Regarding firm traits, the youngest firms are hypothesized to be the least viable, while ongoing firms are assumed to be more viable than those started from scratch.

This is what the discriminant analysis reveals: listed in relative importance, the owner traits most directly associated with firm longevity are: (1) financial investment, (2) owner's age, (3) leverage, (4) hours of owner's labor invested, (5) educational background, and (6) albeit very weakly, sex of owner. In further detail:

The dollar amount of financial capital invested by the owner is clearly more important than any other owner trait when it comes to delineating active from discontinued black-owned businesses.

The second most influential factor is the owner's age; those in the 45 to 54 age bracket are much more likely to remain in business than younger or older owners. Age is undoubtedly related to general experience, up to a point: as old age sets in, general intensity of work effort declines and business viability suffers accordingly.

The third-ranked factor is leveraged debt; active firms are clearly more highly leveraged than discontinued ones. Reliance upon debt capital at the point of startup is *not* associated with heightened risk of failure. The strong, direct relationship between leverage and black firm longevity suggests that the following scenario is operating: black owners who can achieve a highly leveraged position are, in fact, extremely attractive from a credit-risk standpoint. As indicated earlier, college graduates had access to much larger bank loans than less highly educated black business owners.

Fourth factor: owners working longer hours are more likely to belong to the active business group. This is particularly applicable to owners who pursue self-employment full-time: their peers working only part-time are less likely to see their firms survive.

Fifth factor: owners with more than four years of college are more likely to see their businesses survive, but the owner education variables in fact rank lower than expected. This is partly because education has a ripple effect

on other variables—total capitalization and leverage for example, since banks consider education in measuring credit worthiness. Hence education's link to business viability is both direct and indirect. The softened effect of education also stems from factors (explored in chapter five) related to the general exodus of well-educated self-employed blacks from inner-city communities.

Finally, businesses run by males are somewhat more likely to endure than firms owned by black females, though this relationship is weak.

Two firm-specific variables—firm age and buyout status—were found to be associated with business viability. Among the youngest black firms, those formed in 1982—which made up 24.0 percent of the total sample—over 38 percent had discontinued by 1986. The longer the period since the owner entered his/her business, the more likely it was that the business remained active in 1986.

The "ongoing business" variable produced an unexpected finding: firms acquired as buyouts were less likely to survive than businesses started from scratch. This may be due in part to the fact that buyouts are most often small-scale retail firms located in minority neighborhoods. These types of retailing operations have the highest rate of discontinuance observed among the various lines of black enterprise: 40 percent of those in the CBO young black firm sample had folded by late 1986. The entire sample of young black firms had a discontinuance rate of 29.0 percent; net of retailing, that rate drops to 27.7 percent.

Access to Credit and the Likelihood of Small-Business Survival

Borrowers in the black sample of young firms reported a mean financial investment of $32,813 (total), while their nonborrower cohorts began business, on average, with a much more modest $7,660 (table B.4). In light of the findings linking black firm sales levels and survival prospects to size of financial capital invested in the firm, it is tempting to conclude that more debt causes healthier, larger-scale business.

This suggests that increases in loan availability would produce increases in black business viability, independent of all other firm characteristics. This conclusion can be accepted only with important qualifications. Excessive lender caution, including redlining practices, partially shields black businesses from suffering the higher default rates often associated with the liberal lending practices many white firms encounter. And since only the very strongest black business borrowers get large loans, their consequent success could be attributed at least as much to their pre-debt soundness as to the loan itself. In sum, black business viability rises as indebtedness rises, a pattern that does not mirror the usual situation for nonminorities.

Before proceeding, it is useful to summarize what is known about those who do make large financial investments when starting their enterprises. First, for both black and white CBO business samples, debt and equity at the point of startup are complements. Second, in these samples, the single most important determinant of debt level—for white as well as black firms—is the absolute size of the entrepreneur's equity. Third, apart from equity, high educational attainment is associated with the largest loans. And fourth, as a complementary study has shown, owners receiving the largest loans are those who earned the highest personal incomes prior to entering business.[21]

The business owner who has the greatest access to debt therefore typically: (1) is highly educated, (2) has a high personal income, and (3) invests a substantial amount of equity capital into the firm. All of this suggests the following two-stage line of causation:

- High level of education
- High personal income
- High equity investment

→

- Large debt input in the small-business startup

- High level of education
- High personal income
- High equity investment
- Large debt input

→

- Greater likelihood of small-business viability

Would greater loan availability assist the weaker small businesses? The basic hypothesis that higher levels of debt increase firm viability is qualified by a countervailing trend: a high degree of debt may reduce business survival chances by raising the probability of default.[22] It is important to recall that during the late 1960s and early 1970s, the Small Business Administration (SBA) Economic Opportunity Loan (EOL) program approved many thousands of loans to high-risk minority borrowers who could not obtain loans from other sources. In our 1977 analysis of SBA loan data, Donald Hester and I[23] showed that larger loans, other things equal, were directly associated with greater chances of failure. A later study[24] found that weak, highly leveraged SBA loan recipients were more likely to fail, relative to less highly leveraged borrowers.

While those findings concerning the SBA program may seem inconsistent with the findings of this study, it is important to note that lending criteria used by the SBA were quite different from those employed by commercial banks. The point is that the findings of this chapter *do not* disprove the earlier conclusions about the folly of liberal lending to high-risk minority business borrowers.

It may indeed be true that black businesses are being handicapped by restricted access to credit, but in light of SBA's unsuccessful EOL loan program for minorities, this must be proven decisively. The matter is pursued in chapter five, which indeed does find that certain black firms are being unfairly handicapped by limited credit access.

This study has found no evidence indicating that highly leveraged firms are less likely to remain in business than other borrowers; rather, the discriminant analysis suggests that the opposite is true (see table B.6). Nonetheless, high degrees of leverage may indeed be imprudent for many business borrowers.

If capital markets refuse, however, to supply debt to such firms, then the relationship between leverage and business viability—normally an inverse relationship when firm indebtedness is high—fails to materialize. In fact, excessive lender caution does appear to be severely limiting black entrepreneurs' access to credit. In this environment, only the strongest borrowers get the largest loans, and we observe that high indebtedness is now associated with business survival rather than with default. Strength, simply stated, improves credit worthiness, and business startups tend to borrow as much as the banks will permit.

Lender caution—particularly commercial bank caution—is most pronounced in inner-city minority communities (see chapter five). In that milieu, the limited availability of credit amounts to redlining, and it severely undermines small-business prospects for the survival of white as well as black entrepreneurs.

5 Firm Location and Bank Redlining

The chronic economic distress of the ghetto, where many black firms are forced to survive, goes far toward explaining why, in spite of the last 25 years' progress, so much of the black business community continues to stagnate. As the last chapter illustrated, outflows of financial capital and entrepreneurial talent, in combination with weak internal markets, continue to thwart enterprise development in the inner city. Not surprisingly, the success of educated black entrepreneurs in emerging lines of business, discussed earlier in the book, has been most pronounced in locations removed from minority communities.

Even in minority communities outside the core ghetto, small-business owners who would serve minority consumers are beset by barriers that firms elsewhere do not have to contend with, such as redlining by commercial lenders. The analysis that follows compares the relative performance of black-owned businesses both inside and outside of black residential areas, providing a broader picture of their working environment.

The healthier, emerging lines of black enterprise are avoiding or moving out of inner-city minority communities, locating instead in central business districts or outlying suburbs. One of the identifiable causes of this trend is the fact that commercial banks are extensively redlining small firms that do business in minority communities. The net result is that inner-city black communities are increasingly being left out of the business development process.

