

CAPITAL POLICY: FRAMING CAPITAL POLICY FOR INNER CITIES¹

SUMMARY

- Consistent with broader characteristics of inner cities, the distribution of inner city businesses by their capital levels relative to the national industry average shows a significant bifurcation: Some 71% of inner city businesses are dramatically undercapitalized, while the remaining inner city businesses are extremely well-capitalized. Of those undercapitalized firms, 50% are likely to be minority-owned.
- The weak linkages between local firms and institutions, along with the lacking institutional environment in many inner cities, necessitate policies that promote stable, sustainable economic development institutions that strengthen those linkages. Such policies should include – but not be limited to – capital providers.
- The current framing of the capital access debate starts with desirable business outcomes, such as growth, profits or survival, and asks how to secure the capital to achieve these results. In this framing, the set of desirable outcomes is fixed and capital is a variable. A complementary approach that would take capital levels as a given and identify the tools, strategies and complementary investments that would maximize growth and output for a given level of capital is necessary.

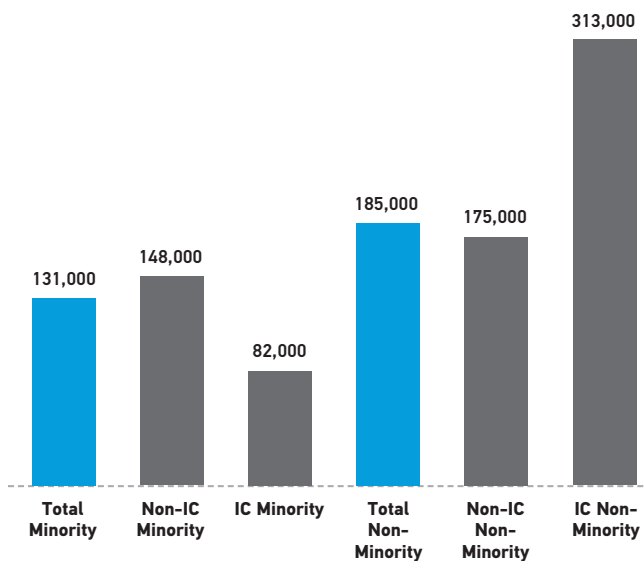
¹ Summary developed from “Lynch, T. and Rho, L. (2011). Capital Availability in Inner Cities: What Role for Federal Policy?”

Explaining the Capital Gap

Inner city businesses fall into two distinct groups. According to Kauffman Survey Data, about 29% of inner city companies are well-capitalized, having raised an average of four times the capital needed to compete in their industries. The other 71% of inner city companies operate with only one-quarter of the capital compared to their industry peers. These companies have very low levels of external equity. External equity makes up just 4% of their total capital, compared to 16% for the other firms in the Kauffman sample. These two groups of firms are separated by more than just their success at fundraising. The undercapitalized firms are 50% more likely to be headed by a minority business owner and also tend to be located in areas of higher economic distress.

Both under- and well-capitalized inner city firms are often characterized by isolation from local capital providers and other local institutions. Under-capitalized firms do not have strong business networks or ties to local capital. The well-capitalized firms are often branch plants of firms in industries such as beverage manufacturing and motor vehicle assembly, which operate in tight, highly vertical structures and likely access their capital from outside of local sources. For inner city economies to thrive, they need stable, sustainable economic development institutions including, but probably not limited to, capital providers.

AVERAGE TOTAL CAPITAL PER FIRM BY RACE AND GEOGRAPHY, 2004-2007



Source: Kauffman Firm Survey (KFS), 2004-2007

Note: Excludes one inner city non-MBE outlier with \$9M in total capital and one non-inner city non-MBE with \$100M+ in total capital. Amounts do not match earlier Figures because sets of firms vary slightly.

Targeting Undercapitalized Businesses

Undercapitalized inner city firms are 50% more likely to be headed by a minority business owner. According to data from the Kauffman Firm Survey, inner city minority business enterprises (MBEs) have an average capitalization of \$82,000, compared to \$313,000 for non-minority-owned inner city companies. Data from Community Development Financial Institutions (CDFIs) paint a similar picture, with inner city MBEs averaging \$90,000 in capitalization, while non-minority inner city companies average \$213,000. Outside the inner city, the disparity is not nearly so stark: Minority firms have an average capitalization of \$148,000 versus \$175,000 at white male-owned companies.

We estimate that close to half of the firms affected by policies that target inner cities are likely to be MBEs; therefore, initiatives that target inner cities will have large dual race and place impacts. Conversely, because most MBEs are located outside inner cities, policies that target MBEs will have relatively small effects on inner cities. (One possible exception to this rule is the least racially diverse regions, where MBEs tend to concentrate in inner cities.) It is important to note that the data do not necessarily constitute an endorsement of place-based approaches to inner city business development but merely indicate that programs that target inner city locations will probably have a larger effect on MBEs than vice versa.

Political Will and Capital Access

Barriers to capital access for inner city entrepreneurs often stem from factors that are the product of decades of social and economic forces that are unlikely to reverse in the short term. For example, low levels of owner equity at large numbers of inner city businesses cannot be separated from the current and historic challenges faced by minority and low-income people in accessing quality education, jobs and other income- and wealth-generating opportunities. But eradicating, or even narrowing, gaps in wealth between social groups is a long-term project for which there may never be sufficient political will.

It is heartening, then, to note that 96 of the 335 firms identified by the ICIC as the fastest-growing inner city companies between 2003 and 2006 were started with \$10,000 or less. The experience of these firms, which is to succeed with low levels of capital, points to a framework that may be complementary to traditional ways of thinking about

capital access and entrepreneurs. If capital levels, at least for some companies, are unlikely to improve dramatically, then perhaps we should devote more resources to the tools, strategies and complementary investments that would most improve these companies' chances of success.

ICIC'S MISSION IS TO DRIVE ECONOMIC PROSPERITY IN AMERICA'S INNER CITIES THROUGH PRIVATE SECTOR INVESTMENT TO CREATE JOBS, INCOME AND WEALTH FOR LOCAL RESIDENTS.



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