Race and Entrepreneurial Success

Black-, Asian-, and White-Owned Businesses in the United States

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1 Introduction

Racial inequality in education, income, and wealth are well known. Less understood are the large and persistent racial disparities in business ownership and performance in the United States. The lack of attention is surprising, given the magnitude of these racial differences and the importance of business ownership as a way to make a living for many Americans. More than one in ten workers, or 13 million people, in the United States are self-employed business owners. These 13 million business owners hold an amazing 37.4 percent of total U.S. wealth (Bucks, Kennickell, and Moore 2006). Yet only 5.1 percent of African American workers and 7.5 percent of Latino workers own businesses compared with more than 11 percent of white and Asian workers. Low rates of business ownership among African Americans have also persisted over the entire twentieth century, and recent trends indicate that racial disparities in business-ownership rates will not disappear in the near future.

Racial Patterns in Business Outcomes

Although racial disparities in business ownership are troubling, perhaps a more important concern is that businesses owned by disadvantaged minorities tend to be smaller and less successful than nonminority-owned businesses. On average, black- and Latino-owned businesses have lower sales, hire fewer employees, and have smaller payrolls than white-owned businesses (U.S. Census Bureau 2006b). Firms owned by African Americans also have lower profits and higher closure rates than those owned by whites (U.S. Census Bureau 1997). For most outcomes, these disparities are large. For example, white-owned firms have average annual sales of $439,579, compared with only $74,018 for black-owned firms (U.S. Census Bureau 2006b). There certainly are a large number of very successful black-owned businesses in the United States, many with revenues of more than $250,000 per year.[1] But a substantial proportion of black firms are less successful, leading to average outcomes that are worse than for white firms. In contrast to these patterns, Asian American-owned firms have average outcomes more similar to—and in some cases better than—those of white-owned firms. Overall, these racial patterns in business outcomes have remained roughly unchanged over the past two decades.

Improving the performance of minority-owned businesses in the United States is a major concern among policymakers. Although they are sometimes controversial, various federal, state, and local government programs offer contracting set-asides, price discounts, and loans to businesses owned by minorities, women, and other disadvantaged groups (Boston 1999b; Joint Center for Political and Economic Studies 1994). One of the goals of these programs is to foster minority-business development, which may have implications for reducing earnings and wealth inequalities (Bradford 2003). Self-employed business owners earn more on average than wage and salary workers (Borjas 1999), and disadvantaged business owners have more upward income mobility and experience faster earnings growth than disadvantaged wage and salary workers (Holtz-Eakin, Rosen, and Weathers 2000; Fairlie 2004b). It has also been argued that some disadvantaged groups facing discrimination or blocked opportunities in the wage and salary sector—such as Chinese, Japanese, Jewish, Italian, and Greek immigrants—have used business ownership as a source of economic advancement.[2] More recently, the economic mobility of Koreans has been linked to business ownership (Min 1996).[3]

Another concern, which is often overlooked, is the loss in economic efficiency resulting from blocked opportunities for minorities to start and grow businesses. Business formation has been associated with the creation of new industries, innovation, job creation, improvement in sector productivity, and economic growth (Reynolds 2005). If minority entrepreneurs face liquidity constraints, discrimination, or other barriers to creating new businesses or expanding current businesses, there is some loss of efficiency in the economy.[4] Although it is difficult to determine the value of these losses, barriers to entry and expansion that minority-owned businesses face are potentially costly to U.S. productivity, especially as minorities represent an increasing share of the total population. Barriers to business growth may be especially damaging for job creation in poor neighborhoods (Boston 1999b, 2006b).

Minority firms in the United States hire more than 4.7 million employees, a disproportionate share of them minorities (U.S. Census Bureau 1997, 2006b), and many of these jobs are located in disadvantaged communities.

A growing body of literature attempts to address these concerns by exploring the causes of racial disparities in business ownership. Human, financial, and social capital appear to be the main driving forces behind racial differences in rates of business ownership. For example, previous research focusing on blacks indicates that relatively low levels of education, assets, and parental self-employment are partly responsible for their low rates of business ownership (Bates 1997; Fairlie 1999; Hout and Rosen 2000). Less is known about the underlying causes of racial differences in business outcomes such as profits, sales, and employment. The lack of evidence is surprising given that the benefits of improving minority-business performance are unambiguous compared with the benefits of simply increasing rates of business ownership among minority businesses.[5] The limited previous research on the topic indicates that the owner's education level and startup capital have been found to contribute to racial differences in business closures and profits (Bates 1997).

