

CAPITAL POLICY: MEASURING THE CAPITAL GAP¹

SUMMARY

■ A key driver of business success is access to financial capital. Historically, inner city access to capital has been lacking. ICIC's own recent surveys of inner city businesses suggest that such problems may continue to persist.

■ The existence of a “capital gap” in low-to-moderate income (LMI) areas is a contentious claim/issue among researchers, practitioners and policy makers. Some have rendered the capital gap a problem of the past. Despite significant improvements, others believe large barriers continue to exist and create a shortage of capital for even investment-worthy inner city businesses. Resolving this debate is critical for designing appropriate public and private sector responses to the anemic economic performance in inner cities.

■ This debate has been largely defined by a lack of uniform, detailed, national metrics on capital supply and demand in local geographies. These constraints have been exploited by both those who believe there is a capital gap in LMI areas as well as skeptics of this claim. While we can-

not fully adjudicate these debates within the context of this study, we do provide a broad range of data that can address key claims within these debates.

■ Various observations of capital flows in distressed urban areas suggest that a substantial capital gap exists for inner city businesses.

■ To estimate the size of any capital gap, it is essential to use comparable measures of both supply and demand for capital among businesses. The Kauffman Firm Survey (KFS) data capture the industry in which each of several thousand firms compete and also provide detailed data on capital acquisition. These data allow a comparison of inner city capital levels to the average capital of firms with similar technical and competitive requirements.

■ Based on KFS data, it appears that for 70% of inner city companies, a severe capital gap is the norm. These companies have, on average, only one-quarter of the capital needed to compete in their industries.

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

Supply of Capital to Inner City Companies: Loan Flows

Within urban areas, businesses in low- and moderate-income census tracts receive far fewer loans worth far less money than their wealthier counterparts. The lowest-income census tracts get only 79% of the loans they would be expected to receive based on the number of firms located there, according to data collected under the Community Reinvestment Act (CRA). By loan amount, LMI firms' performance is relatively strong by national standards (loan amount-to-firm share >100%, at 103%). National comparisons, however, obscure the vast differences in urban and rural firms and economies. Within the urban areas, LMI firms significantly underperform versus firms in upper-income areas (103% vs. 126%).

AVERAGE CRA LOAN SHARE TO FIRM SHARE BY INCOME LEVELS OF CENSUS TRACTS, 1998-2007

	Low	Moderate	Middle	Upper
Share of Loan Volume to Firm Share	79%	89%	101%	117%
Share of Loan Amount to Firm Share	103%	100%	105%	126%

Source: Federal Financial Institutions Examination Council (FFIEC), "Findings from Analysis of Nationwide Summary Statistics for Community Reinvestment Act Data," various years; ICIC analysis

The number of brick-and-mortar bank branches in the most distressed areas has significantly diminished over the past decade, further exacerbating issues of capital access and availability in these areas. According to FDIC data, the number of national bank branches increased by only 3% from 2005 to 2008 in the most distressed parts of the inner city, while growing by 5% in the U.S.

The Demand for Capital by Inner City Companies

One common explanation for the lack of capital among inner city firms is that inner city firms tend to be smaller than those in other areas. A preponderance of mom-and-pop shops in the inner city could mean that inner city companies are often too small to attract investor interest. Yet, on average, inner city firms are actually slightly larger than others, according to an analysis of the State of the Inner City Economies (SICE) database. Average firm size in the inner city is about 19 employees, compared to 16 nation-

wide. In addition, the share of very small firms and self-employed people in the inner city is slightly lower than that of the country as a whole. Some 51% of inner city firms employ between one and four workers, compared to a national average of 54%. The inner city self-employment rate is about 5.1%, compared to a national average of 7.4%.

