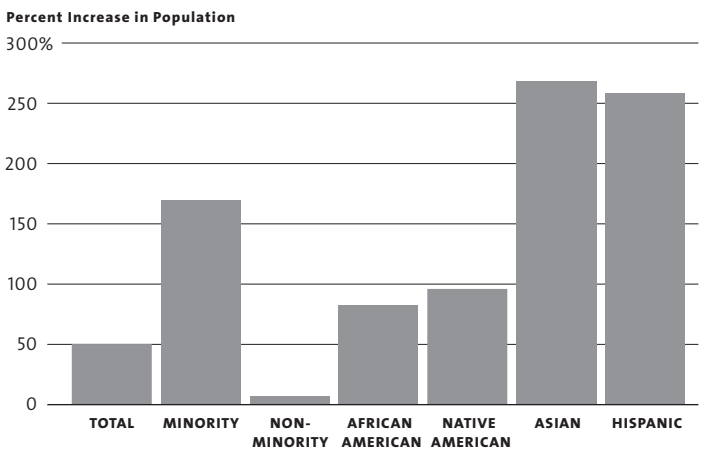


BY GLENN YAGO AND BETSY ZEIDMAN

# Creating an inclusive economy that reflects the

United States' diverse demography has always been the right thing to do; today, it is the only thing to do.

## THE EMERGING MARKETPLACE IN AMERICA 1995-2050



Since the heady days of the civil rights and women's movements, activists and business leaders have butted heads about social and economic justice. Both sides implicitly assumed that fairness was at odds with efficiency – that equity necessitated some sacrifice in productivity. Now we are coming to understand that bringing everyone into the fold doesn't compromise growth. Quite the contrary, it is the key to sustaining Americans'

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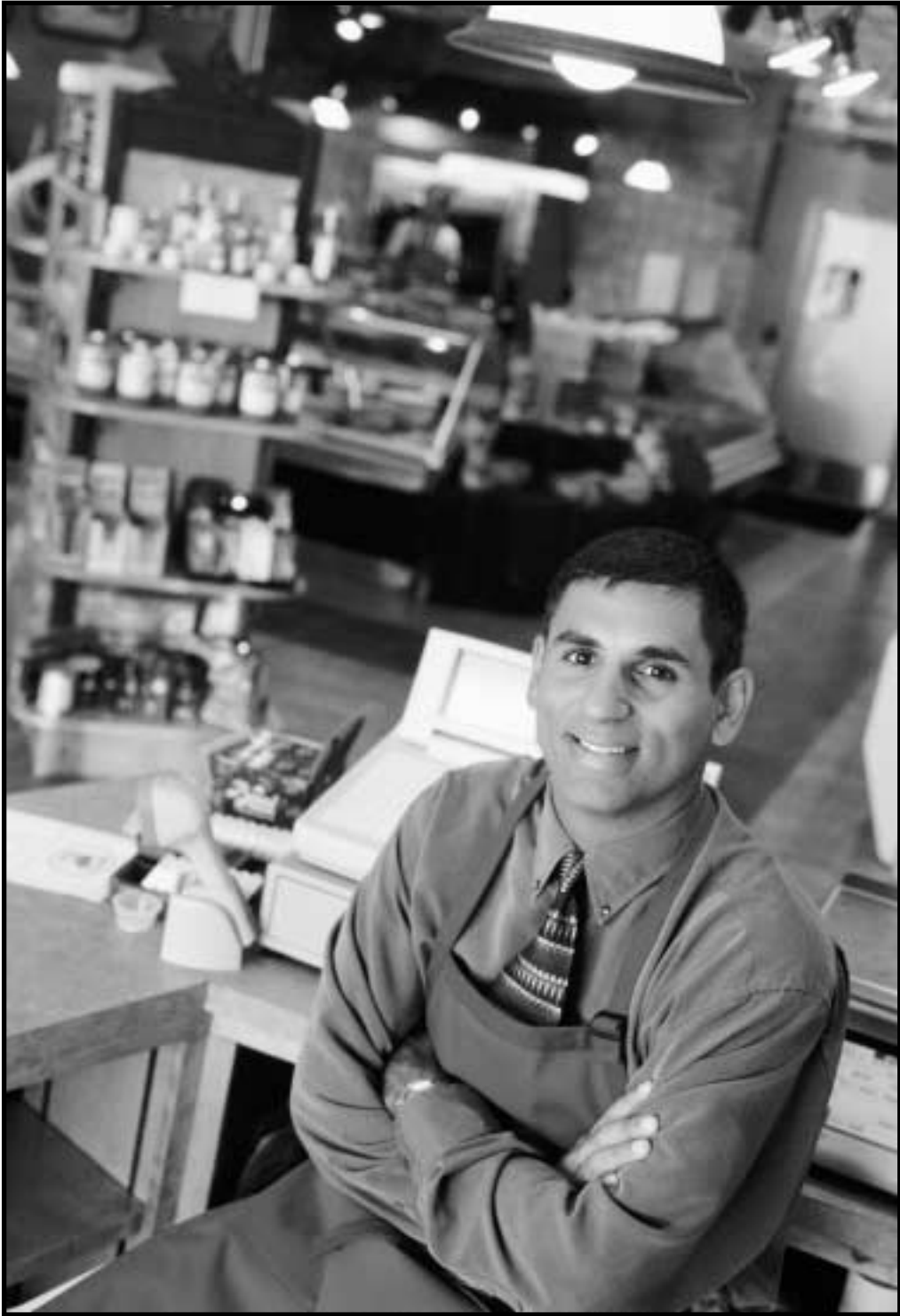
standard of living as the giant baby boom generation retires.

