, 1989). For these reasons, many families found to be below the poverty line based solely on current income may be living quite comfortably on assets acquired during more prosperous years. Likewise, those with incomes above the poverty line may, in reality, have considerable debt and few assets, making them vulnerable if current income were to be reduced or to cease entirely. Hence, current income may be a poor indicator of true financial stability (Wolff, 1990).

Moreover, wealth has important advantages beyond those associated with income. Wealth provides current use value (as in the ownership of a home), generates more wealth when it is invested, provides a buffer during financial emergencies, and can be passed to future generations. Wealth provides its owners with political power, educational and occupational opportunities, and social advantages that accumulate within and across generations (Keister & Deeb-Sossa, 2000).

Access to assets is not evenly distributed. Between the 1960s and the 1990s, the total wealth owned by American households as homes, other real estate, stocks, and other financial assets (converted into 2000 dollars using the CPI) increased

from about \$7.8 trillion to more than \$23.5 trillion (Keister, 2000b). Between 1989 and 1998, median household net worth increased more than 20%, and the number of billionaires in the Forbes 400 rose from 85 to 267 (Kennickell, 2000). In that period of an overall increase in wealth, the proportion of net worth owned by the top 1% of wealth owners rose from 30% to more than 34%, while the proportion of net worth owned by those in the bottom 90% declined from 33% to just over 30% (Keister & Moller, 2000). This difference might not seem particularly large, but enormous changes in wealth ownership at the household level are necessary to produce small distributional changes. When mediating factors such as race are considered, inequality in wealth ownership is even more severe (Keister, 2000a).

Net Worth and Entrepreneurship

For an entrepreneur, household net worth may be particularly critical. Assets can be used as start-up capital for entrepreneurs who want to start a business. Household assets can also provide a financial safety net during the transition to business ownership or during financial crises that occur later in the life of the business. Accumulated wealth also sends a positive signal to external parties, such as creditors, potentially enabling an entrepreneur to secure additional capital for start-up in the early stages of entrepreneurship or later expansion.

Although we might expect a strong positive relationship between household net worth and entrepreneurship, previous research on the effect of financial capital on new business formation has generated mixed results. Some researchers argued that financial capital is critical for entrepreneurship and that liquidity constraints inhibit start-ups (Bates, 1997; Dunn & Holtz-Eakin, 2000; Evans & Jovanovic, 1989). They reasoned that business start-ups often require a substantial sum of money in order to buy the necessary equipment and supplies. This perspective emphasizes that equity, particularly from family wealth holdings, allows entrepreneurs to obtain credit, and those with little personal wealth simply cannot secure necessary start-up capital. Thus, those with high net worth, high income, and home ownership are expected to be more likely than others to become self-employed (Evans & Leighton, 1989; Fischer & Massey, 2000). In support of this viewpoint, research has shown that obtaining money from an inheritance increases the likelihood of self-employment (Holtz-Eakin, Joulfaian, & Rosen, 1994).

Personal savings are often the key to funding new businesses. Financing through bank loans or investors can be difficult and disadvantageous for the small business owner for many reasons. For those with little or no wealth, financing through institutional loans can exact a high price in the long term. Because small businesses are higher-risk clients for potential financiers, lenders often compensate by increasing the financial costs associated with the loans, making this a less appealing path to gaining business capital in comparison to personal savings. In addition to the high costs of using financiers, small businesses also incur the cost of identifying

potential financiers and undergoing bonding activities to ensure firm legitimacy. Furthermore, there is also evidence from research on home-based businesses, which comprise a large proportion of all new businesses, that few were eligible for bank loans (Jurik, 1998).

Researchers who disagree with the emphasis on financial capital argue that too much importance has been placed on the availability of monetary assets. These researchers contend that many entrepreneurs require little or no capital to begin forming a new business (Aldrich, 1999). Data from a 1992 survey show that the majority of business owners started their firms with less than \$5,000 (U.S. Bureau of the Census, 1992). Others have shown that personal wealth is not a major factor in new business ownership (Aldrich, Renzulli, & Langton, 1998). Home-based businesses, for instance, which accounted for half of all new businesses in 1992, often require little capital up front.

