Small Business Ownership and Finance

A Landscape Scan of the Historical Underpinnings of Current Conditions

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Understanding the history of small businesses is crucial to understanding the history of how inequitably decades of American economic growth has been distributed. Small business ownership has been an important tool for many Americans to attain economic freedom, but debt and equity capital, land, licensing, and other business supports have not historically been equitably distributed, especially for communities of color (Woodstock Institute 2017). This has limited the extent of business ownership in these communities and the size and profitability of businesses.

This document is a landscape review that describes the current state of small business ownership for business owners with respect to race and ethnicity, explores relevant historical context, and details support structures for advancing entrepreneurship in communities of color and for people of color. We reviewed relevant literature and analyzed publicly available datasets to better understand what existing publications and research have uncovered about small business ownership in America.

Background

Small businesses have been a key driver of financial and social capital in local economies. Businesses with fewer than 20 employees make up 89 percent of all US businesses.[1] Small businesses are important pathways for local communities to grow and retain wealth. Money earned by independent retailers is multiple times more likely than money earned by national chains to return to the communities in which those small businesses reside (Civic Economics 2008).[2]

Small businesses have also built generational wealth for families (Klein 2017). In 2019, business equity made up 34 percent of household nonfinancial assets, second only to people's primary residences, which made up 45 percent (US Small Business Administration 2019).

Small businesses also contribute to neighborhood cultural identity by building social and entrepreneurship networks that facilitate people feeling embedded in their communities. The intangible social benefits that small businesses provide contribute to the community's character, fostering the feeling of "place" that encourages neighborhood residents to become financially and emotionally invested in their communities.

Small business ownership can also improve equity in job opportunities. Black business owners, for example, are considerably more likely than white business owners to hire Black workers (Holzer, Raphael, and Stoll 2001). But publicly available small business data and research make clear how disparities caused by historical and contemporary racism pervade the small business ecosystem. Evidence shows that businesses owned by people of color are less likely to generate significant revenues (Austin 2016), to pay competitive salaries (Litwin and Phan 2012), and even to survive (Vlad 2009).

Root Causes of the Racial Wealth and Income Gap

The legacy of enslavement, land and wealth appropriation, exclusion, redlining, and segregation directly led to the racial disparities evident in the US today, including in small business ownership. And given the interconnectedness of finances, discrimination in one sphere directly affects others.

Redlining, the institutionalized denial of loans on the basis of race, inhibited people of color, especially Black communities, from building equity through homeownership. The intergenerational wealth that white homeowners were able to pass down to their children, and that families of color were not, compounded the racial wealth gap. (See Young, Neal, and Ratcliffe [2022] for a companion landscape scan regarding homeownership among households of color.) Residential segregation also depresses home equity, including via discrimination in appraisals (Young, Neal, and Ratcliffe 2022). Homes in predominantly Black neighborhoods are valued at $48,000 less than homes in comparable predominantly white neighborhoods (Ray et al. 2021).

The discrimination that caused the low homeownership rates among Black and Hispanic/Latino people that we see today can also be directly linked to the lower levels of small business ownership. Starting a business is expensive; in 2008, the average start-up company capitalized with about $25,000 of the founder's savings (Hurst and Lusardi 2004). People without access to sufficient cash on hand often need collateralized loans for their financing. A 2012 survey reported that 45 percent of small business owners who could not get a loan were denied because of insufficient collateral (National Small Business Association 2012). Home equity is the most common source of external financing for start-up and operating costs (Robb and Robinson 2010). Homeowners who have low initial credit scores and high credit card usage rates are especially likely to borrow against their home equity, and the effects of these dynamics are exacerbated by differences in average credit scores and credit profiles by race and ethnicity (Mian and Sufi 2011). Even where home equity is not directly used to finance a business, a home often serves as collateral. Today, it is largely impossible to receive a small business loan without the owner providing a personal guarantee for the loan.