As a practical matter, gains in social equity turn on increasing opportunities for business ownership in what is coming to be known as "emerging domestic markets." And that turns on broadening access to capital, management talent and product markets.

Over the past few years, the Milken Institute in conjunction with the U.S. Commerce Department's Minority Business Development Agency,

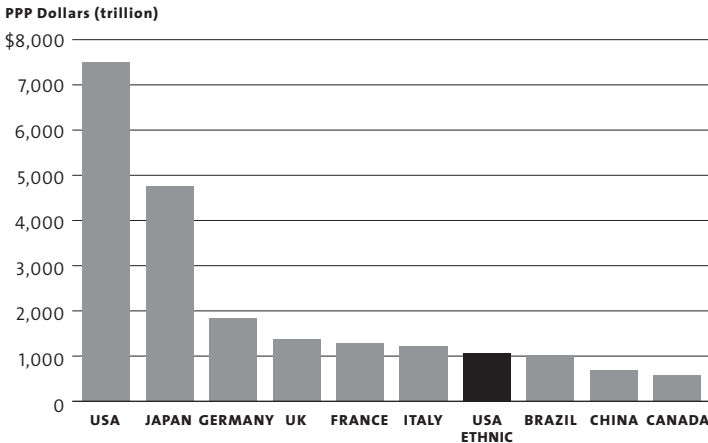
the California state treasurer, state pension funds and private foundations, has quietly built the case for investing in emerging domestic markets – that is, in people, places or enterprises that have been undercapitalized because of race, ethnicity, gender or location. Eliminating barriers to opportunity has, of course, always been a good idea. Now, it is becoming prerequisite for strong economic growth.

Five phenomena will largely determine the American economy's success in coming decades, and all of them are linked to our ability to get the most from new sources of

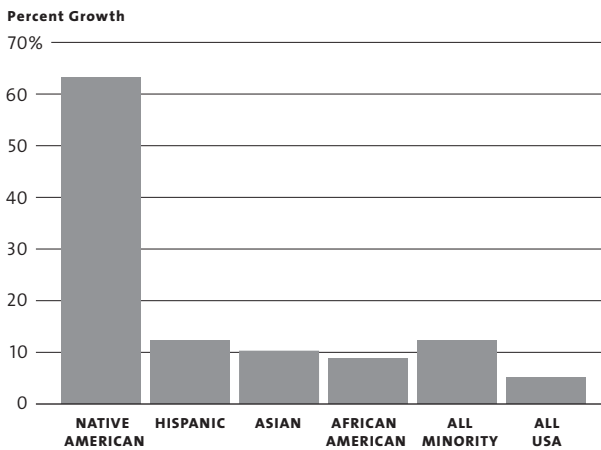


**INSTITUTE VIEW**

**PURCHASING POWER OF ETHNIC MARKETS COMPARED WITH THE 10 LARGEST ECONOMIES**



**AVERAGE ANNUAL GROWTH RATES: EMERGING DOMESTIC MARKET FIRMS 1992-1997**



labor and capital.