Since inner-city communities are unpromising business sites, it would only seem logical to expect that minority communities outside the ghetto would offer entrepreneurs far better chances of success. In their economic and social characteristics, residents of these more affluent minority areas are often indistinguishable from the surrounding white suburban population. A much stronger base of purchasing power is potentially available there for black-owned retailers and consumer-service firms to draw on.

In fact, minority businesses in minority suburbs do not do as well as their neighborhood customer profile would lead one to expect. The advantages inherent in serving stronger internal markets are offset by restricted access to financial capital. Black firms located in all minority communities—ghetto and nonghetto alike—tend to be very small in part because their access to credit is restricted: they are less likely than owners in nonminority locations to borrow at all, and when they do borrow they receive substantially smaller loans. A significant part of this problem can be traced to lender discrimination against minority borrowers, discussed next, and to redlining against minority neighborhoods, discussed subsequently.

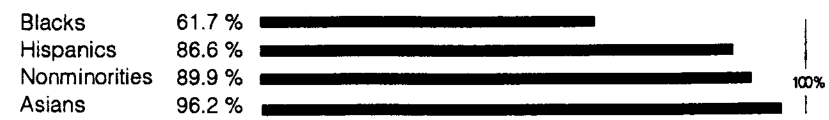
Discrimination Against Minority Borrowers: The Ando Study

Redlining by commercial banks applies to minority communities in general—not just to the core regions of the poverty ghetto that are typified by intense poverty and racial segregation. Moreover, in addition to this geographic discrimination, banks are discriminating against owners: black business owners of established firms have had substantially less success than nonminorities in obtaining commercial bank credit. This is the conclusion reached by Faith Ando's pathbreaking 1988 study, which offers the most concrete evidence of discrimination against

existing black businesses by commercial lenders that is currently available.[1]

Given its importance to the subject, Ando's study is worth briefly reviewing. Until recently, no systematic data existed concerning how banks have treated the loan requests of established small businesses. Ando's study, which was sponsored by the U.S. Small Business Administration, remedies this. Ando compares bank loan availability for large national samples of small businesses owned by black, Hispanic, Asian, and nonminority entrepreneurs, looking at their success in applying for commercial bank loans over a three-year period in the early 1980s. By design, only established businesses participated in the study. Firms from all 50 states are represented. The percentages of all short-term bank loan applications that were accepted are these:

Acceptance rates for short-term loans requested by . . .



The above figures do not necessarily reflect discrimination against blacks, if, in fact, black loan applicants are higher credit risks overall than the other business groups. To test for discrimination, Ando examined the relevance of numerous factors that influence loan approval. Ando found that even when borrowers' credit risk is statistically controlled for, black businesses are much more likely to be denied commercial loans than are nonminorities, Asians, or Hispanics.

More specifically, Ando found that four conditions are the most important in ensuring loan approval: (1) the owner's having lengthy business experience; (2) the firm's size being sufficiently large; (3) an excellent credit rating; and (4) the owner's requesting shorter loan maturities rather than long ones.

Six factors Ando found to be causes of loan rejection are (1) a record of previous bankruptcy; (2) a poor credit rating or no rating at all; (3) being in the "wrong" industry, such as manufacturing (the period under consideration coincided with widespread recession in manufacturing industries); (4) the owner's being divorced; (5) the owner's needing cosigners for the loans; and (6) the owner's belonging to the "wrong" racial or ethnic group—black borrowers were less likely to achieve loan approval.

Redlining Against Minority Neighborhoods

Beyond the basic question of access to startup loans is the question of what influences banks in determining how much to lend. When most people borrow from commercial banks to establish small businesses, the amounts they are loaned depend first and foremost on the size of the equity investment they put up. A larger equity investment means more access to debt; the surest way to get a $100,000 startup loan is to invest $50,000 or so of one's own money as owner's equity. For black entrepreneurs, however, it is not their equity investment that typically has the most influence on their loan amount—it is where their firms are situated. That is the conclusion reached by the analysis conducted for this study. If the proposed business is located in a minority community, loan size is cut drastically.

This chapter documents the practice of redlining against the neighborhoods where black businesses are located. For this analysis, black businesses in 28 large metropolitan areas are further subdivided into two groups: those operating in minority neighborhoods and those located in mixed or nonminority sections. In addition to documenting redlining, the analysis of firm location turns up three other important findings. First, when their firms are located in minority neighborhoods, even highly educated black owners are much more likely than they otherwise would be to abandon self-employment. Second, while black college graduates prefer to locate their firms in nonminority locales, owners who are high school dropouts are the owners likely to survive when they operate in the ghetto milieu.

The third finding, which concerns patterns of employment, deserves special comment. Black-owned firms, it turns out, employ minority workers to a much greater extent than white-owned firms doing business in the same areas. Black employers tend to utilize a work force consisting largely of minority workers, and this is true whether they are located in inner-city ghettos, central business districts, or outlying suburban areas. White-owned businesses behave quite differently. Among all small-business employers located in nonminority areas of the applicable 28 cities, 62.7 percent of the white firms (versus 3.1 percent of the black firms) had no minority employees at all. More surprisingly, even when located within minority communities, most white-owned firms employ predominantly nonminority workforces, and many employ no minority workers whatsoever. In sum, the evidence clearly suggests that the race of owners is a major determinant of minority workers' access to jobs in the small-business sector.

Metropolitan areas chosen for this study. The 28 SMSAs analyzed in this study all have the following traits: (1) a substantial black population, (2) identifiable ghetto areas, and (3) numerous black-owned businesses. A metropolitan area was identified as having a ghetto if it contained five or more census tracts with 1980 poverty rates of 40 percent or more.[2] The applicable metropolitan areas in this study therefore are not merely the nation's largest, although most of those having one million or more residents in 1980 did qualify for the list of 28. In fact, the above three criteria also led to the inclusion of several Southern areas with fewer than one million residents (such as Richmond, Jackson, and Nashville) as well as one small Northern area (Gary-Hammond-East Chicago, in Indiana).

The list of 28 is dominated by 14 large metropolitan areas in the sense that most of the black businesses sampled were, in fact, located in these areas. These 14 are:

Atlanta
Baltimore
Chicago
Cleveland
Dallas-Fort Worth
Detroit
Houston
Los Angeles
New Orleans
New York
Philadelphia
St. Louis
San Francisco-Oakland
Washington, D.C.

The other 14 areas are:

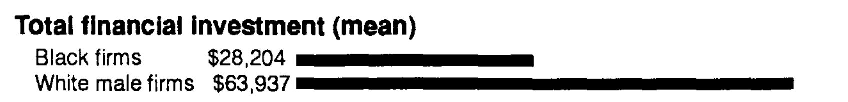
Birmingham
Columbus
Gary
Indianapolis
Jackson
Jacksonville
Kansas City
Memphis
Milwaukee
Nashville
Newark
Omaha
Richmond
Shreveport

It is worth noting that 10 central city governments in these 28 metropolitan areas were headed by black mayors in 1982: Los Angeles, Detroit, Washington, D.C., New Orleans, Atlanta, Oakland, Richmond, Birmingham, Newark, and Gary. A major objective of this chapter is to provide a context for the later discussion of the impact black political power has on black business development. Chapter six examines the possibility that the forces that constrain black business progress may somehow be counterbalanced by that manifestation of black political power, the black mayor; it also examines whether the derivative effects of black business development are more beneficial to residents of cities presided over by black mayors. Those questions cannot adequately be addressed, however, until the urban context—and its impact on black business viability—is explored in more depth.