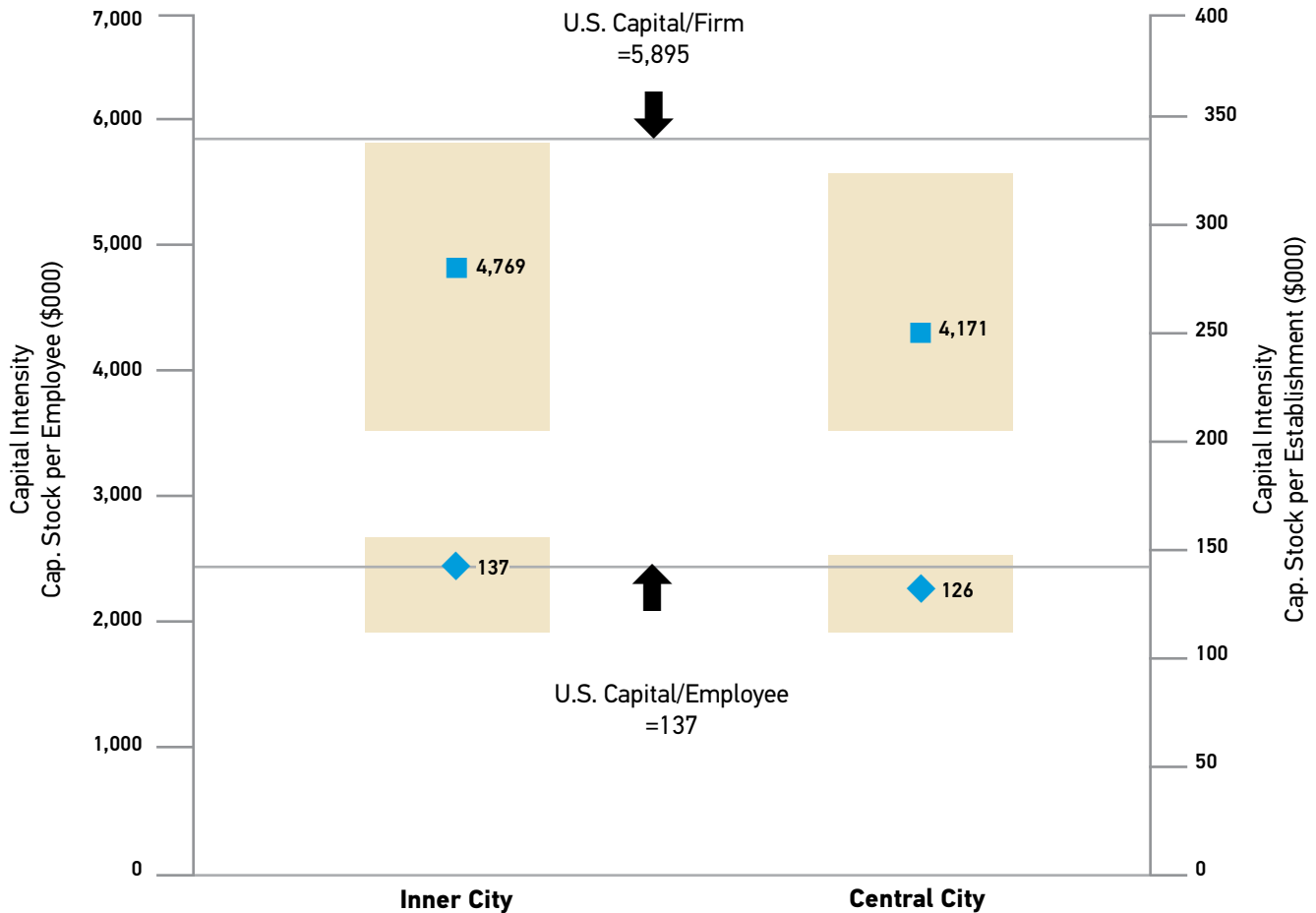
It has been shown that inner city firms need less capital than others because of the types of businesses in which they engage. An industry analysis allows a comparison of the capital needs of inner city manufacturers with those of manufacturers located elsewhere. ICIC examined two measures of capital intensity: the annual average investment per employee and cumulative fixed investment.

The capital investment per employee of inner city manufacturers is nearly identical to that of manufacturing overall, according to the National Bureau of Economic Research (NBER) manufacturing productivity database. For inner cities, as for the U.S. generally, capital stock is \$137,000 per employee. In the rest of the center city, capital stock per employee is slightly lower at \$126,000.