**Demographic diversity.** African-Americans, Latinos, Asians, Native Americans and other ethnic and immigrant groups will account for 90 percent of the 131 million people added to the United States population by mid-century. Last year, California became the

first state in which less than half of the residents were white. And 12 more of the nation's most populous states will follow California's lead over the next 15 years. Already, ethnic and racial minorities represent a consumer spending base that is larger than all but six countries in the world. How much – as well as how efficiently – we invest in these groups will determine whether the United States will sustain its place as the model of political and economic democracy.

**Labor supply constraints.**

Since the 1970s, the rate of growth of the labor force has been ebbing – from 2.7 percent in the 1970s, to 1.6 percent in the 1980s, to between 1 and 1.5 percent today. Everything points to even lower rates over the next few decades. Thus, with 70 percent of increases in the work force coming from ethnic populations, the failure to integrate these groups into the broader business culture would sharply limit economic growth.

**Entrepreneurial energy.** Economic growth spurts have historically been triggered by waves of entrepreneurial innovation, which in turn have been triggered by demographic shifts. Each period of demographic change – the

westward movement of the mid-19th century, Western European immigration during the late 19th century, the Southern and Eastern European immigration of the early 20th century – yielded rich harvests of entrepreneurial talent that drove industrial expansion. There is good reason to believe that the current

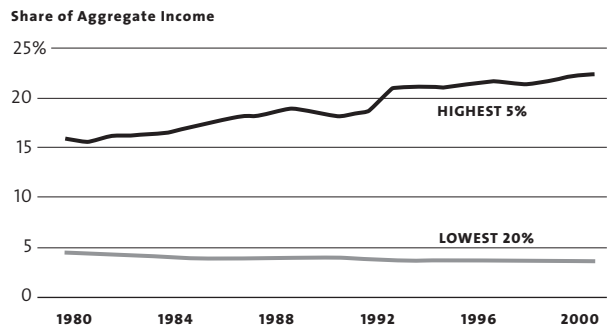


demographic wave will be equally productive, provided the new entrepreneurs have access to human and financial capital.

The minorities that constitute emerging domestic markets represent 27 percent of the population, but own only 15 percent of the nation's businesses. And those businesses generate just 6 percent of the sales. The case against investment myopia is even stronger when viewed from the perspective of women-owned businesses. Companies owned by women accounted for only 5 percent all businesses and about 1 percent of all sales 30 years ago. Today, women own 28 percent of all privately held firms and their businesses generate almost 10 percent of sales. In the last five years alone, the number of women-owned firms has grown at twice the rate of all companies, with employment increasing 30 percent.

**Wealth and income polarization.** In the last decade of the 20th century, the share of national income going to the top fifth of the

### INCOME INEQUALITY IS GROWING



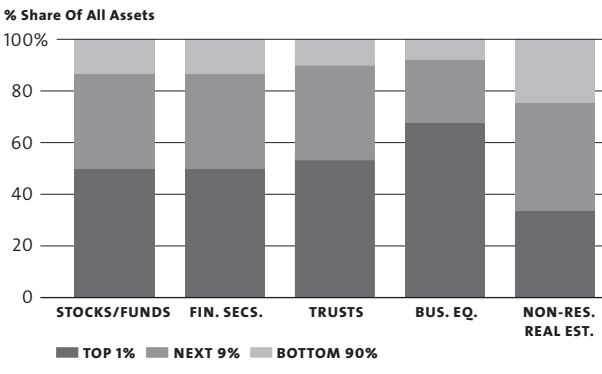
population expanded at a faster rate than any previous period of United States history since the Great Depression. Changes in the distribution of wealth have been even more extreme. Yet, limits on the government's ability to

## INSTITUTE VIEW

redistribute income through tax and spending policies have long since been conceded by erstwhile champions of the poor. Hence, social justice now more than ever depends on gains in economic mobility through skills

### THE HAVES AND HAVE-NOTS

#### HIGHLY CONCENTRATED INVESTMENT ASSET OWNERSHIP



### DOMESTIC VS. INTERNATIONAL MARKETS

RISK FACTORS	EMERGING DOMESTIC MARKETS	EMERGING INTERNATIONAL MARKETS
Political Risks	NO	YES
Expropriation	NO	YES
Regime Volatility	NO	YES
Legal Contract	NO	YES
Currency Risk	NO	YES
Financial Risk	YES	YES

acquisition and individual enterprise.