Violence

The racial wealth gap is a result of more than discrimination. The history and extent of appropriation in Native and tribal lands is massive. And following the Civil War, Jim Crow laws excluded Black people from white institutions, and the Freedman's Bank collapsed in 1874,[3] making community-organized groups necessary institutions in Black communities. These mutual aid organizations, which had been important to Black communities in America since at least the late 1700s,[4] eventually grew into Black-owned commercial lending banks that supported Black business districts. Black Wall Streets began to emerge. Communities such as Greenwood in Tulsa, Oklahoma, and Hayti in Durham, North Carolina, were organized around Black-owned banks that financed Black-owned businesses. For hundreds of Black farmers and other small business owners, these banks were the only accessible source of capital. In addition to the concerted efforts to undermine and exclude Black business communities, there were acts of violence that tore down Black institutions and Black wealth. Most well known is the 1921 Tulsa Race Massacre, which led to the burning of 35 blocks of the neighborhood, millions of dollars in damage, and the displacement of thousands of Black families.[5]

Although Tulsa may be the most notorious example, similar violence occurred throughout post-Reconstruction America. The 1898 Wilmington massacre in North Carolina, the 1917 East St. Louis Riots, and the 1919 Chicago race riots all displaced thousands of Black families from their homes and businesses. The harmful impacts of racialized violence can reverberate beyond direct victims of an attack. The violence in the Ocoee massacre in Florida revealed that when most Black-owned businesses and residences in Northern Ocoee were burned down, the Black residents of Southern Ocoee subsequently felt pressured to leave their communities out of fear of future violence. As Black residents fled their communities and had their homes and businesses destroyed, wealth stripping translated into less ability to start and expand small businesses.

Exclusion through Land Use

Exclusionary land-use policies have also contributed to the racial wealth gap. Urban Renewal and the use of eminent domain to clear "blighted" land facilitated the demolition of communities of color for economic improvement. Hayti, for example, escaped the worst of racial violence and was a thriving business center until 1958, when the State of North Carolina decided to build the Durham Freeway straight through it. Using eminent domain, the state bulldozed homes and displaced more than 4,000 families and either displaced or permanently shuttered more than 500 businesses. At the height of Urban Renewal in the mid-1960s, at least 50,000 families were displaced every year nationwide; while being only 13 percent of the population, Black families were 55 percent of those displaced.[6] These families were denied access to stable housing and the network effects that are necessary for most people to access small business ownership as a means of economic uplift.

Restrictive covenants and exclusionary zoning laws have also contributed to the racial wealth gap through de facto and de jure segregation. Even after race-based segregation was ruled unconstitutional in 1917, cities like St. Louis displaced Black homeowners by rezoning areas from "residential" to "industrial" if many Black families moved in. Small businesses owned by people of color who relied on local communities for their consumer base could no longer sustain themselves. Explicit displacement aside, zoning restrictions that constrain housing supply to buoy home prices have priced out low-income families. One study found that condominium prices in Manhattan are 50 percent higher than they would be absent explicit supply-based constraints (Glaeser, Gyourko, and Saks 2005), and given the link between home wealth, location, personal finance, and small businesses starts and successes, these constraints have implications far beyond housing.

Procurement and Government Assistance

The federal government is, today, a relative bright spot with respect to procurement, where businesses owned by people of color receive a share of contracts higher than their share of businesses or the population (Theodos et al. 2023).[7] There is, however, a notable disparity in the number of government contracts that businesses owned by people of color win relative to white-owned small businesses at the state and local levels. For example, the Civil Rights Division of the US Department of Justice has opened an investigation to determine whether contract procurement in Kansas City has violated Title VI of the Civil Rights Act. A 2021 study revealed that only 1.2 percent of Boston's contracts between 2014 and 2019 went to businesses owned by Black or Hispanic/Latino people (BBC Research and Consulting 2020).