Traits of the small businesses studied. The same sorts of discrepancies between black- and white-owned small businesses that were documented in chapter three

are again evident in the 28 metropolitan areas reviewed here. The white-owned firms are typically much larger in sales than their black cohorts, and they were started with much greater financial investments. (See appendix C; appendix table C.1 presents summary statistics for the entire sample of black- and white-owned firms under consideration; tables C.2 through C.5, which will be referred to in the following pages, illustrate other statistical analyses relevant to this chapter.)

As expected, black firms with paid employees, which make up 23 percent of the black businesses studied, fare much better than black nonemployer firms. Mean sales in 1982 were over $150,000 for black employers, compared to just $27,445 for the nonemployers; and the survival rate (as of 1986) was 82.4 percent for employers versus 71.4 percent for nonemployers. Yet the starkest contrasts emerge when comparing black firms with white firms—employers and nonemployers alike. Not only are white firms more likely to have paid employees, their mean sales are more than twice as high and their financial investments dwarf those reported by black enterprises:



Obtaining debt capital is enormously important to a firm's total capitalization. This is evident in tables 5.1 and 5.2, which break down capital amounts for borrower and nonborrower groups. The CBO data for firms formed between 1976 and 1982 show that borrowers, whether black or white, consistently enter business with much more financial capital than nonborrowers (table 5.1).

White-owned firms are more likely to borrow than black-owned firms, and when they do borrow, their average loan size ($41,605) is nearly double the corresponding black figure ($22,607). Moreover, most business loan dollars come from commercial banks, particularly among black borrowers: mean debt for black entrepreneurs receiving bank loans was $33,860, versus $12,543 for those borrowing from nonbank sources.

Of course, white-owned businesses are much less likely than black firms to cater to a minority clientele, and their geographic distribution differs sharply. Black firms tend to be located in inner-city minority communities, whereas white-owned enterprises rarely are. This distinction goes far toward explaining both the laggard overall performance of black enterprise and the growth trajectory of black businesses' more successful subset. Consider the figures in table 5.2, which group the study's young black firms according to location.

The greatest disparity is in debt capital: mean debt for black firms in nonminority communities was almost three times greater than that for minority-area firms. Chapter three emphasized the vast differences in financial capitalization that distinguish black businesses from white ones. Those differences are partly rooted in the fact that debt capital is much more readily available to black-owned

Table 5.1
Financial Capital, Debt Capital, and Loan Incidence Among Young Firms, by Owner Race

	Borrowers Only		Nonborrowers Only	
	Black firms	White firms	Black firms	White firms
Total financial capital (mean)	$33,937	$64,815	$8,545	$22,692
Debt capital (mean)	$22,607	$41,605	—	—
Percent receiving bank loans	47.2%	55.6%	—	—

firms located outside urban minority communities than to otherwise equally qualified firms located inside (where the bulk of black firms exist). The practice whereby firms get smaller loans because they are located in minority neighborhoods, often called redlining, is uncovered through a statistical analysis, discussed next.

Statistical evidence of redlining. The questions addressed by this analysis are straightforward: among business borrowers who are otherwise identical in age, education, equity investment, and so forth, does the borrower whose firm is located in a minority community receive a smaller loan? If so, is the difference significant? By employing multiple linear regression models (see table C.2), the relative importance to loan size of a firm's location can be clearly separated out from other owner traits. The analysis shows that startup firms in minority communities are being redlined, and that the amounts that they are denied in the form of forgone debt capital are quite significant.

Overall, it is assumed that, in the case of small-business startups, loan amounts are decided upon as a supply-side dominated matter. Lenders such as commercial banks are expected to approve larger loans to stronger borrowers, those who possess relatively large investments of equity capital and whose owner traits suggest greater viability. While weaker borrowers may have a greater demand for

Table 5.2
Financial Capital, Debt Capital, and Owner Education Among Young Black Firms: Minority vs. Nonminority Location

	Black Firms Located in Minority Communities	Black Firms Located in Nonminority Areas
Total financial capital (mean)	$15,096	$27,865
Debt capital (mean)	$5,994	$16,859
Percent of owners with four or more years of college	27.4%	41.3%

credit, particularly to overcome their lack of equity capital, lenders' aversion to risk is expected to limit the loans they give out to less attractive borrowers. A study by Scott and Dunkelberg[3] reported that very small firms received, on average, only 50 percent of their initial loan requests. Geographic location aside, it is expected that the stronger borrower will get the larger loan; debt and equity are expected to be complements rather than substitutes.

The choice of owner traits measured in this econometric exercise was shaped by chapter three's findings on business viability. Attractive owner traits include (1) high levels of education, (2) owners' ages being in the middle—rather than on the extreme ends—of the age distribution, and (3) significant managerial experience. In addition, it is expected that the purchase of ongoing firms is viewed by bank officers as a likely shortcut to business viability (although this relationship was not confirmed in chapter three). Businesses located in minority communities are hypothesized to receive smaller loans, whether the firm in question is owned by whites or blacks, because bankers assume that urban minority neighborhoods provide an unfavorable environment for most types of business.

After controlling for owner equity investment, demographic traits, and traits regarding skill, education, and experience, the black business from a minority community receives an estimated $39,564 less in loan funds than the equivalent black business from a nonminority area. This is the essence of redlining. It is the *location* of one's firm that is the *largest single determinant* of loan size for the black business that receives a bank loan.

As long as their firms are not situated in minority communities, highly educated owners with large investments of equity capital can typically expect to receive larger bank loans. Equity capital also has a most significant effect (table C.2). Black firms on average have less equity capital than their white counterparts and for that reason alone could expect to receive less debt capital. Moreover, these same black owners are less likely to be college graduates: 33.6 percent of them had completed four or

more years of college, versus 45.6 percent of their white cohorts.

Nonetheless, the analysis of the 28 metropolitan areas shows that equity capital and minority location are the most influential factors in accounting for differences in the size of loans awarded. While the white bank loan recipient is awarded $1.79 in debt capital for every dollar he (or she) puts up in equity, other things being normal, the black business borrower is awarded only $0.89. This suggests that all of the black owners borrowing from banks—not just those in minority communities—are being underfunded relative to their white counterparts. Differential commercial bank treatment of black and white business borrowers accounts for most of the difference in mean debt amounts—$49,679 for whites, $33,860 for blacks—and this is particularly applicable for firms located in minority neighborhoods.

Treatment of neighborhoods with different concentrations of minorities. The finding that loan size depends on whether a black firm has a minority-neighborhood location is, statistically, highly significant, and it is not contingent on how minority neighborhoods are defined. Even where minority populations are not in the majority, the relationship between location and loan size holds as long as minorities are a significant part of the community.

This was tested by repeating the above analysis several times, each time applying a different minority-population concentration as the criterion for labeling the zip-code areas as "minority": concentrations of 50 percent or more and of 40 to 49 percent. It turns out that banks do discriminate against firms situated in zip code areas where the minority residents make up less than 50 but more than 40 percent of the total, neighborhoods where black firms are quite frequent.

Redlining against white firms. White firms seem to be redlined in minority locations along with black firms, though the evidence is sparse. Most black firms are located in areas that are 50-percent-plus minority, and in these same areas white male firms are nearly nonexistent. Only five of the white business borrowers analyzed in table C.2 are located in such neighborhoods; their small number makes statistical proof of redlining very difficult. One way to overcome this limitation, however, is by looking to see if white firms are restricted to increasingly smaller loan amounts as their neighborhoods show higher percentages of minority residents.

When this is done—utilizing minority cutoff points of 20 percent, 40 percent, and 50 percent to define "minority area" in the regression equation—the resulting statistics show the following levels of loan reduction for white firms (measured as the amount below the mean loan size for white business-loan recipients of $49,679):

Definition of Locale	Loss in Loan Amount for White Firms
20% to 39% minority population	- $ 4,180
40% to 49% minority population	- $ 9,594
50% or more minority population	- $16,782

As minority population rises, white-owned firms in the area receive smaller and smaller loans. Thus, white borrowers appear to be redlined by banks—although to a lesser degree than black-owned firms. Unfortunately, small sample size makes it difficult to confirm the statistical significance of this relationship.