Using NBER capital intensity ratio measures and ICIC employment and establishment data, we calculate the capital intensity of the manufacturing sectors in the inner city, central city and U.S. manufacturing bases by taking an employment-weighted average of the U.S. industry capital intensity estimates. If we were to see a lower average capital intensity value for inner cities, it would be evidence that inner cities specialize in manufacturing segments that are less capital intensive. If average capital intensity of inner city manufacturing is at least as high as the national average, this would suggest that demand for capital is no lower in the manufacturing sector in inner cities than elsewhere in the country and would undermine claims that structural characteristics of inner city economies lead to lower demand for capital.

In fact, the data show that capital investment per employee in the inner city manufacturing base is nearly identical to that of all U.S. manufacturing and somewhat higher than in the rest of the central city. For inner cities (and the U.S.), capital stock is \$137,000 per employee compared to \$126,000 in the rest of the central city. Capital stock per establishment—a number that can be more meaningfully compared to traditional financing metrics—tells a somewhat different story: Inner city manufacturing (\$4.8M per

AVERAGE CAPITAL INTENSITY OF MANUFACTURING, INNER CITIES AND U.S., 1999-2005



Source: NBER, 1999 – 2005; SICE
 Note: The boxed areas denote the 25th-75th percentiles; the weighted averages are labeled for each.

firm) requires more capital per firm than central city manufacturing (\$4.2M per firm) but less than the average U.S. manufacturing firm (\$5.9M)². This discrepancy, however, is not the result of the capital intensity of the economies but of differences in average firm size: The typical inner city and central city establishment has 50 employees compared to a national average of 75 employees.

Inner city manufacturing is more concentrated in industries with high capital intensity. The exceptions are cities with extremely high population densities, where land availability constricts growth.

Methodology for Calculating Inner City Capital Gap

The previous observations of capital supply and demand do not account for possible differences in the types of economic activities conducted in inner city and non-inner city areas outside of manufacturers. We need to determine if inner city firms receive capital at the same rate as their competitors (categorized by six-digit NAICS codes) in other parts of the country. The Kauffman Firm Survey data enable just this comparison. The KFS collects data on about 5,000 firms founded in 2004. Of these firms, 2,516

² The median capital stock per establishment is roughly equal for inner cities and central cities at slightly less than \$4.3 million. The difference between the weighted average and median is consistent with the larger range of capital intensity numbers across inner cities, shown in the figure above.

answered the survey in each of the four years in which it has been conducted and also accessed some form of capital. To estimate the capital demand and gap, we restrict the KFS sample to firms that compete in one of the 155 industries with representation from both inner city and non-inner city firms. Using this sample, we compare the average total capital at inner city firms (supply) to the average at firms in the same industry across the country (demand). This enables us to see the amount of capital raised at each firm relative to the technical and competitive requirements of its industry. This is the most relevant metric for assessing any capital gap at inner city firms.

Analysis

Excluding a handful of firms with more than \$10 million in capital, it appears that inner city firms, on average, have more capital than non-inner city firms. Inner city firms in the KFS have an average of \$367,000 in capital, compared to an average of \$276,000 for non-inner city firms in the same industry.

There is no such thing, however, as an “average” firm. The data show that inner city businesses are dramatically split between the “haves” and “have nots.” For 70% of inner city businesses—the “have nots”—a tremendous capital gap is the norm. These businesses have, on average, only one-fourth the capital of others in their industries. The over-capitalized group is equally unusual, having, on average, four times the average capital of its peers. Companies in the undercapitalized group are 50% more likely to be headed by a minority business owner.

Well-capitalized inner city companies are likely to be more highly leveraged than those located elsewhere in the U.S. These companies have an average debt-to-equity ratio of 1.9, compared to 1.3 for other companies. Undercapitalized firms have leverage ratios similar to their non-inner city counterparts but are less likely to have raised external equity. At under-capitalized companies, owner equity accounts for an average of 37% of capital, compared to 16% at well-capitalized firms.

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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