Furthermore, small business owners can often find ways around capital constraints. Many small business owners use financial “boot-strapping” methods to decrease capital needs in the start-up phase (Freear, Sohl, & Wetzel, 1995). These methods include relatives working below market salary, using owners’ personal credit cards for business expenses, borrowing from relatives, withholding owners’ salaries, taking on freelance assignments from other businesses, and leasing equipment rather than buying it (Winberg & Landstrom, 2000). New business owners may be forced to start out by relying exclusively on their own and their relatives’ resources (Aldrich & Waldinger, 1990).

Human capital, that is investments in skills and knowledge that boost earning power, has been proposed as a more important influence on business formation than income and wealth. Education, training, and workplace experience are the most common indicators of human capital used in labor force participation analyses, and these traits have been associated with the success of entrepreneurs (Bates, 1997; Evans & Leighton, 1989). Human capital clearly shapes entrepreneurial activity and success, but the degree to which human capital versus financial capital matters is still an open question.

Income and Net Worth Questions on the PSED

The PSED is uniquely designed to assess the role that household income and net worth play in entrepreneurship. PSED respondents were asked a series of questions designed to determine their household income and net worth. For both series of questions, respondents had the opportunity to provide an exact value. If the respondent refused, the interviewer asked a series of questions to narrow the range of possible values. In the following sections, we describe the nature of the survey questions, the methodology used to code the responses, response rates, and descriptive statistics for the recoded household income and wealth variables. We based our analysis on 1,225 cases, which is a subset of the full data set of 1,261 cases in Wave 1. Thirty-six cases were omitted due to various selection criteria that qualified a respondent as a nascent entrepreneur and due to missing information in other

variables. Additional information on selection rules can be found in Shaver, Carter, Gartner, and Reynolds (2001).

Income Questions

Household income included all sources of income such as work, government benefits, and pension before taxes in the previous year. Because data collection took place at different times for different subsamples, these figures were relative figures rather than absolute figures for a specific year. Complete question wording is presented in Table 5.1. Respondents were first asked Q386 to obtain an exact report, and if necessary, taken through the sequence of categorical income questions. The initial question for this categorical sequence (Q386a) was "Is your household's annual

Table 5.1 Household Income Questions (Q386 to Q386m)

<i>Item Number</i>	<i>Question</i>
Exact Report	
Q386	What was your total household income from all sources and before taxes last year? Be sure to include income from work, government benefits, pensions, and all other sources.
Categorical Reports	
Q386a	Question stem: Then, would you tell me, is your household's total annual income, before taxes, over . . . \$50,000 per year?
Q386b	\$30,000 per year?
Q386c	\$10,000 per year?
Q386d	\$5,000 per year?
Q386e	\$20,000 per year?
Q386f	\$40,000 per year?
Q386g	\$80,000 per year?
Q386h	\$60,000 per year?
Q386i	\$100,000 per year?
Q386j	\$200,000 per year?
Q386k	\$150,000 per year?
Q386m	\$500,000 per year?

income, before taxes, over \$50,000 per year?" Depending on the response, branching questions were then asked to channel respondents into one of two question series to determine a more precise range above or below \$50,000.

To create a continuous household income measure, we took the following steps. For all respondents that did not provide an exact report, we examined their responses to the series of categorical questions (Q386a to Q386m). When a valid range could be determined (e.g., \$20,000 to \$40,000), we coded the value at the midpoint of the range. When respondents did not complete the sequence of categorical questions, we employed the following rules. When a range could be determined (i.e., a definite lower and upper bound), we again coded the value at the midpoint of the range. We assumed the lower bound could not be lower than zero. When an upper bound could not be determined, we coded the case to missing. Respondents who reported household income of greater than \$500,000 per year were also coded to missing, since no other categorical question could be used to determine an upper bound. When no categorical information was provided, cases were coded to missing. After following these procedures, we achieved complete income data on 96% of the cases, as shown in Table 5.2.