Addressing this disparity in procurement would help close the racial wealth gap. US cities spend collectively $1.6 trillion on goods and services, so even a small adjustment in allocation of procurement funding could mean billions of dollars more for minority-owned small businesses (Johnson et al. 2021). Additionally, by reducing the administrative burden of the procurement process, cities can encourage businesses owned by people of color to bid on projects they otherwise would not have bid on.

In the context of the COVID-19 pandemic, the inequitable distribution of government support to small businesses was made clear. The Paycheck Protection Program (PPP) loans that were part of the Coronavirus Aid, Relief, and Economic Security (CARES) Act helped many businesses stay solvent. But only 1.9 percent of loans went to Black-owned businesses while 83 percent went to white-owned businesses (Harker 2021). Additionally, Black business owners were turned down for PPP loans at higher rates than white business owners with comparable levels of revenue and credit. And some businesses owned by Hispanic/Latino people had unique challenges accessing PPP loans (Theodos, González-Hermoso, and Park 2021). As the loans were primarily distributed through banks, businesses with access to banking relationships had a significant head start in terms of applying for and receiving a majority of PPP loans, whereas only half of Hispanic/Latino business owners had any banking relationships at all, putting them at a disadvantage.

The Impact of Climate Change

Weather events caused by climate change could threaten small business sustainability in the future, and this is especially true in communities of color (Reynolds 2013). For example, the US Chamber of Commerce Foundation's Business Civic Leadership Center determined that Hurricane Sandy was the sole cause of the shuttering of up to 30 percent of the 60,000 to 100,000 small businesses that were negatively affected by the hurricane in 2012.[8] Many small businesses will not reopen after being affected by a major disaster. Even for the businesses that do not close down, the median cost to a business while it is closed because of weather is around $3,000 a day (Reynolds 2013). And evidence shows that roughly 90 percent of small businesses in majority-Black or majority- Hispanic/Latino neighborhoods had less than 14 days of cash on hand; in majority-white neighborhoods, that share is 35 percent (Farrell, Wheat, and Grandet 2019).

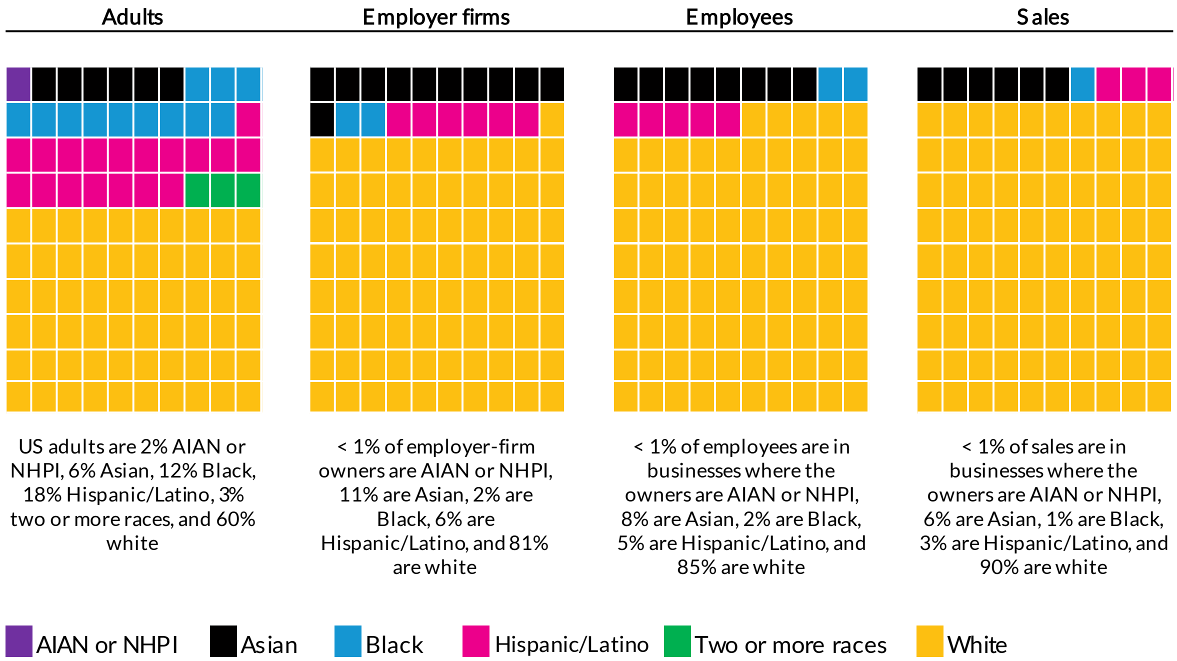
Small businesses have several characteristics that make them particularly vulnerable to such events. For one thing, most small businesses operate out of a single physical location and access customers from near where they are located. Therefore, while larger, more capital-rich businesses have access to alternate facilities and branch locations to supplement their income during a weather event, small businesses often cannot benefit from geographic diversification. If a small business's sole location is caught in an earthquake, for example, the business will be much more heavily affected by direct weather damage and any indirect obstacles, such as employee absences, declining business caused by road closures, and any technological or telecommunications failures.