**Land constraints.** Growth in urban markets – for both housing and commerce – requires significant amounts of land. Much of this demand could be met by using parcels located in emerging market neighborhoods. Roughly 25 percent of this overlooked property – urban infill skipped over during the suburban expansion of earlier decades – has adequate infrastructure, is close to metropolitan markets and, if amassed and developed,

could meet the needs of urban cores. This real estate thus creates a significant investment opportunity for those with patience and vision.

### SPURRING DOMESTIC MARKETS

The case for doing well by doing good could hardly be stronger. Indeed, if pension funds and other institutional investors fail to channel Americans' savings into emerging domestic markets (where risk factors are modest compared with foreign emerging markets) the United States economy will not be productive enough to cover the retirement of the baby boomers in the style which they have come to expect.

There is little question that minority entrepreneurs are capital constrained. Latino and African-American business owners are turned down for loans at far higher rates than white owners. Moreover, the black-to-white loan denial rate is 3.5 times greater in the small-business credit market than in the home mortgage market.

Women face similar problems. Despite the fact that they own close to 30 percent of all United States businesses, only 16 percent of women-owned companies have \$100,000 in bank credit (compared with 36 percent of male-owned companies), and 46 percent have less than \$50,000 (compared with only 34 percent among their male counterparts).

Emerging domestic market companies face continuing challenges in gaining access to the funds needed to grow. Some of these challenges are driven by powerful forces in the economy and affect virtually all small companies: high levels of debt that lead to tighter credit; the shift from a bank-based financial system to a securities-based system, which places new demands on businesses



lacking financial sophistication; and consolidation of the banking industry, which increases reliance on score-based standardized lending and reduces the role of personal relationships between lender and borrower.

However, there is no doubt that emerging domestic market entrepreneurs face additional barriers. They receive only a small percentage of private equity investments, most likely because they lack relationships with individuals in positions to provide the resources. What's more, lenders are far more cautious in minority lending; the average size of commercial loans in minority areas and to minor-

ity companies is smaller, even when controlling for the quality of collateral, education, age and experience of the borrowers.

The success of the United States economy in recent decades is closely linked to the exceptional efficiency of the financial markets in supplying capital to high-risk, high-tech enterprises. It is important to achieve the same efficiency in directing capital to minority entrepreneurs. To manage this, we must address the information and data gaps in these markets, and we must adapt financing mechanisms that have worked well in the mainstream sectors. Partnerships involving government, business and nonprofit organizations can be extremely successful at leveraging resources and expertise, and facilitating the flow of capital.

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Financial innovations fall into three broad categories:

- Systemic innovations that broadly affect the financial sector, such as securitization, corporation-bank-community lending partnerships, expanded receivable-based financing, and intermediary structures providing credit enhancement or mezzanine financing for entrepreneurial ventures.
- Products that better serve markets, such as new models for financing emerging businesses begun by the California Public Employees' Retirement System and the California State Teachers' Retirement System (through private equity programs aimed at underserved communities) and the Bay Area Council (though its Family of Funds, addressing smart growth, environmental restoration and small businesses generating "double bottom lines").
- New business processes, such as networks to

collect reliable data on emerging domestic market businesses, and credit-scoring models applicable to entrepreneurs lacking traditional bank histories.

Among the most promising of these innovations is securitization of small business loans, which enables institutional investors to enter the market and allows America's remarkably efficient fixed income securities markets to work their magic. Moreover, by using innovative "credit enhancement" vehicles like foundation grants and government guarantees, riskier community development loans can be pooled and securitized.

Developing reliable data on emerging domestic market businesses and their loan performance is critical to increasing access to capital that will allow these enterprises to meet their potential. We are convinced that government-business-foundation collaborations can significantly advance this effort. **M**