Table 5.2 Coding Distribution: Household Income

<i>Household Income Responses</i>	<i>Cases</i>	<i>Percentage</i>
From single report (Q386)	1089	88.9
Code midpoint (\$0–\$50,000)	57	4.7
Code midpoint (\$50–\$80,000)	18	1.5
Code midpoint (\$80–\$100,000)	4	0.3
Code midpoint (\$100–\$200,000)	7	0.6
Missing (No Information)	40	3.3
Missing (Partial Information)	10	0.8
Total	1225	100.0

Net Worth Questions

The PSED asked respondents for details about their components of wealth (real and financial assets) to get a more accurate picture of the household's financial circumstances and to allow researchers to explore variations in the effects of the components of net worth on entrepreneurship. The PSED questions on net worth were modeled after questions on the Survey of Consumer Finances, an authoritative data source on household net worth collected by the Federal Reserve Board. In Table 5.3, we present the questions in the net worth module of the PSED.

Table 5.3 Household Net Worth Items in the PSED

<i>Item Number</i>	<i>Question</i>
Wealth Components Measures	
Q387a	What would be the current value of this home if it were sold today?
Q387b	If there are mortgages or land contracts on this home, land, apartment, or property, how much is still owed after the most recent payments were made? (Interviewer Probe: Do not include home equity loans or lines of credit.)
Q388	It would also be useful to know the total value of any tangible assets owned by the household, other than the primary residence. Please include all those things owned by the husband, wife, or household partner, or jointly. What would be the total current value of any other real estate, cars or other vehicles, such as boats or recreational vehicles, home furnishings, jewelry, and the like? Do <u>not</u> include savings and investments.
Q389	An estimate of all of the household's savings and investments would also be useful. What would be the current value of stocks, bonds, mutual funds, savings accounts, checking accounts, retirement accounts, non-incorporated business assets, and the like? (Interviewer Probe: Include all those owned either by the husband or wife, or jointly.)
Q390	Next, it would be useful to have an estimate of all the other debts or land contracts for the household, not including the first mortgage on the primary residence. What is the current value of all loans outstanding, such as mortgages on other property, home equity loans, automobile loans, credit card loans, education loans, and the like? Again, please include all debts for which either the husband or the wife are responsible.
Single Report	
Q391	What do you think is the current net worth of the household? This is the total value of what you have—physical property and all investments and checking accounts—minus what you owe—all mortgages, home equity loans, car loans, and the like—all those things owned or money owed separately, or jointly, by the husband and wife.
Categorical Reports	
Q391a	Would you consider the total household net worth to be more than \$1,000,000? Again, include any assets or debts shared with a spouse or household partner.
Q391b	Is your total household net worth over \$500,000?
Q391c	Is it over \$750,000?
Q391d	Is it over \$250,000?
Q391e	Is it over \$100,000?
Q391f	Is your total household net worth over \$5,000,000?
Q391g	Is it over \$2,500,000?

Respondents were asked to provide their household net worth using three separate approaches. First, respondents responded to questions for each wealth component (Q387 to Q390). To determine the value of real (tangible) assets owned, respondents were asked whether they owned their own home (Q387), the value of the home if owned (Q387a), and the value of other tangible assets such as other real estate, cars, and home furnishings (Q388). To determine equity in these assets, respondents were asked the value of mortgages (Q387b), debts, and land contracts on these assets (Q390). To determine the value of financial assets, respondents were also asked the value of their savings and investments (Q389). By subtracting all liabilities (i.e., mortgage and other liabilities) from all assets (i.e., home value, savings and investments, and other assets), we created the *calculated wealth value*. Second, respondents supplied an estimate of the total current value of the household's net worth (Q391). We refer to this value as the *single wealth report*. Third, if respondents refused to give a single wealth report, they were asked a series of categorical questions that allowed them select a range for their total current household wealth (Q391a to Q391g). We refer to this value as the *categorical wealth report*.