Current Ownership Status, by Race and Ethnicity

In light of these historical and emerging causes of racial inequality in small business ownership, where do things stand today? Data from the US Census Bureau's Annual Business Survey reveals that Black- and Hispanic/Latino-owned businesses make up only about 2 and 6 percent of all businesses, respectively, whereas white-owned businesses make up more than 80 percent. Additionally, Black- and Hispanic/Latino-owned businesses employ around 2 and 5 percent of all employees, whereas white-owned businesses employ more than 85 percent of all employees. This disparity is most apparent when analyzing shares of total business earnings, as Black- and Hispanic/Latino-owned businesses earn only about 1 and 3 percent of all business sales, while white-owned businesses earn nearly 90 percent of all business sales (figure 1). American Indian, Alaska Native, Native Hawaiian, and Pacific Islander–owned businesses are also underrepresented in ownership, employees, and sales relative to their share of the US adult population. Asian-owned businesses are overrepresented in ownership and employees and proportionally represented in sales.

FIGURE 1

State of Business Ownership, by Race and Ethnicity



Sources: 2018 American Business Survey and 2016–20 American Community Survey, five-year estimates.
Notes: AIAN = American Indian and Alaska Native; NHPI = Native Hawaiian and Pacific Islander. Two more races not tracked in the Annual Business Survey.

Black- and Hispanic/Latino-owned businesses are also disproportionately less likely to have employees. Businesses with employees expand job opportunities for people within communities. For many underemployed small business owners, owning a business without employees can often be a substitute for working at an employer-provided job; these owners, therefore, may receive benefits that are inferior to those given by employer-provided jobs.

The retirement of baby boomers and increasing diversity among younger Americans are beginning to change these trends. Businesses owned by people of color have made up a majority of recent new business growth. The number of minority-owned firms increased from 4.0 million in 2002 to 9.7 million in 2018, more than doubling in 16 years (Minority Business Development Agency 2018). As a share of total firms, minority-owned firms increased from being 17.8 percent of all firms to around 31 percent during that same period. And over the past decade, Hispanic/Latino entrepreneurs have started small businesses at a higher rate than any other racial or ethnic group (Orozco et al. 2021).

The "silver tsunami" (i.e., baby boomer retirement) poses an opportunity for young would-be entrepreneurs, as retiring owners of businesses that predominantly employ people of color can further support the growth of minority-owned businesses by structuring their succession plans to transfer ownership to their workers. Local governments can facilitate this process by ensuring business owners have the knowledge and legal and financial resources to ensure a smooth transition, as was done recently in New York City (Funk and Trenholm 2021; Theodos, Shakesprere, and Hariharan 2022).