To get an idea of the potential importance of access to financial capital in contributing to racial disparities in business ownership and outcomes, one only has to look at the alarming levels of wealth inequality that exist in the United States (U.S. Census Bureau 2005a). Half of all blacks have less than $6,200 in wealth. Wealth levels among whites and Asians are *11 times higher*. Low levels of wealth among disadvantaged minorities are likely to translate into less successful businesses because the owner's wealth can be invested directly in the business or used as collateral to obtain business loans. Lending discrimination can exacerbate this problem by further restricting access to capital (Blanchflower, Levine, and Zimmerman 2003; Cavalluzzo, Cavalluzzo, and Wolken 2002).

Another contributing factor is racial disparities in education. Fewer than 20 percent of blacks have a college education, compared with nearly 30 percent of whites. Asians have even higher levels of education: nearly 50 percent of Asians, whether born abroad or in the United States, are college educated. The general and specific knowledge and skills acquired through formal education may be useful for running a successful business. If this is the case, racial differences in the education levels of the owners will lead to racial disparities in business outcomes.

The legacy of slavery and historical discrimination underlies another concern about current disparities in the performance of black- and white-owned firms. Blacks made scant progress in rates of business ownership throughout the twentieth century, even in light of their substantial gains in education, earnings, and civil rights. The ratio of white to black self-employment rates remained roughly constant at 3 to 1 over the twentieth century (Fairlie and Meyer 2000) with only slight improvements shown in the past several years. Why was there no convergence in racial self-employment rates over the twentieth century? Early researchers emphasized the role that past inexperience in business played in creating low rates of business ownership among blacks. Du Bois (1899) and later Myrdal (1944), Cayton and Drake (1946), and Frazier (1957) identify the lack of black traditions in business enterprise as a major cause of low levels of black business ownership at the time of their analyses.

The argument for the importance of black traditions in business relies on evidence of a strong intergenerational link in business ownership; that is, the children of business owners are more likely than those of nonbusiness owners to own businesses. We might expect the intergenerational link to be strong because working in a family business is an excellent way to acquire general business or managerial experience that is later useful for starting and running a successful business. Children who choose to work in an industry similar to that of their family's business may also acquire industry- or firm-specific expertise (learning how to run a restaurant by working in their parents' restaurant, for example). The inheritance of a family-owned business and correlations among family members in entrepreneurial preferences may also contribute to intergenerational links in business ownership. Indeed, a few recent studies find that the likelihood of being a self-employed business owner is substantially higher among the children of business owners than among the children of nonbusiness owners (Lentz and Laband 1990; Fairlie 1999; Dunn and Holtz-Eakin 2000; Hout and Rosen 2000). Current racial patterns in self-employment rates are also in part determined by racial patterns of self-employment rates in the previous generation (Fairlie 1999; Hout and Rosen 2000).

Although the previous literature provides evidence that racial disparities in financial-capital, human-capital, and family-business backgrounds contribute to the likelihood that some minority groups will not own businesses, less is known about whether these factors also contribute to racial differences in business performance. The standard theoretical model of entrepreneurship posits that human capital and access to financial capital are two of the most important determinants of the entrepreneurial decision (Evans and Jovanovic 1989), and these types of capital are clearly inputs in the production process potentially affecting performance. But we know little about the business consequences of racial disparities in these factors. Although owner's education and access to financial capital have been identified as contributing to racial differences in closure rates and profits, the relative importance of these factors is unknown. Ideally, one would like an estimate of how much of the racial differences in several business outcomes can be explained by each factor and whether, for example, racial differences in access to startup capital are more detrimental to business success than are racial differences in human capital.

Knowledge about the importance of family-business backgrounds is especially lacking. In particular, the intergenerational transmission of business ownership is found to contribute to racial disparities in *rates* of business ownership, but whether it also contributes to racial disparities in business *outcomes conditioning* on ownership is unknown. For example, can differences in family-business backgrounds explain why black-owned businesses underperform white-owned firms on average? Can they explain why Asian-owned firms have better outcomes than other racial groups? If they do contribute to racial disparities in outcomes, how do they contribute? Do family businesses primarily provide an opportunity for would-be entrepreneurs to acquire general and specific business human capital, or are inheritances and correlated preferences more important? Very little is currently known about the exact mechanisms that drive the intergenerational relationship in business ownership and outcomes.