Among the three approaches, we prefer the calculated wealth value over the other two approaches and recommend it to other investigators. We believe respondents would be more accurate in providing values for individual components rather than estimating the single wealth report. Respondents may not have accounted for or been aware of all components in calculating net worth when providing the single report or categorical information. Using the calculated wealth value approach allowed us to determine the magnitude of negative net worth, which was not captured in the single wealth report. For nearly three quarters of the cases, we utilized the calculated wealth value for the respondent's household wealth. Respondents in the cases provided complete information for all wealth components.

For the remaining cases with partially complete component information, we devised a set of complex decision rules to estimate the household wealth value in order to maximize the use of all available information. We assigned these cases to nine categories based on the combinations of missing component information. Our guiding principle still remained that respondents were more accurate in reporting wealth component information than the two other wealth estimation approaches. Thus, for each category, rules were developed for three different conditions where the single wealth and categorical wealth reports could supplement the calculated wealth value based on the available component information.

For the majority of the decision rules, we approached the estimation of the household wealth value using the *principle of midpoints*. We attempted to determine the lower and upper bounds of a range for the calculated wealth by making assumptions of how missing component information, if available, would change our estimated wealth value. Calculated wealth values with missing asset information could only increase, because an asset contributes positively to the total wealth value. In this case, the calculated wealth value would be a *lower bound*. Similarly, calculated wealth values with missing liability information gave us an *upper bound*, because a

liability would be subtracted from the total wealth value, if it were known. If we were able to determine both lower and upper bounds using all information available, we took the midpoint as the assigned value. However, in some cases, only one bound could be established. To maximize the useful information obtained in these cases, we created two household wealth variables, based on conservative and aggressive estimations. For our conservative household wealth estimate, we coded the single-bounded cases as missing. However, for the aggressive estimation variable, we assigned cases the value of the bound that was calculated and an indicator variable to signify a lower or upper bound. For the remaining cases, where the bounds were not in dispute, the conservative and aggressive wealth variables were equal.

Two other scenarios relied on the principle of midpoints for cases using missing mortgage information. For cases missing mortgage information, we assumed that home equity was positive and the value of the missing mortgage would be no greater than the reported home value. As a result, under certain circumstances, we took one half of the value of the home as the midpoint in order to estimate home equity. For cases relying on the categorical wealth report, we determined the midpoint based on the ranges provided by the respondent. However, due to the question-sequencing pattern, the application of the principle of midpoints became more complicated for a small number of cases. The categorical sequence started with the respondent answering if household wealth was greater than \$1 million. If the respondent answered this question, but then refused to provide additional information in the sequence, a range could not be determined and the rules on conservative/aggressive estimation applied. The omission of a question presented another complexity. The categorical sequence ended with a question of whether household wealth was less than \$100,000. However, from this question, we do not know if household wealth was negative, and thus without any additional information, a lower bound could not be established.

In Figure 5.1, we diagram the decision steps used to apply the various principles we have described. After applying these decision rules, we assigned a wealth value for 88% of cases using the conservative approach and 96% of cases using the aggressive estimation approach. In Table 5.4, we show the distribution of cases in each calculated wealth category.

In Table 5.5, we provide descriptive statistics for the household income and wealth variables. The correlation between the raw household wealth variable and our calculated wealth variables (conservative and aggressive) ranges from approximately 0.72 to 0.80. The raw household wealth variable (HHNETW) is available for 968 cases and was constructed by the Survey Research Center at the University of Michigan. Although the two forms of the wealth variable correlate positively, using our proposed coding methodology allows researchers to utilize additional cases that would otherwise be considered missing. We thus recommend using our constructed wealth variable, rather than the variable in the data set. Detailed coding algorithms for using our rules are available from the authors.