To check on those findings, the same regression equation can be reestimated for a pooled sample of all 519 black and white bank loan recipients (with binary variables for minority area and race of owner). Two conclusions emerge from this exercise: (1) Business borrowers located in minority areas—whether black or white—receive an estimated $35,489 less than borrowers in nonminority communities; even when all other factors are held constant, the differences in loan size attributable to firm location are statistically significant;

(2) After controlling for minority location and other factors, the owner's race has an effect on loans; black owners are found to receive smaller loans, but this relationship was not statistically significant.

In sum, bank redlining against minority communities does go on, handicapping black-owned businesses disproportionately because that is where most of them are located. A remaining question may be asked: Are black owners discriminated against by lenders if they do business in nonminority areas? The evidence from this study does not show significant discrimination of that type, in part because the number of black business loan recipients in those areas is so small that no pattern can be confirmed with statistical confidence.

Nevertheless, potential borrowers may indeed be discriminated against at an earlier stage in the lending process—the point at which bankers decide whether to accept or reject loan applications. The previously discussed study by Ando (1988) documented this type of discrimination. The 28-city analysis conducted for this study offers some corroborating evidence—finding that among all firms doing business in nonminority communities, black firms are less likely than white firms to receive any bank loans (irrespective of amount); at the same time, the data at hand are not sufficient to distinguish between firms that were denied loans and those that might have needed but never applied for loans.

How Business Survival Traits Differ Inside and Outside Minority Communities

The discriminant analysis findings in this section corroborate earlier findings, suggesting that in the minority communities of the 28 regions studied, the prospects for black businesses are quite dismal. This particular group of firms clearly has the least access to financial capital relative to other black firms as well as to white male businesses. In addition, these firms are characterized by the very traits that, as chapter three illustrated, hamper development the most: they are the smallest, utilize the fewest employees, and are more likely to remain in business by catering to a predominantly minority clientele. And in complete contrast to the norm for small-firm startup among black firms in minority areas, those run by the least educated owners are the most likely to remain in business.

Very few firms can survive on minimal financial investments, minimal owner education and skill, and a clientele that excludes most higher-income customers. Personal services (including beauty parlors) are a significant exception. Compared to all other black industry groups, personal services are (1) most concentrated in minority areas, (2) least reliant on nonminority clients, and (3) smallest in the investment of financial startup capital. Although their mean 1982 sales per firm were the lowest reported by any industry group, black-owned personal service firms reported higher survival rates over the 1982 to late 1986 period than other black firms (as well as the sample of all white male businesses).

Survival is one thing; development is quite another. The black firms with the best prospects of development are those located *outside* minority communities. Among these black businesses, one observes larger scale, more viable firms run by generally well educated owners—over half of their owners have attended college. They are most likely to remain active if (1) they were started by owners with four or more years of college, (2) they made larger investments of financial capital, and (3) their clientele is racially diverse.

Methodology. In order to sort out which traits of the black firms in the 28 chosen metropolitan areas are most closely linked to the firms' viability, a discriminant analysis similar to that employed in chapter three is utilized. Chances of survival are expected to be influenced not only by owner traits but, given what the previous analyses have shown, by business location and the minority composition of clientele as well. As in chapter three, the measure of firm viability is, by definition, whether or not the busi-

nesses (which all began operating between 1976 and 1982) were still operating in late 1986.

The black sample of business startups is divided into two groups—those located in minority communities and those located elsewhere—and discriminant functions are estimated for each of these subsamples. Due to the very small number of white firms located in minority areas, the white sample was not similarly divided; instead, "minority area" was used as an explanatory variable. Appendix tables C.3 and C.4 list the resulting coefficients, which indicate the relative importance to firm survival of the owner traits.

Survival traits: overview. Certain universal traits are consistently and strongly linked to firm survival for all firms analyzed—black as well as white, minority as well as nonminority location. These include: (1) having been started up with substantial owner investments of financial capital—both debt and equity; (2) being an established firm (in business for at least three years); and (3) the owner's working full-time in the business.

The importance of other survival traits differs for blacks and whites, particularly in the case of leverage. While for white firms being highly leveraged (i.e., heavily in debt) raises the probability of business failure, for black firms at all locations, the pattern is the exact opposite (see table C.3). This analysis is consistent with that discussed in chapter three, which found that highly leveraged black firms consistently appear to be the strongest.

Being highly leveraged is not the only survival trait where the pattern among black firms reverses the usual pattern among white firms: In the topsy-turvy business environment of the minority community, the least educated owners are the ones most likely to remain in business, as well as those who rely most heavily on a minority clientele. In nonminority business environments, the exact opposite patterns prevail for both black and white firms.

The impact of leverage and education. Firms started with very little capital are often too small to compete for nonminority customers, particularly in the government and corporate procurement markets. Their only potential customer base lies in the minority community. Note in table C.3 that among black firms the mean value for leverage is lowest for firms located in minority communities (1.695 for discontinued firms) and highest for active firms located in nonminority areas (3.105). Also note that among black owners the discontinued firms as a group were much less highly leveraged than the surviving firms. Those firms viewed as more viable at startup—such as emerging firms that can serve a broad clientele in nonminority areas—are the ones that have greater access to debt and can therefore (1) borrow more heavily than their weaker counterparts and (2) create larger scale operations. It is not surprising that in the end these are the firms most likely to survive.

As discussed earlier (see chapter three), the fact that greater leverage corresponds with business survival positively for black owners but negatively for whites (table C.4) is completely consistent with the finding that financial capital is less accessible for black owners. Only the strongest black borrowers obtain business loans, whereas for white borrowers lending tends to be more lenient and the attendant risk is highest for those who borrow most heavily.

Nationwide, for business startups in general, those that remain active are most likely to be run by highly educated owners; owners who are high school dropouts are least associated with viable businesses. The exception to this rule occurs among black owners operating in the minority community, where dropouts are the group directly associated with business viability. The explanation may lie in the narrow options faced by black entrepreneurs who have dropped out of high school. Few highly educated blacks are willing to restrict themselves to a redlined, capital-starved minority community when greater opportunities are available elsewhere. Overall, the prospect of running a tiny firm catering to a minority clientele makes sense

mostly to those who have few alternative opportunities in the broader economy: high school dropouts.

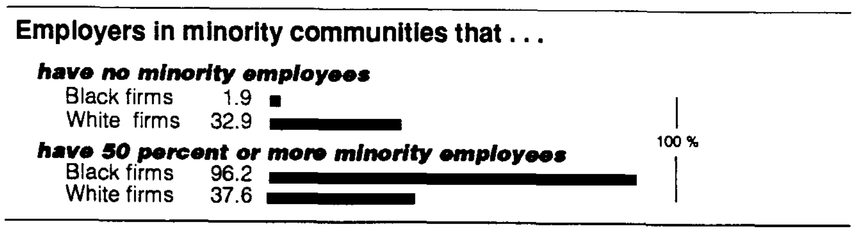
Buyout status and owner's age also have widely diverging impacts on the black and white business samples. Purchasing an ongoing firm appears to be a shortcut to business viability for white owners but not for black owners. This may be explained in part by owner assistance; buyouts are frequently financed by loans from former owners, a practice that is three times as common among white business buyers as it is among their black counterparts. The relative weakness of black buyouts may also be explained by the fact that in minority areas buyouts are concentrated in the high-risk retail sector. Finally, the owner's age is generally more important as an explanatory factor in business survival for black owners than for whites. Blacks in the 45-to-54 age bracket are more likely to remain in business than their younger or older cohorts.

