

BY JAMES R. BARTH, GLENN YAGO AND BETSY ZEIDMAN

Entrepreneurship drives economic innovation. Equally important, entrepreneurs create jobs through self-employment and small-business formation. And it is precisely these jobs that pave the route out of poverty. Indeed, research by the Small Business Administration and the Kauffman Foundation suggests that firms with fewer than 500 employees have generated 60 to 80 percent of the net new jobs in the American economy over the past decade.

ENTREPRENEURSHIP IN AMERICA'S EMERGING DOMESTIC MARKETS

Business-formation rates in emerging domestic markets (that is, firms owned by women and ethnic minorities) are even more striking. Between 1997 and 2002, the number of firms owned by minorities grew at three times the overall growth rate of businesses – a fact that reflects the reality that ethnic communities in the United States are expanding rapidly. Indeed, over 85 percent of the estimated population growth between now and 2050 will come from minority groups.

Still, a close look at the breakdown of distribution of business ownership by race, gender and ethnicity relative to the distribution of receipts, employees and payroll reveals significant imbalances. Women, for example, are significantly under-represented as majority owners of firms, and the under-representa-

tion only increases as one goes up the ladder in terms of firm revenues and payrolls. Much the same can be said of Latinos, who account for 13.5 percent of the population – but own just 6.8 percent of all firms, employing just 1.3 percent of workers and generating less than 1 percent of revenues. African-Americans account for 12.4 percent of the population, but own only 5.2 percent of firms – less than 1 percent of both employees and revenues.

STUMBLING BLOCKS TO ENTREPRENEURSHIP

Despite the recognition that entrepreneurship generates jobs and economic development, there is uncertainty about the roots of entrepreneurship and the policies that best support enterprise development. There is even greater uncertainty about how to foster entrepreneurship in low- and moderate-income communities.

Much of this confusion can be attributed to the wide variations of findings in the rapidly growing research base. Some data sets enable researchers to study individuals or groups over time to identify the factors ex-

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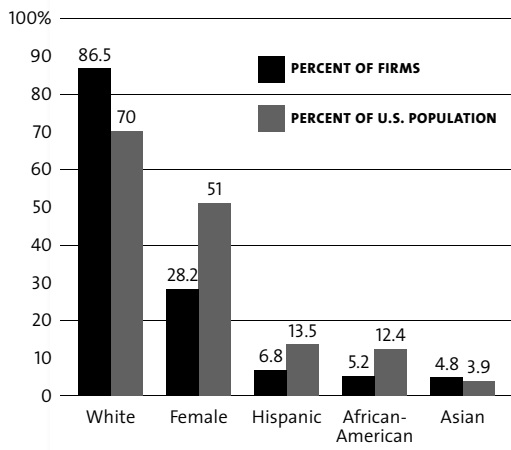
plaining why they choose self-employment. Other data sets allow researchers to examine startups or established small businesses over time and across geographical regions.

If the idea is to identify barriers to entrepreneurship, one way is to ask the entrepreneurs. Business owners polled by the National Federation of Independent Business stressed a variety of problems beyond the reach of government, such as low margins in competitive markets. Among problems that policy-makers could conceivably solve: the cost of workers' compensation insurance (ranked third in importance), business taxes (ranked fifth), property taxes (ranked sixth) and "unreasonable" government regulation (ranked ninth).

CREDIT ACCESS AND LIQUIDITY CONSTRAINTS

There is, however, significant empirical re-

THE DEMOGRAPHICS OF FIRM OWNERSHIP

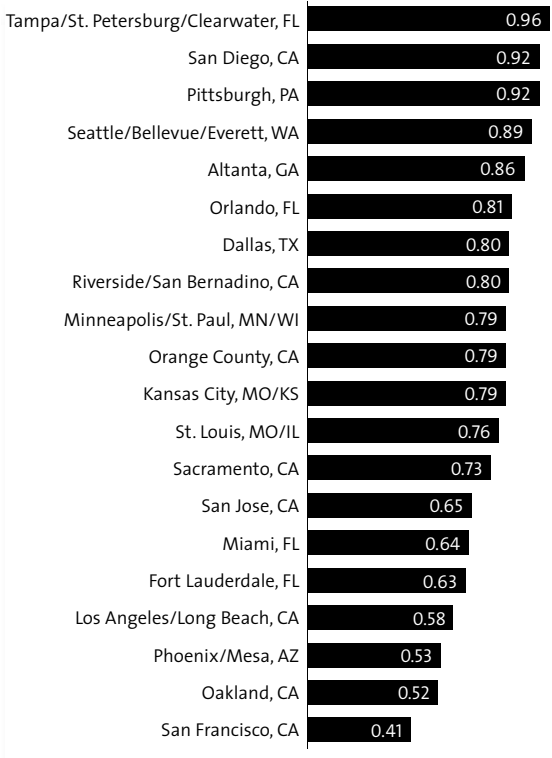


SOURCE: U.S. Census

search suggesting that liquidity constraints – limits on the amount an entrepreneur can borrow – inhibit the rate and growth of business formation. To analyze data on liquidity

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SELECTED LARGE METROPOLITAN STATISTICAL AREAS BY LOAN BIAS



SOURCE: Author's calculations

NOTE: Loan bias is defined as one minus the percentage of loans going to low-income borrowers divided by the percentage of the population with low incomes. Thus, a city with no loan bias would have a score of zero.

in low- and low-to-moderate income communities, we crafted a measure called “loan bias” that measures the share of loans to these communities relative to their share of the population. Using data from the year 2000 collected by the Census Bureau and the Federal Reserve, we found that the number of loans made to individuals and businesses was smaller than one would expect based solely on population figures. The results are less straightforward when we compare ratios of loans to community income level. Nonethe-

less, a majority of low-income communities, along with 13 percent of low-to-moderate income communities, experience loan bias.

