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Policy Brief

Financing Black-Owned Businesses

By Robert Fairlie

More than half a century after the passage of the Civil Rights Act, economic differences between whites and blacks continue to be a source of social and political tension in the United States.

One out of four black families lives in poverty, and the median household income for black families is $37,000. Meanwhile, roughly one out of 10 white families live in poverty, and white families have a median income of $63,000.

Inequality is even higher for wealth and financial assets. For example, the median household net worth for black families is 14 times lower than that of whites (Figure 1) and only 6 percent of black families own stocks or mutual funds. Levels of home ownership and home equity are also much lower among black families.

Entrepreneurship is often viewed as a path for promoting economic growth, wealth, and jobs in minority communities, a tool for alleviating these differences.[1] But starting a business requires financial backing, and black entrepreneurs are often at a disadvantage. Research shows black business owners are often fighting an uphill battle against low credit scores, racial bias, and societal expectations.

This policy brief examines how black entrepreneurs experience different financing outcomes, both at founding and as the firm matures. The answers to why this is requires more research, but policymakers should be mindful of these data when considering programs aimed at bolstering black-owned businesses and encouraging black entrepreneurs to seek financial backing.

My research with David Robinson from Duke University and Alicia Robb from the Kauffman Foundation indicates that black-owned businesses start with less money when they begin and invest money at a slower rate over the years when compared with white-owned business.[2] This means that differences between funding for black- and white-owned businesses when a firm begins persist and even worsen over time. Figure 2 displays financial capital disparities between white and black startups at their founding and over the next seven years of existence.

About the Author

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1 Boston, Thomas D. 1999. "Generating Jobs Through African American Business Development," in J. Whitehead and C. Harris, eds. *Readings in Black Political Economy* (Dubuque: Kendall-Hunt); Boston, Thomas D. 2006. "Black Patronage of Black-owned Businesses and Black Employment" in J. Whitehead, J. Stewart and C. Conrad, eds. *African Americans in the United States* (Rowman & Littlefield Publishers, Inc.); Bradford, William D. 2003. "The Wealth Dynamics of Entrepreneurship for Black and White Families in the U.S.," Review of Income and Wealth, 49(1): 89-116.

2 Fairlie, Robert W., Alicia M. Robb and David Robinson. 2017. "Black and White: Access to Capital among Minority-Owned Startups," Stanford Institute for Economic Policy Research Working Paper 17-003; Fairlie, Robert W., and Alicia M. Robb. 2007. "Why are Black-Owned Businesses Less Successful than White-Owned Businesses: The Role of Families, Inheritances, and Business Human Capital," *Journal of Labor Economics*, 25(2): 289-323.

Racial differences in outside debt (e.g., bank loans) explain more than half of the disparities in total financial capital. Indeed, leverage ratios for black-owned startups are persistently below those observed for white-owned startups.

But the disparities do not end here: Black-owned startups also have lower levels of all other major sources of funding than do white-owned startups. In other words, they are not able to simply substitute owner equity or debt for bank loans. Previous research provides evidence of lending discrimination against black-owned businesses.[3]

But what explains these differences? One factor that is important is the difference in credit worthiness between black and white entrepreneurs. Black entrepreneurs have lower credit scores than white entrepreneurs on average, and the disparity contributes to why black entrepreneurs attain less capital. On the other hand, there is no evidence that human capital (measured by education and previous experience) is an important explanatory factor.

While credit scores account for the bulk of the observable differences in outcomes between white and black borrowers, part of the difference remains unexplained by business and owner characteristics, suggesting that attitudes, expectations, and racial bias in lending may also play a role.

Indeed, our work shows that black entrepreneurs apply for bank loans less frequently than white entrepreneurs, but this stems largely from differences in the fear of having their loan applications rejected.

Overall, black entrepreneurs are about three times more likely to state that they did not apply for credit when needed for fear of having their loan application denied. Similarly, black-owned startups are about three times less likely than white-owned startups to report that their loan requests are always approved. These differences persist even after controlling for credit scores and net worth. In areas of the country where inequality has been historically high, black entrepreneurs have lower capital levels and are more likely to report not obtaining enough financial capital for their businesses.