The previous literature has not explored these questions in depth partly because of the lack of available data. The primary difficulty is finding a nationally representative dataset that includes a large enough sample of minority-owned businesses, information on business outcomes, and the family-business background of the owner. An exception is the Characteristics of Business Owners (CBO), conducted by the U.S. Census Bureau, which contains detailed information on the characteristics of owners and firms. To our knowledge, it is the only dataset that includes large samples of minority-owned firms and information on family-business ownership, prior work experience in family businesses, prior work experience in similar businesses, and business inheritances.

In this study, we use CBO data to explore the role that racial differences in financial-capital, human-capital, and family-business backgrounds play in contributing to racial disparities in small business outcomes, such as closure rates, profits, employment, and sales. Low levels of education and wealth may limit the ability of disadvantaged minorities to start successful businesses. The inability of minorities to acquire general and specific business human capital through exposure to businesses owned by family members may also contribute to their limited success in business ownership. The richness of these data allows us to examine the contributions of many additional owner and business characteristics in racial disparities in business outcomes. Unlike individual-level datasets, such as the Census of Population and the Current Population Survey, the CBO contains detailed information on both business and owner, allowing us to explore the determinants of several different business outcomes.

Although the CBO provides an excellent dataset for exploring the underlying causes of racial differences in business outcomes, it has been used by only a handful of researchers. The lack of use appears to be due primarily to difficulties in obtaining access, using, and reporting results from these confidential and restricted-access data. All research using the CBO must be conducted in a Census Research Data Center or at the Center for Economic Studies (CES) after approval by the CES and the Internal Revenue Service (IRS), and all output must pass strict disclosure regulations.

Another contribution of the study is to provide a new compilation of estimates of racial patterns of business-ownership rates and business outcomes. Surprisingly, there is no comprehensive source of information on recent trends in minority businesses in the literature. Combining estimates from the most widely used and respected sources of government data, we provide an assessment of the state of minority business in the United States. Estimates of business-ownership rates and performance are generated from public-use and restricted-access microdata taken from published sources and obtained from special tabulations prepared for us by the U.S. Census Bureau.

The focus of the analysis is on African American- and Asian American-owned businesses. Estimates presented later in this study indicate that Asian American-owned businesses have the best average outcomes of all major racial groups. In contrast, the average outcomes of businesses owned by African Americans are at the low end of all groups. Although a sizeable body of research has focused on why there are few black-owned businesses, very little research focuses on the causes of their relative underperformance. Furthermore, relatively little research using business-level data focuses on the performance of Asian American-owned firms. We also present statistics on recent trends in business outcomes for Latino-owned businesses but do not explore the causes of differences between firms owned by Latinos and those owned by whites because we do not find notable differences in average outcomes in the CBO data used. Thus, the analysis of CBO microdata focuses on identifying why Asian-owned businesses have the best and black-owned businesses have the worst average outcomes of all major racial and ethnic groups. The answers to these questions have important policy implications, given the importance of successful business ownership for income generation, wealth accumulation, job creation, and economic development.

Outline of This Book

The main goals of this book are to (1) document recent trends in business ownership and outcomes by race using the most up-to-date and respected sources of government data, (2) identify the owner and business characteristics associated with business success, (3) explore potential explanations for the relative underperformance of black-owned businesses, and (4) explore potential explanations for the relative success of Asian-owned businesses. The findings from this analysis of racial differences in business outcomes are useful for characterizing the state of minority-owned businesses in the United States.

Chapter 2 documents recent trends in racial patterns in business ownership and performance using the most up-to-date and widely used government data on minority-owned businesses, the Survey of Minority-Owned Business Enterprises (SMOBE) and the Survey of Business Owners (SBO), and on self-employed business owners, the Current Population Survey (CPS). These datasets are described in detail in the book's data appendix. We first provide new estimates of recent trends in business ownership rates by race and ethnicity from the CPS and a brief review of previous literature examining the causes of racial differences in business ownership. Estimates from CPS microdata improve on published estimates from the same source by the U.S. Bureau of Labor Statistics that do not include incorporated business owners. Using the SMOBE, SBO, and CBO, we provide estimates of recent trends in business outcomes by race. Racial differences in sales, profits, employment, payroll, and closure rates are documented and discussed. Estimates from published sources, public-use and restricted-access microdata, and special tabulations created for us by the Census Bureau are combined to provide a comprehensive picture of the performance of minority-owned businesses in the United States. The compilation of estimates of business outcomes by race over the past two decades presented here is new and makes definitions as comparable as possible over time.