Lending and Equity Investments

Having sufficient data about lending and equity investments is important for improving overall access to credit. But compared with data on mortgage finance, small business lending data are less readily available. The Consumer Financial Protection Bureau acknowledges in a 2017 landscape study that "currently there is only a very limited ability to accurately size the small business lending market even by broad product categories, let alone subcategories" (Consumer Financial Protection Bureau 2017). The bureau has yet to implement small business lending data reporting requirements as required under Section 1071 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Theodos 2022a), which would lead to reporting of race with loan information (analogous to what the Home Mortgage Disclosure Act requires for mortgages). Large banks report some lending activity through required Community Reinvestment Act reporting, and the SBA shares some data about its federally guaranteed loans, but there are many gaps. Especially of note is missing insights about loans made by small business financial technology companies or alternative lenders such as Square, PayPal, Stripe, Amazon, Funding Circle, and Intuit.

The Importance of Lending

Debt financing is a crucial tool for small business owners to be able to access capital to expand their operations and smooth out their cash flows without having to divest control of their business ownership. Debt financing is also a crucial tool for small businesses to be able to hire employees; there is a strong correlation between a small business owner's ability to hire and their ability to access credit (National Small Business Association 2016). The National Small Business Administration also found that an inability to secure financing may have led 16 percent of small businesses to reduce their staff and around 10 percent of small businesses to reduce employee benefits. Credit is especially important for growth among small businesses with few employees.

Lending Dynamics

Funding is crucial for the success of many start-ups; 79 percent of start-ups that fail often started without enough capital to maintain their operation. And researchers have observed inequities in the small business lending space (Lee, Mitchell, and Lederer 2017). People with greater personal wealth are less likely to be turned down for small business loans. But even after controlling for wealth, there are still significantly higher denial rates among Black-, Hispanic/Latino-, and Asian-owned businesses relative to those owned by white men (Cavalluzzo and Wolken 2002).

Assessing differences in loan seekers' experiences is also important to understanding the full context of discrimination in the small business space. Mystery loan applicants can help reveal disparities in how loan applicants are treated by race and ethnicity. In a recent National Community Reinvestment Coalition study, testers presented banks with nearly identical businesses and strong credit histories when applying for small business loans, where Black and Hispanic/Latino profiles were slightly stronger relative to their white counterparts (Lee, Mitchell, and Lederer 2017). In almost every metric, white testers received better customer service. They were greeted more often and were asked fewer questions about their eligibility. Black and Hispanic/Latino testers were asked to provide personal income tax statements 28 percent and 32 percent more, respectively. White testers were also consistently given more information about loan products and fees. Black testers were the only group asked about their education level. Hispanic/Latino testers were asked about their credit card debt more than five times as often as their white and Black counterparts.