Conclusion: The Prospects for Economic Development in the Ghetto

Within minority communities, capital access is constrained and the black business startups that survive consist disproportionately of tiny firms serving a purely minority clientele. Firms that stay in business in this milieu are run by those with the least education: high school dropouts who often hang on by running very small firms, such as beauty parlors, that typically have few or no paid employees. Many of these firms may be incapable of competing in the broader marketplace. No matter how long they remain active, such firms can do little to alleviate the ghetto's economic underdevelopment.

Unless greater financial capital is forthcoming and better educated owners can be induced to keep their firms there, the black business community that is located in the urban minority neighborhoods is going to stagnate, and the ghetto will continue to suffer from its endless cycle of economic drains. Unfortunately, the capital and talent that have evolved in the nation's black business community have increasingly gone into firms located either in central business districts or in outlying (and largely nonminority) suburban areas. The analyses show that the most sought-after business locations do not necessarily differ for owners of different races or ethnic origins: all businesses prosper most in environs where financial capital and markets are readily accessible. For the black (or white) college graduate seeking to start a viable business, the rationally preferred location is likely to continue to be outside the minority community.

Minority employment. Even businesses that locate in central business districts can generate net inflows of resources into minority communities if, in fact, they expand job opportunities for the residents of those communities. Wage income is the main source of cash that flows into these areas. In fact, black-owned firms are the only group that employs minorities predominantly, while white firms follow an entirely opposite pattern of hiring. (See table C.5.) The following figures highlight these clearcut differences in hiring patterns:



Among white-owned small businesses in general, well over half of those that hire paid workers have no minority employees at all, and as the above figures show, even among white employers in minority communities, nearly one third have no minority workers on their payrolls. By contrast, nearly all black firms have minority workers, with 93.1 percent of black employers relying on minority workers for 75 percent or more of their employees.

The pattern holds regardless of where businesses are located. Even in the nonminority sections of the large metropolitan areas analyzed here, 86.7 percent of black-owned firms have work forces that are 50 percent-plus minority, and most had 75 percent-plus minority work forces. Among the white-owned small businesses in these same areas, most firms have no minority employees whatsoever. The prevalence of minority employees in black firms also holds regardless of firm type: it typifies large as well as small firms, white-collar industries like finance and insurance as well as blue-collar industries like manufacturing and construction. Among white firms, it is only in the manufacturing and construction industries that minority employment is widespread.

Politics and government contracts. Job creation, however important, is not synonymous with economic development. The most important barriers to inner-city development may be political rather than economic: markets *can* be found for larger scale ghetto enterprises, especially through minority business set-aside and procurement programs. To date, however, such programs have most benefited those minority firms that are located in nonminority sections of urban America.

Both as a lender and as a contractor, government regularly serves as a source of financial capital for various industries and interest groups, both domestically and abroad. Yet government's minority assistance efforts, such as the Small Business Administration's loan programs, have focused primarily on very small firms, the ones with little potential for contributing to their communities' economic development.[4] Of course, decisions about the use of public resources are made primarily by people who do not reside in urban minority communities themselves; in normal times, it is easiest for them to ignore ghetto problems.

The mayor of a large city, however, might not be able to ignore the concerns of its minority neighborhoods if, in fact, these communities are a major part of the mayor's political constituency. It is possible, then, that cities run by black mayors provide a politically friendlier environment for black-owned businesses. Testing this hypothesis is the purpose of the next chapter.

7 Public Policy That Would Make a Difference

Given the multitude of barriers to black business development, what public policy options offer the best hope? The policy discussion that follows draws upon this book's finding that a vibrant, growing black business community is best promoted by well-educated entrepreneurs whose businesses have the broadest possible access both to markets and to financial capital.

Minority Business Set-Asides in the Wake of *Richmond* v. *Croson*

Over the last two decades, the most noteworthy change in market access for black firms has been brought about by the growth of set-asides and procurement efforts targeted specifically at minorities. As discussed earlier, large corporations in consumer products industries have targeted procurement dollars to minority firms, and government set-asides for minorities now constitute a multibillion-dollar market. Government agencies have often subsidized private groups, such as the National Minority Supplier Development Council, which in turn have encouraged minority set-aside programs throughout the corporate sector. At the local level, the rise of black political power has been a powerful impetus to the expansion of minority set-asides in municipal contracting. The superior performance of black emerging firms in large urban areas with presiding black mayors reflects the success of these preferential procurement efforts.

Such programs, however, must adapt to new judicial standards if they are to survive at the state and local government levels. Richmond, Virginia, had a minority business set-aside plan that required recipients of city-awarded construction contracts to subcontract at least 30 percent of each contract to minority-owned businesses. This set-aside law was challenged in court, culminating in the January 23, 1989, U.S. Supreme Court ruling (*Richmond* v. *Croson*) that it "violates the dictates of the Equal Protection Clause." Richmond argued that its law only attempted to remedy various forms of past discrimination, such as the exclusion of blacks from skilled construction trade unions and training programs. Writing for the majority, Supreme Court Justice Sandra O'Conner rejected this argument as "an amorphous claim." According to O'Conner, "a generalized assertion that there has been past discrimination in an entire industry provides no guidance for a legislative body to determine the precise scope of the injury it seeks to remedy." Despite the Court's negative ruling, O'Conner directly indicated that minority business set-aside programs in general may be found acceptable. "Nothing we say today," she wrote, "precludes a state or local entity from taking action to rectify the effects of identified discrimination within its jurisdiction." Furthermore, "evidence of a pattern of individual discriminatory acts can, if supported by appropriate statistical proof, lend support to a local government's determination that broader remedial relief is justified." Finally, where there is a significant statistical disparity between the number of qualified minority contractors willing and able to perform a particular service and the number of contractors actually engaged by the locality or its prime contractors, an inference of discriminatory exclusion could arise.

The references to "statistical proof" and "significant statistical disparity" make it clear that detailed, hard data on applicable business characteristics and practices will be required if government set-asides for minority business are

to survive. Those programs that do survive the current flood of litigation on the heels of *Richmond* v. *Croson* are likely to have two traits: (1) detailed statistical documentation, and (2) vague language.

Detailed statistical documentation of discrimination. Many of the discriminatory practices that have shaped today's black business community appear to have been "ruled out" by the Supreme Court as possible justifications for preferential treatment of minority enterprise. Any serious student of racial discrimination knows, for example, that American Federation of Labor construction trade unions have often barred blacks from entering apprenticeship programs in the building trades. Mere common sense suggests that this discriminatory practice reduced the number of black-owned construction companies, particularly in trades such as plumbing, where discrimination was rampant.[1] Yet Justice O'Conner's majority opinion in *Croson* explicitly disregards the construction firms that *would have been* created by blacks discriminatorily excluded from apprentice programs. According to O'Conner, a disparity between the number of "qualified minority contractors willing and able to perform a particular service" and the number of such contractors "actually engaged by the locality" *could* lead to an inference of discrimination. But consider this hypothetical extreme case: no minority plumbing firms at all. In such a case there would be no qualified minority plumbers available "to perform a particular service" for the city; hence there would be no inference of discrimination by the city and no justification for an affirmative corrective measure. The *Croson* ruling is now the law of the land. Cities and states will presumably have to deal with it in coming years if they wish to pursue minority set-aside programs and so it is treated as a given in the discussion that follows.