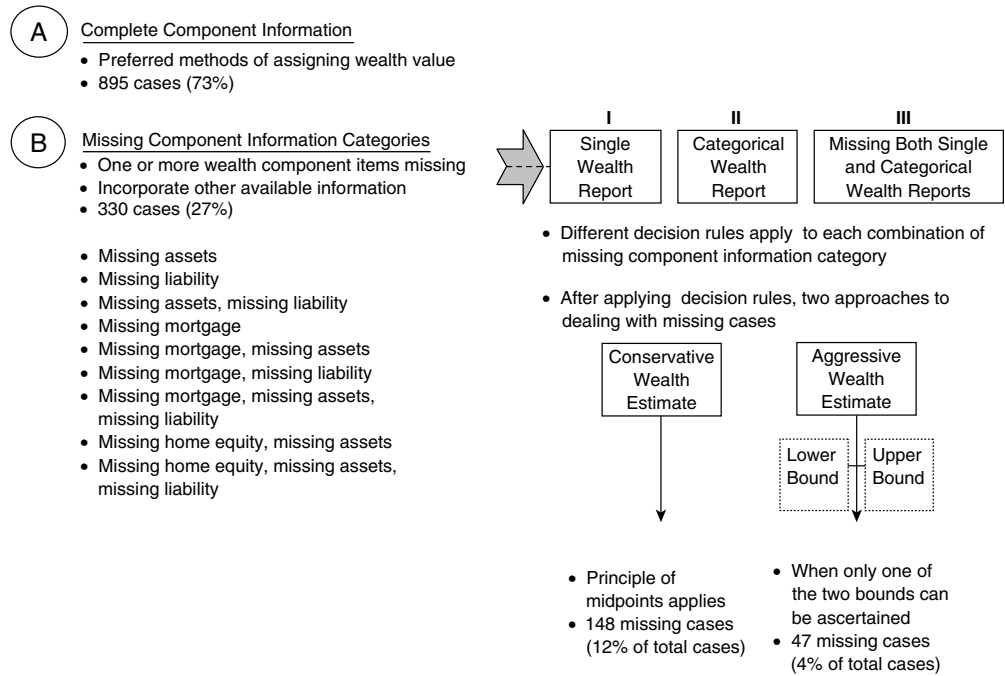


Figure 5.1 Decision Rules for Assigning Wealth Value

Table 5.4 Coding Distribution: Household Wealth

<i>Household Wealth Responses</i>	<i>Cases</i>	<i>Percentage</i>
Complete component information	895	73.1
Missing assets	140	11.4
Missing liability	13	1.1
Missing assets, missing liability	70	5.7
Missing mortgage	19	1.6
Missing mortgage, missing assets	20	1.6
Missing mortgage, missing liability	5	0.4
Missing mortgage, missing assets, missing liability	23	1.9
Missing home equity, missing assets	16	1.3
Missing home equity, missing assets, missing liability	24	2.0
Total	1225	100.0

Table 5.5 Descriptive Statistics: Household Income and Wealth Variables

	Mean	Median	S.D.	S.E.	Correlations with Original Wealth Variable (HHNETW)
Household Income	\$54,364	\$45,000	\$44,450	\$2,410	
Nascent Entrepreneurs	\$58,062	\$45,000	\$70,231	\$2,364	
Comparison Group	\$54,131	\$45,000	\$42,327	\$2,561	
Household Wealth					
Conservative	\$208,737	\$87,000	\$490,177	\$28,613	0.773
Nascent Entrepreneurs	\$234,235	\$60,000	\$768,803	\$31,205	0.721
Comparison Group	\$207,104	\$87,000	\$467,111	\$30,410	0.799
Aggressive	\$196,780	\$80,200	\$470,311	\$26,213	0.774
Nascent Entrepreneurs	\$224,895	\$60,000	\$742,863	\$29,043	0.716
Comparison Group	\$195,016	\$82,000	\$448,044	\$27,824	0.800

NOTE: These statistics have been calculated using survey weights—explanation on weighting methodology can be found in Appendix B of this book.

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