Taken together, these findings imply that a great deal of the capital investment differences between black- and white-owned businesses is the result of persistent differences in the founder's financial health that are present at the very inception of the firm.

Improving credit scores and wealth should be a high priority for helping black entrepreneurs. But there appears to be an enduring belief among even the most creditworthy black borrowers that they will be turned away as borrowers. The fact that many well-qualified black borrowers do not apply for credit, even when they feel they need it, because they anticipate being denied credit suggests that overcoming differences between black and white borrowers is not simply a matter of expanding the supply of credit available to lower income borrowers.

Getting to the root cause of racial differences in the way that new businesses are financed likely requires changes in perceptions and financial planning behaviors as much as it requires augmenting the supply of credit to traditionally underserved borrowers. But, these concerns have received much less attention than they deserve in the policy arena. There needs to be more policy discussion on how to improve both the financial health of minority entrepreneurs and their access to capital.

3 Blanchflower, David G., P. Levine and D. Zimmerman. 2003. "Discrimination in the small business credit market," *Review of Economics and Statistics*, November 85(4): 930-943; Blanchard, Lloyd, Bo Zhao and John Yinger. 2008. "Do lenders discriminate against minority and woman entrepreneurs?" *Journal of Urban Economics* 63(2): 467-497; Cavalluzzo, Ken, Linda Cavalluzzo and John Wolken. 2002. "Competition, Small Business Financing, and Discrimination: Evidence from a New Survey," *Journal of Business*, 75(4): 641-679.

Figure 1. Wealth and Home Ownership Inequality U.S. Census Bureau (2011)