In reality, states and large cities will probably be able to demonstrate statistically the necessary disparities between minority businesses' share of city (or state) contracts and the number of minority firms willing and able to undertake such work. Let us assume that, in a certain state, minority firms made up eight percent of all construction contractors. If, in fact, minority contractors had gotten only two percent of the dollar amount of all state-awarded construction work during the past decade, then the state government could legally adopt a goal of increasing the share of contracts targeted to minority firms. It would be a straightforward matter for this hypothetical state to select random samples of several hundred minority and nonminority contractors, and to survey them in order to establish scientifically the proportions of minority and nonminority contractors "willing and able" to work for the state.

The next step would be to turn these sample-based percentages into actual numbers. The U.S. Bureau of the Census produces reliable estimates of minority and nonminority firms, which could be used to establish the relative total numbers of minority and nonminority firms in most of the larger states. Such documentation of minority business underrepresentation would seem to fully meet the *Croson* ruling's strict scrutiny standard for justifying a minority business set-aside program. Among smaller states that have few minority firms—Delaware, New Hampshire, South Dakota, for example—federal databases are presently not capable of accurately describing the local minority business community. Statistical reliability simply cannot be achieved in geographic areas where minority businesses are scarce.

Nonetheless, it is perfectly feasible for many states and large cities to generate statistical proof of minority business underrepresentation in their share of procurement contract dollars, in the absence of set-aside programs. This type of detailed statistical documentation should indeed be compiled by cities and states that seriously desire to pursue these programs in coming years.

Another justification for minority set-asides that is likely to meet the Supreme Court's standard of strict scrutiny concerns the "passive participant" doctrine. According to Justice O'Conner, "Any public entity, state or federal, has

a compelling interest in assuring that public dollars... do not serve to finance the evil of private prejudice.... [If] the city could show that it had essentially become a 'passive participant' in a system of racial exclusion... the city could take affirmative steps to dismantle such a system."

This book has documented that commercial banks today continue to redline black-owned businesses in urban minority communities. This lending discrimination weakens the prospects of black firms in general and harms their ability to compete for procurement contracts in particular. A set-aside program that sought to assist firms operating in redlined areas would be able to cite the "passive participant" doctrine to justify its actions.

Alternatively, cities could try to outlaw commercial bank redlining. In the end, however, they would lack the legal authority to enforce such laws. Cities do not charter banks, and it is unlikely that banks would willingly hand over the internal loan data cities would need to prove the practice of redlining. Moreover, very large international banks, such as Citicorp and Bank of America, operate in ways that make it difficult for federal regulatory agencies to keep tabs on them. The thought that New York City might effectively regulate any aspect of Citibank's operations is naive. What New York could do, however, is target business assistance to black entrepreneurs operating in redlined areas; in the absence of such assistance, the city would indeed be a passive participant in banks' discriminatory practices.

Vague language. Given the current legal climate, the set-aside programs that survive will no longer be referred to explicitly as minority business set-aside programs. Set-aside regulations will most likely refer to "disadvantaged" businesses, and government procurement officials will have broad discretionary powers to decide which firms qualify as disadvantaged. Perhaps the oldest of the large minority business set-aside efforts has been the federal Small Business Administration's 8(a) procurement program. Under 8(a), disadvantaged businesses are usually minority-owned; a report from SBA indicated that 96 percent of the 8(a) companies were owned by minorities. Yet the 8(a) effort is strictly a de facto minority business set-aside. It is altogether possible that procurement officials may in the future choose to shift 8(a) contracts away from minorities and toward low-income or women entrepreneurs.

Future minority business set-asides are likely to be based upon "goals" rather than rigid percentage requirements or quotas. Richmond, Virginia's now unconstitutional Minority Business Utilization Plan had required that prime construction contractors hired by the city subcontract at least 30 percent of each award to minority-owned businesses. A rewording of this law in the post-*Croson* era would refer to a *flexible goal* for subcontracting to disadvantaged businesses.

The goal is not only likely to be flexible, but may also be subject to waiver in the event that suitable disadvantaged businesses are unavailable. In the Supreme Court decision *Fullilove* v. *Klutznick*, which upheld federal minority set-asides, Justice Louis Powell stressed the "flexible waiver provisions" of the set-aside contained in the Public Works Employment Act of 1977. The Supreme Court's decision to uphold that program was partly based on this flexibility.

Of course, flexible programs that rely on goals for assisting disadvantaged businesses can only be effective if they are administered by committed officials. Vague wording of set-aside regulations necessarily puts great discretionary power into administrators' hands. This is not a new phenomenon. Procurement officials in some localities have been using their discretionary powers to water down the effectiveness of minority business set-asides for years.[2] This is one of the key reasons why black-owned businesses were observed (in chapter six) to be much more successful if they were located in areas with presiding black mayors. The presence of a black mayor highly correlates with the appointment of procurement

officials who really do want to assist minority enterprises. The political will to make minority set-asides work effectively has always been vital to their success.

The Future of Set-Asides

Despite judicial challenges, it is possible that minority business assistance efforts will continue to expand in the years ahead. Programs to encourage minority business formation and growth continue to enjoy broad-based political support. It is instructive that the three major challenges to minority business assistance programs in the 1980s have not attacked the rationale for these programs. Rather, attacks have been aimed at the programs' effectiveness and legality.

Reports by the General Accounting Office as well as scholarly studies have documented inefficiencies in specific government efforts, such as SBA's embattled 8(a) procurement program. One of the complaints has been that a handful of politically well-connected minority enterprises—such as Wedtech Inc.—have benefited disproportionately from the 8(a) program.[3] In the case of Wedtech, prominent government officials, including congressmen and the U.S. attorney general, had lobbied to obtain defense department contracts for the firm. A small group of 8(a) firms has received the bulk of the SBA's 8(a) contract dollars. Of the many thousands of 8(a) firms, 31 percent of the contract-dollar volume accrued to a mere 50 firms, according to the General Accounting Office. According to the chief of the SBA's requirements division, successful 8(a) firms "have strong political connections that they are quick to use if any of their contracts are in jeopardy."[4]

Focusing upon another aspect of program effectiveness, the U.S. Commission on Civil Rights asserted in its 1986 report that government efforts to help minority business should be eliminated because they had not helped minority communities, "particularly in regard to increasing minority employment."[5] The Commission's report was seriously flawed, however; it presented no evidence to justify its strongly stated conclusion regarding the employment impact of minority business.

The Supreme Court's *Croson* ruling is the most far-reaching of the various challenges minority business-assistance programs have faced. The tension between the Fourteenth Amendment's guarantee of equal treatment to all citizens and the use of race-based measures to ameliorate the effects of discrimination was squarely addressed in this ruling, and it was resolved to the detriment of minority groups.

The line of criticism that focuses on program inefficiencies, by contrast, does not appear to threaten minority business assistance. While the SBA's Economic Opportunity Loan program, which assisted minority businesses largely but not exclusively, was abolished after its general ineffectiveness was repeatedly documented,[6] the more successful programs, such as SBA's 7(a) minority loan effort, are still in existence. In the realm of minority business set-asides, criticisms of program inefficiency have, to date, generated program reform rather than abolition.[7]

The superficial efforts of the U.S. Commission on Civil Rights to attack minority business assistance had little impact, in part because their criticisms were invalid. Chapter five of this volume documented that black firms operating in large urban areas employ a labor force that consists overwhelmingly of minority employees. In contrast, white-owned firms frequently use no minority workers, even when these firms are located in predominantly minority inner-city communities. Previous studies using nationwide data have reached similar conclusions about the employment patterns of black- versus white-owned businesses.[8] The evidence conclusively shows that an expanding black business community generates jobs for minority workers.

It must be kept in mind, finally, that while minority business programs may continue to enjoy broad-based political support, judicial support for many of these programs is problematic.