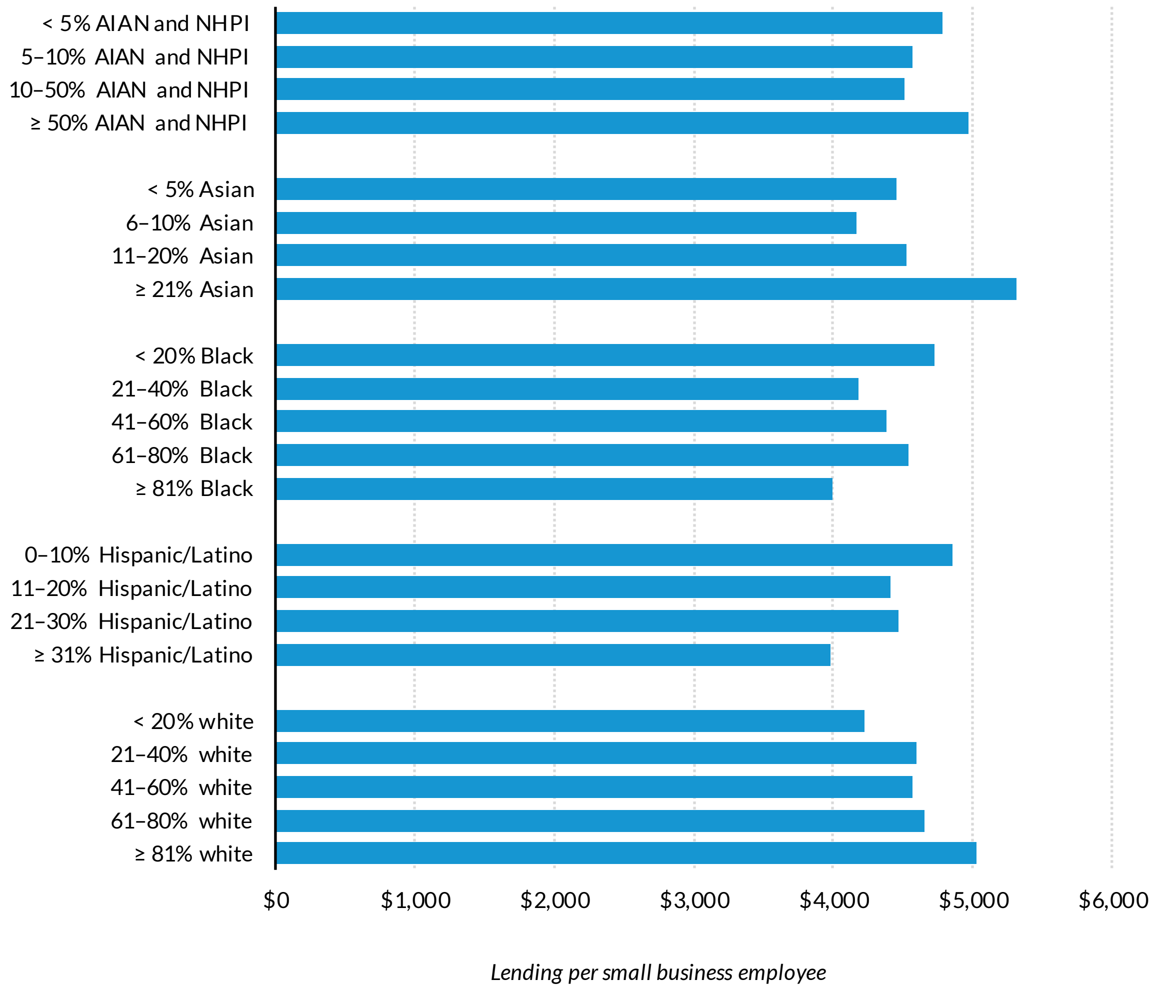
Surveys of small business owners also reveal disparities in accessibility to banking services. Although not nationally representative, the Federal Reserve's 2022 Small Business Credit Survey helps us understand business owners' experiences. When asked what financial difficulties they were facing in the past 12 months, white business owners were least likely to cite credit availability (27 percent), whereas 50 percent of Black business owners and 37 percent of Hispanic/Latino business owners cited credit availability. Similarly, when surveying businesses that had not applied for financing, white business owners were the most likely to cite having sufficient financing as the reason (50 percent), while only 13 percent of Black business owners and 26 percent of Hispanic/Latino business owners claimed they had sufficient financing. Conversely, 12 percent of white business owners claimed the reason they did not apply for financing was because they felt discouraged from applying, compared with 40 percent of Black business owners and 24 percent of Hispanic/Latino business owners.

Complete or representative data about lending to small business owners by race are not available (Theodos 2022a). Although different, it is instructive to investigate trends in small business lending by race and ethnicity of the neighborhood residents where small businesses are located. (These data are available for large banks and for SBA loans but not for other financial institutions.) The data show geographic disparities in the flow of small business loans. Neighborhoods with more Asian or white people generally have higher levels of small business lending than neighborhoods with more Black, Hispanic/Latino, or Native Hawaiian and Pacific Islander people. The trends for American Indian and Alaska Native people were less linear. The differences evident in figure 2 are sizable. Also, even though lending disparities by neighborhood race and ethnicity are higher in the Community Reinvestment Act (CRA) small business bank loan data, the SBA also has been criticized for serving too few borrowers of color (Lee, Mitchell, and Lederer 2017).