We also used statistical analysis to distinguish factors other than loan bias that help to explain variations in entrepreneurship levels – here, defined as the total number of businesses in each city – across 204 metropolitan statistical areas (MSAs). In MSAs that have the largest percentage of self-employment (the smallest businesses), we find a lower share of the population aged 25 to 44, higher household income, a lower percentage of the labor force with a college degree, a smaller share of the labor force that has a high school diploma or less and a larger racial/ethnic mix in the population. These areas have a greater number of loans to low- and low-to-moderate income communities, but the loan sizes are lower on average. Our findings are similar in MSAs with the largest share of establishments with between one and 10 employees. This suggests that self-employment is associated with population concentrations that are older, poorer, less educated and more demographically mixed.

Conversely, the greater the share of businesses with 11 to 100 employees, the greater the share of the population aged 25 to 44, the higher the poverty rate, the higher the state sales tax rate and the higher the average loan size. We find similar results in MSAs with more 100-plus employee establishments and a lower racial/ethnic mix, higher state sales tax rate, a larger average loan size and a higher share of total loans to businesses in their moderate-income communities.

When we analyze the relationship of these variables to the total number of establishments in an MSA (regardless of size), we find that only four factors are significant: the share of population in the 25 to 44 age group (the age of most entrepreneurs), the homeowner-



ship rate (not surprising, as homes are frequently used as collateral for business loans), the number of financial institutions in the MSA (indicating the availability of capital) and the total number of loans made (indicating capital actually provided). The size of the pool of potential entrepreneurs, the link between home and business ownership and the accessibility of financial services are all factors encouraging entrepreneurship.

WHAT COULD BE DONE

We offer several suggestions aimed at increasing entrepreneurial activity in low- and low-to-moderate income communities.

Measure, monitor and manage efforts to support entrepreneurship. Researchers use different measures of entrepreneurship and widely varying sets of data, limiting the ability to compare their work and making it less useful in designing effective policies. Probably the most practical approach for integrating data is to give all researchers access to all the data available. The Milken Institute recently

completed a study (supported by the Ford Foundation) that maps the data providers and explores the feasibility of creating a database open to all serious researchers.

Bridge the financing gap. Our calculations of loan bias suggest that, even when accounting for income disparity, many depressed communities are getting the short end of the stick. In general, our first measure of loan bias (based on population) indicates that businesses in low and low-to-moderate income communities receive a significantly smaller share of the total amount of loans. Our second measure of loan bias (based on income) suggests that the lending gap exists in a large number of cities. To the extent that this bias is not explainable by economic factors or regulatory barriers, a variety of state and federal programs should be coordinated to offer options to close the gaps.

Increase small-business loan origination and investment vehicles. We are not alone in finding that access to financing is critical to entrepreneurship. Urban areas with fewer

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financial institutions and larger average loan sizes tend to have a smaller share of total establishments with fewer than 10 employees (potentially the most entrepreneurial establishments or those most associated with new startups). One way to increase small-business loan origination would be to increase the securitization of such loans. This would allow small-business lenders to sell portions of their loan portfolios and use the proceeds to originate more loans. Additionally, creating investment products secured by these loans that could be rated would enable large, institutional investors to support entrepreneurship in a more cost-effective manner.

Note, too, that while the focus here is on lending programs, it should be recognized that many entrepreneurs must build their businesses with equity, not debt capital. In-

deed, until a business has a track record, it is typically difficult to qualify for a loan. And while entrepreneurs in wealthier areas may be able to tap savings, credit cards, family and friends, those in low-income communities are often at a loss for sources of equity. Several programs attempt to meet this need, including community development venture capital funds, mezzanine debt funds and the federal government's New Markets Tax Credit, but more innovation is needed.

Reach out to African-Americans and Latinos. Discrimination in access to capital appears to persist, particularly against African-American and Latino entrepreneurs. This ongoing difficulty to gain financing suggests a continuing need for efforts to extend capital as well as other forms of support. This is particularly important when one considers that the number of these firms is growing faster than the rate of all firms, and that access to capital is probably a major issue in determining whether they can reach the size needed to compete effectively.

Re-examine tax and regulatory policies that are impediments to entrepreneurship. Often, well-meaning regulations have unanticipated consequences. For instance, bankruptcy exemptions intended to shelter borrowers have in fact hurt them because it reduces lenders' willingness to take chances.

Take advantage of well-developed education programs with targeted outreach. Individuals can learn to become entrepreneurs. What's more, the existence of entrepreneurial firms seems to lead to a snowball effect making it easier to start businesses. Programs such as those supported by the Kauffman Foundation and other foundations should produce greater understanding of entrepreneurship in communities and increase the likelihood of more new businesses being established throughout the country. **M**