Combating Redlining: Opening Access to Financial Capital

The availability of commercial bank credit is a key problem for black business development. Chapters three and five of this study documented discriminatory loan treatment at the point of business startup, particularly for firms operating in urban minority communities. While information about bank lending to black firms after the startup stage was not available from the CBO database, the Ando study (discussed in chapters four and five) demonstrated that established black-owned businesses have far less access to commercial bank credit than their nonminority counterparts.

The constraint on financial capital available to black-owned businesses is unlikely to ease anytime soon. The low net-worth holdings that typify most black households will be alleviated, at best, only gradually over a period of many years. Limited personal wealth restricts business development in several ways. Commercial banks lend most freely to those who possess solid equity capital to invest in their businesses. Beyond banks, the second and third most important sources of loans for new small business are family and friends, respectively. The low net-worth holdings of black households in general mean, of course, that family and friends of black entrepreneurs are equally unlikely to be able to invest significantly in small business ventures.

In theory, the Community Reinvestment Act (CRA) of 1977 appears to address the problem of bank credit in urban minority neighborhoods. This act requires banks to service the borrowing needs of their local communities, including low-income areas such as inner-city minority neighborhoods. In fact, the applicable federal regulatory authorities have made no systematic attempts to define such abstract concepts as "the banking needs" of these communities. Likewise, no comprehensive attempts have been made to determine which banks are or are not meeting such needs.

Recent amendments to the CRA require that banks increase their collection of data regarding the race, sex, and income levels of their loan applicants and recipients. Further, bank regulatory agencies are now required to disclose information on the efforts of individual banks to service the credit needs of minority borrowers. The Community Reinvestment Act may therefore be a useful tool in the 1990s for prodding banks that are reluctant to finance minority borrowers.

If federal inaction continues despite ostensible strengthening of the CRA, state and local governments will need to enter the void to address the problem of commercial bank redlining. While cities have little power to measure, much less punish, redlining, the larger cities can exert some leverage on the banks. At the least, city governments can restrict their own banking business solely to those institutions with a record of actively lending in inner-city minority neighborhoods. Similarly, cities can publicize what they do know about bank lending patterns and call attention to those institutions that are least active in financing minority borrowers.

States can successfully demand information from banks on their lending practices. It is the states, after all, that charter many of the commercial banking institutions. If they care to, states can also outlaw discriminatory lending, and they can back up these laws with nontrivial sanctions. Banks that redline can be barred from opening new branches. They can be denied state government banking business. Redlining institutions can be barred from taking over other commercial banks, both intrastate as well as interstate. Banks rely upon public deposits as their primary source of funds and they are therefore sensitive to publicity regarding their good citizenship or the lack thereof. By focusing public scrutiny on the activities of redlining banks, cities and states have a powerful tool for encouraging nondiscriminatory bank lending practices. To date this tool has been underutilized.

Encouraging Business Development in Inner-City Minority Communities

An effective strategy for developing the ghetto's economy would have to include (1) developing lines of business that can employ the ghetto's supply of underutilized labor, and (2) relying heavily upon nonghetto sources for both capital and markets. Fundamental changes must take place in the flow of ghetto resources. To date, the majority of black-owned businesses exclusively serve a ghetto clientele. The activity of those businesses can only aid economic development, however, when other forces have generated rising incomes for ghetto residents. If black-owned businesses as a group rely solely upon the limited ghetto market, they will never achieve the economic strength necessary to alleviate inner-city problems.

The following example illustrates how the dynamics of resource inflows can benefit the overall ghetto economy. Assume that black firms in fields such as construction and manufacturing succeed in attracting large-scale procurement contracts from corporate and government sources. Assume, furthermore, that these contracts increase both the wage earnings of ghetto workers and the profits of the contract recipients. In this situation, black firms have successfully increased the flow of income into the ghetto, a portion of which will be spent through consumption at local retail and service establishments. The contract-holding firms will presumably use a portion of this income flow to purchase intermediate goods from local suppliers. Finally, part of the income flow will end up in local banks in checking and savings accounts. The spending and saving activities resulting from the initial income flow will generate a second round of spending and saving within the ghetto, causing what is known as the multiplier effect. The strength of the ensuing movement of income directly depends on the degree to which the recipient firms (and their employees) shop within the inner city: with more locally owned firms there is more rechanneling of funds and more respending within the local economy. As the multiplier effect strengthens, the resultant impact on ghetto incomes and employment also increases.

Note, however, that the streams of spending and respending percolating through the local economy are, in this example, entirely dependent on the income initially received by the black-owned construction and manufacturing firms from the outside economy: no inflow—no multiplier effect. Most of the ghetto's business community is ghetto-oriented and therefore fundamentally reactive to income flows influenced from outside. By contrast, ghetto businesses that can compete in the broader marketplace can actually shape the flow of income into the local economy. Further, the prospects of such firms are not held hostage by income levels within the ghetto, but depend instead on the firms' ability to compete in the broader economy. Yet powerful forces that currently dominate in the ghetto tend to undermine the development of such viable firms. Among these forces are weak internal markets, lack of capital, and an exodus of well-educated people.

Black-owned firms operating outside of minority communities assist ghetto areas in one very important respect—they create jobs for minority workers. But job creation is only one aspect of ghetto economic development. Other important aspects include strengthening local multiplier effects and investing capital inside the minority community. The strategy whereby a ghetto-based black business community would contribute directly and powerfully to local economic development is straightforward (in theory): businesses providing inner-city jobs would obtain outside capital to produce for outside markets. The practical questions raised by this strategy are similarly straightforward: who will provide the capital and the markets, and at what cost? Successful black-owned businesses have gravitated away from the inner city precisely because local ghetto markets are weak and financial capital is hard to raise. Enterprise zones could have the potential to lure these firms back into the inner city.

Enterprise zones. Former President Ronald Reagan endorsed "enterprise zones" as a tool for revitalizing business investment in depressed areas such as ghettos. The Reagan version of enterprise zones envisioned few government regulations, low taxes, and high levels of entrepreneurial initiative—supply-side economics for the ghetto. In practice, the aim of "few regulations" was never politically feasible: occupational safety and health rules, environmental restrictions, equal employment opportunity laws, and so forth remain intact in all versions of enterprise zone legislation. The Reagan program, in fact, based its incentives largely upon reducing capital gains taxes, a technique that is particularly unsuited for generating jobs for local residents.[9]

Taxes are one of the less important considerations when deciding where to locate a business, and urban enterprise zones would have to compete with a variety of tax concessions that many states and cities offer to attract business investment. Tax concessions alone will not lure the business investment required to revitalize ghetto economies: they provide very little in the way of financial capital to fund business startups, and they provide even less in the way of markets to absorb the new businesses' output.

Upgrading the local infrastructure, on the other hand, is essential if the urban enterprise zone strategy is to become viable. Reagan's enterprise zone concept of "unfettered free enterprise" notwithstanding, what is in fact needed is a concentrated public investment in the ghetto's infrastructure: public service improvement, land use planning, business loan funds, and access to outside markets.

One state-sponsored enterprise zone, in Louisville, Kentucky—though it is too recent to be properly evaluated—shows strong promise. Louisville's effort is an excellent example of how a whole set of policies can be coordinated to make enterprise zones work for minority residents as well as for business owners. The city's enterprise zone covers 2,400 acres of land, including (1) 12,000 residents, (2) old industrial buildings suitable for rehabilitation, (3) vacant land, and (4) ongoing businesses. The zone is surrounded by low-income residential areas. It also has easy access to two interstate highways and three railroad lines. The city has spent or committed more than $50 million to land clearance and assembly as well as infrastructure development, aimed largely at making the industrial areas more attractive to potential business investment. Working with local banks, Louisville is developing a pool of $30 million in financing for firms that locate within the zone. Added to these incentives are reductions in utility fees, connection charges, and various state and local taxes. To be eligible for all these benefits, firms investing in the zone must employ at least 25 percent of their workers from local residents having "disadvantaged" backgrounds (which includes zone residents, unemployed persons, public assistance recipients, and so forth).[10]

Louisville's enterprise zone addresses some of the most fundamental needs of the urban ghetto: it could reverse the drain of resources that maintains ghetto poverty. Together with the ghetto's chief resource—its labor—this strategy could raise many in the ghetto out of poverty and start a self-generating process of economic development.