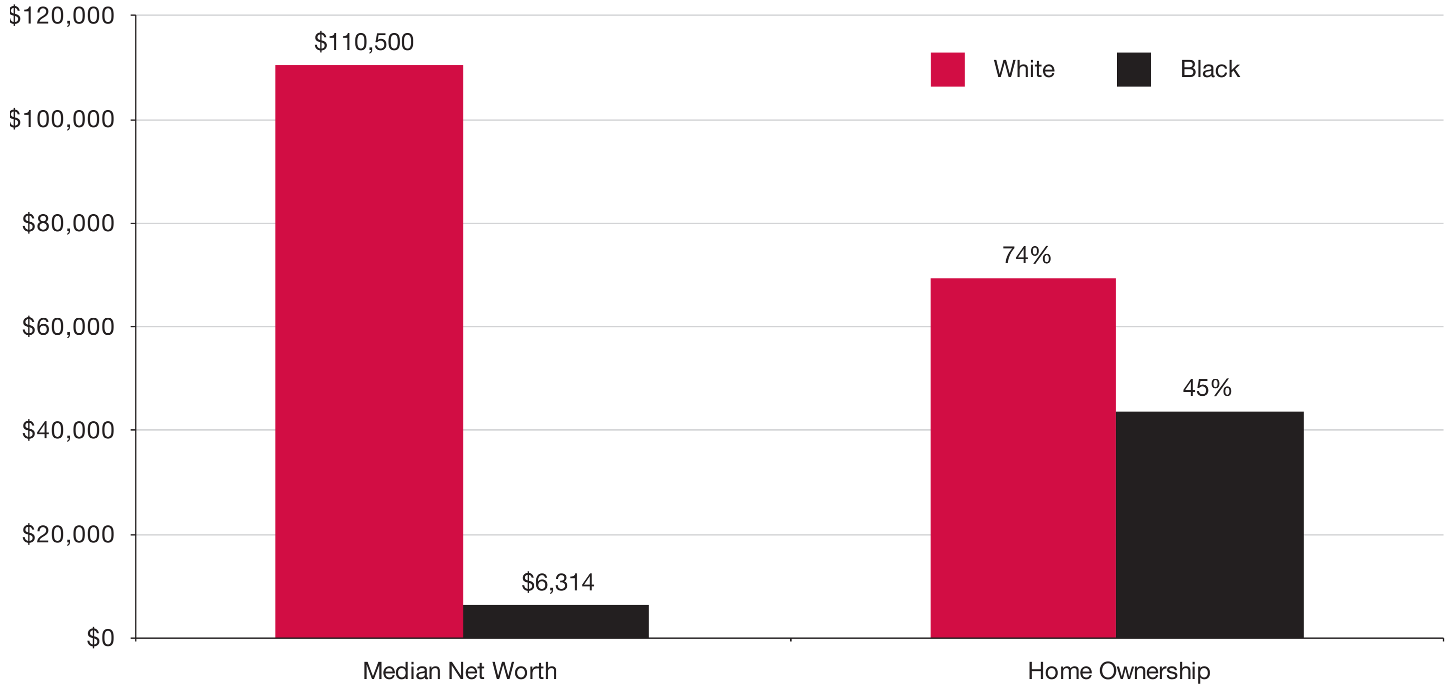
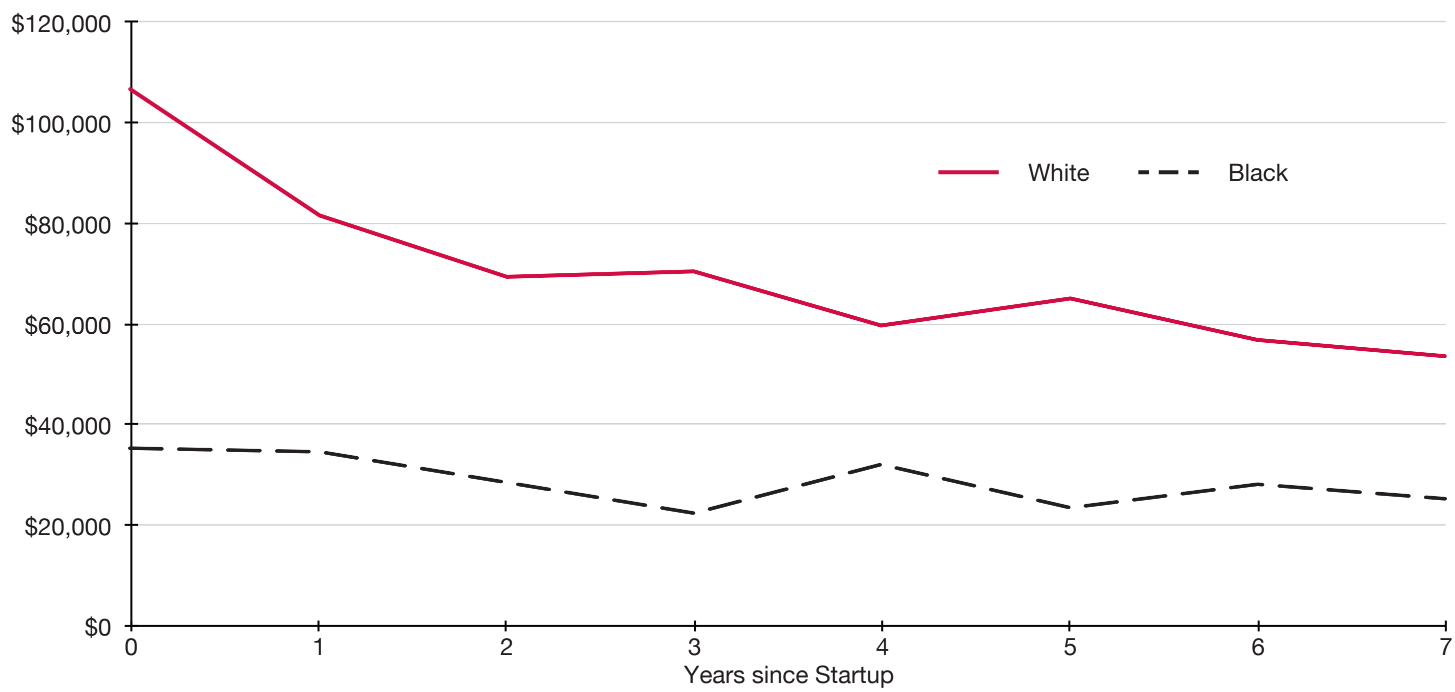


Figure 2. Total Capital Investment by Years since Startup and Race, Kauffman Firm Survey



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