FIGURE 2

Lending Flows, by Race or Ethnicity, 2010–20

Per small business employee median of tracts with given racial or ethnic percentages of the population



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Sources: Community Reinvestment Act small business loan data and Small Business Administration 7(a) and 504 loan data.
Note: AIAN = American Indian and Alaska Native; NHPI = Native Hawaiian and Pacific Islander.

Equity Investments

Equity investments are a useful way for entrepreneurs who struggle to access credit markets or want to avoid the risks of debt financing to still be able to secure the necessary capital to fund their start-up. But the narrow distribution of equity financing in turn created reinforcing limits and gaps in the ability of small business owners in and from poorly served places, industries, and groups to take advantage of equity investments. Investors are also increasingly financing more mature businesses, shying away from smaller start-ups.

This is especially true for venture capital and angel investors, important players in the small business space, as these investors are more likely than others to fund smaller firms with higher perceived risk in their earliest stages. Unlike smaller firms, large companies often have more broadly diversified business structures that give them more stable business performance from year to year, with fewer variable earnings and revenue streams.[9]

Equity financing is highly concentrated by a variety of factors, such as race, geography, and industry (Theodos and González-Hermoso 2021). One-third of venture funds invested in 2021 were based in Silicon Valley, and just three states (California, Massachusetts, and New York) receive around 75 percent of all venture capital investments. Black- and Hispanic/Latino-owned firms receive only 2.3 percent of venture capital despite accounting for 8 percent of employer firms (Theodos and González-Hermoso 2021).

Venture capital has shifted its allocation away from smaller businesses to more mature ventures. Equity investments of less than $5 million have declined while investments of $5 to $10 million have increased, indicating that investors are participating less in the earliest stages of seed funding and shifting their investments toward mature businesses. Given the associations between firm size and race and ethnicity, this trend may have racially disparate effects.

Conclusion

Disparities in the small business landscape by race and ethnicity are well documented. The challenges are long-standing, and they are contemporary. Government efforts to bolster business ownership for people of color are often inadequately designed and targeted. Even ones that are well designed and implemented are nevertheless too often limited in scope and scale (Theodos 2022b).

There are green shoots in the broader landscape, policies and philanthropically backed efforts that have promise. And with attention, resources, and will, these efforts can be refined and expanded. Areas of attention include improved contracting and procurement supports and requirements. (Actors such as hospitals, universities, and large construction projects can be important resources in these regards as well.) Technical assistance supports are available from the SBA, the US Minority Business Development Agency, and others. The new SBA Community Navigator Pilot Program has the potential to be more community embedded as a model going forward. Capital access remains a major obstacle and pathway toward growth. Reforms to several programs including the SBA's Small Business Investment Company Program, 7(a) loan program, and 504 loan program will be needed to better serve entrepreneurs of color. The new State Small Business Credit Initiative will provide a real boost to community development finance institutions and other mission lenders working to serve businesses not well connected to bank and nonbank market finance tools. Philanthropy and local government are experimenting with pairing well-targeted grants (as opposed to what was done under the Paycheck Protection Program) with loan capital for higher-risk or lower-wealth businesses (Theodos and González-Hermoso 2023). Finally, regulatory protections for small business owners are limited and need to be expanded. For example, at present, there is no truth-in-lending protection for small business owners and loans the way there is for consumers, meaning entrepreneurs can face inaccurate and unfair credit practices. In sum, a great deal of work needs to be accomplished if America's small business landscape is to reflect its racial makeup, but there are viable solutions and approaches we can collectively pursue.

Notes

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