At this stage, we do not know how well the Louisville program is working. Relative to the costs of investing in infrastructure, improving public services, and subsidizing loans to enterprise-zone businesses, how many successful business startups and expansions have been generated? Of the resultant jobs created, how many have gone to minority workers? Are net new jobs being created, or is employment simply being shifted to the enterprise zone from other parts of Louisville? A comprehensive accounting of the benefits and the costs produced by the various enterprise zone efforts throughout the country is vitally needed. Enterprise zones of the future must learn from the successes and failures of existing efforts.

The participation of black-owned businesses in enterprise zones would certainly be furthered by making debt capital more readily available to promising firms. Inventive political leaders in local government have potentially powerful development tools at their disposal. Development capital could

be channeled into the inner city, for example, by depositing city and state government funds in local banks on the condition that the banks lend actively to enterprise-zone firms. Furthermore, city and state funds could be used either to guarantee such bank loans (in the event of default) or to participate directly with banks in appropriate business financing. Similarly, the procurement powers of local government could be used to provide markets for enterprise-zone firms, just as set-aside programs are now utilized to provide markets for minority-owned businesses in general. Strategies for generating inner-city economic development should ultimately be chosen though the trial-and-error process of identifying cost-effective methods for sustaining businesses that generate employment.

Strong political leadership, political cohesiveness, and local political control could make it possible to institute such a development program. The election of black officials alone cannot solve the ghetto's problems. It is important that an ambitious program, one that attacks the very roots of ghetto poverty, be produced. Such a program is necessary as well to mobilize political support within the inner-city minority community and to build the economic foundations for sustained political action.

Appendix B: Summary Tables and Econometric Models for Chapter Three

This appendix presents three tables of summary statistics (tables B.1, B.2, and B.4) discussed in chapter three. It also summarizes the results of three econometric modeling exercises. Linear regression models are used to explain 1982 total sales levels for black- and white-owned firms (table B.3) and to explain the levels of debt capital input for firms that received commercial bank loans as groups of black and white loan recipients are analyzed separately (table B.5). A discriminant analysis model is used to differentiate between active black firms and those that have discontinued operations (table B.6).

All of the variables used in these three separate econometric exercises are defined below. Note that certain variables are used in every econometric model, while other variables may appear in only one of the models. All of the applicable variables are drawn from the CBO data source described in appendix A. Variables utilized in the econometric exercises include explicit measures of owner human capital as well as (1) year of entry into self-employment, (2) age and sex of owner, and (3) whether the owner created a firm from scratch or acquired an existing business. The CBO survey collected data on the amounts of financial capital used by self-employed persons to start or become owners of their businesses; these include variables measuring total financial inputs at the point of business entry as well as the component parts, debt capital and equity capital. Other relevant variables include (1) average hours of labor contributed per week by the business owner, (2) the industry of the business, (3) 1982 sales volume, and (4) whether or not the business was still operating in late 1986. Businesses still operating in 1986 are referred to as "active" firms; those that have closed down are "discontinued." Exact variable definitions are summarized below.

Education

Ed2: For owners completing four years of high school, the value of Ed2 = 1; otherwise Ed2 = 0.

Ed3: For owners completing at least one but less than four years of college, the value of Ed3 = 1; otherwise Ed3 = 0.

Ed4: For owners completing four or more years of college, the value of Ed4 = 1; otherwise Ed4 = 0.

Management Experience

For owners who had worked in a managerial capacity prior to owning the business they owned in 1982, *Management* = the number of years one had worked as a manager.

Age and Sex of Owner

Age2: For owners between the ages of 35 and 44, Age2 = 1 ; otherwise Age2 = 0.

Age3: For owners between the ages of 45 and 54, Age3 = 1 ; otherwise Age3 = 0.

Age4: For owners 55 or older, Age4 = 1 ; otherwise Age4 = 0.

Sex: For male owners, Sex = 1 ; otherwise, Sex = 0.

Labor Input and Firm Acquisition

Labor input: The average number of hours per week in 1982 spent by the owner working in or managing the business that he/she owned.

Ongoing: If the owner entered a business that was already in operation, Ongoing = 1 ; if the owner was the original founder of the business, then Ongoing = 0.

Year of Firm Startup

For the year in which the business was started or acquired two variables reflect the following categories:

Time82: If the business was started or ownership was acquired during 1982, then Time82 = 1; otherwise Time82 =0.

Time80: If the business was started or ownership was acquired during 1980 or 1981, then Time80 = 1 ; otherwise Time80 = 0.

Debt, Equity, Leverage, and Related Variables

Debt is defined as borrowed money used to start or become an owner of the business, measured in dollars.

Equity is defined as financial capital (other than borrowed money) used to start or become an owner of the business, measured in dollars. The dollar value of business assets contributed by the owner at the point of business entry is also included as equity.

Leverage: The ratio of debt to equity; the value of this ratio is constrained not to exceed 19.

Log Capital: The logarithm of the sum of debt and equity capital.

Log Sales: The logarithm of total sales revenues for the 1982 calendar year.

Industry Groupings

A series of self-explanatory dummy variables is employed to identify firms in six major industry groups: (1) *Construction*, (2) *Manufacture*, (3) *Transportation* (includes communication and public utilities), (4) *Trade* (includes both wholesale and retail industries), (5) *FIRE* (includes finance, insurance, and real estate), and (6) *Service*.

In the econometric exercises summarized in tables B.3, B.5, and B.6 of this appendix, no education variable is used to measure the presence (or absence) of owners having less than 12 years of formal schooling; the age variables similarly contain no direct measure of owners under age 35.

The technical details of the econometric models estimated in this chapter are described in a fashion that is appropriate for a readership of nonspecialists. Much more detailed technical discussions—regarding hypothesized relationships, variable function form, and choice of econometric technique—are readily available (see Bates 1990a).

Table B.1

Selected Statistics: Firms by Employer Status—Employers Versus Firms Having No Employees

	Black-Owned Businesses Only			White Male Businesses Only		
	All	Employer firms	Zero employee firms	All	Employer firms	Zero employee firms
Business Traits (mean value)						
Total sales, 1982	$55,402	$138,030	$28,421	$164,003	$378,549	$47,268
No. employees, 1982	0.8	3.0	NA	2.0	5.6	NA
Owner Traits						
Total financial capital (mean)*	$15,908	$28,095	$11,929	$37,170	$60,950	$24,244
Equity capital (mean)	$7,945	$12,346	$6,509	$17,815	$28,626	$11,932
Debt capital (mean)	$7,963	$15,749	$5,420	$19,363	$32,324	$12,321
Percent with under 4 years of high school	25.5%	22.5%	26.4%	15.4%	12.9%	16.8%
Percent with 4 or more years of college	24.5%	29.0%	23.0%	32.9%	37.5%	30.3%
Percent of Firms Still in Business, 1986	75.1%	82.0%	72.9%	78.0%	84.7%	74.3%
(N=)	4,883	1,202	3,681	7,807	2,751	5,056

*At the date of entry into self-employment ($ figures are not inflation-adjusted).