Although a large body of literature examines the causes of racial differences in rates of business ownership, much less is known about the causes of racial differences in business outcomes, such as survivability, profits, employment, and sales. Examining the factors associated with successful businesses is the first step in identifying the causes of racial differences in business outcomes outlined in chapter 2. Chapter 3 provides a detailed analysis of the determinants of small business success using confidential and restricted-access CBO microdata. We examine the owner and business characteristics associated with higher sales and profits, more employment, and a lower likelihood of closure among small businesses. In addition to examining more traditional determinants, such as owner's education and financial capital, we examine whether family-business backgrounds are important in predicting business success. We estimate the independent effects for small business outcomes of having a self-employed family member, of having prior work experience in that family member's business, and of inheriting a business. The results have implications for the importance to business success of general and specific business human capital and of correlations in entrepreneurial preferences across family members. To identify measurable and causal factors affecting business success, we focus on parsimonious models for business outcomes common in the economics literature.

Building on the findings from chapter 3 on the determinants of business success, chapter 4 employs a special decomposition technique to identify the underlying causes of differences in business outcomes between African American- and white-owned firms. The decomposition technique provides estimates of how much each factor explains of the racial gaps in business outcomes. Black-owned businesses are found to have lower revenues and profits, to hire fewer employees, and to be more likely to close than white-owned businesses. We explore the role that owner's education, financial capital, family-business backgrounds, and other owner and firm characteristics play in creating racial disparities in small business outcomes. Do black business owners have limited opportunities to acquire general and specific business human capital by working in a family-owned business or inheriting a business, in addition to having less education and less access to financial capital?

Estimates from CBO microdata indicate that Asian-owned businesses have better outcomes, on average, than white-owned businesses. Chapter 5 explores why Asian-owned firms have higher sales and profits, are more likely to hire employees, and are less likely to close than white-owned firms. The oversample of Asian-owned firms in the CBO allows us to explore whether the relative success of these firms is because of higher levels of human and financial capital, advantaged family-business backgrounds, or other factors. We use estimates of the determinants of small business outcomes identified in chapter 3 and the decomposition technique described in chapter 4 for this analysis. The results for Asian Americans are important because only a few previous studies in the literature explore business outcomes for this group using nationally representative business-level data.

Chapter 6 concludes by reviewing the findings from our analysis of racial patterns in business outcomes from CBO, SMOBE, SBO, and CPS data. Policy implications of the results are also briefly discussed.

Main Findings of the Research

The main findings from our analysis of racial differences in business outcomes are as follows.

1. African Americans and Latinos are substantially less likely to own a business than are whites and Asian Americans. Estimates from 2006 CPS microdata indicate that 11.1 percent of white workers and 11.8 percent of Asian workers are self-employed business owners, whereas only 5.1 percent of black workers and 7.5 percent of Latino workers are business owners. In the past few years, however, there is some evidence of rising black and Latino business-ownership rates.

2. Black-owned businesses have lower sales and profits, hire fewer employees, have smaller payrolls, and have higher closure rates than white-owned businesses. For most outcomes, the disparities are extremely large. For example, estimates from the 2002 SBO indicate that white-owned firms have average sales of $439,579 compared with only $74,018 for those owned by blacks.

3. Although white firms generally outperform Asian firms when examining data for all businesses, Asian firms clearly have the strongest performance among all major racial and ethnic groups after removing small-scale businesses. Estimates from 1992 CBO microdata indicate that Asian-owned firms have higher sales and profits, are more likely to hire employees, and are less likely to close than white-owned firms.

4. Estimates from the SBO/SMOBE data also indicate substantially worse outcomes among Latino-owned firms than white-owned firms. Latino-owned businesses have lower average sales, are less likely to hire employees, and hire fewer employees than white-owned businesses. Estimates from our CBO sample, however, do not reveal large disparities in business outcomes between Latino-owned firms and white-owned firms.

5. Trends in minority business outcomes do not indicate improvement relative to white business outcomes in the past two decades.

6. Intergenerational links in business ownership are strong. Estimates from the CBO indicate that more than half of all business owners had a self-employed family member prior to starting their business. Where there was a self-employed family member, fewer than half of small business owners worked in that family member's business. On the other hand, only a very small percentage of all small businesses were inherited.

7. Estimates from regression models for small business outcomes *conditioning* on business ownership indicate that having a self-employed family member plays only a minor role. In contrast, prior work experience in that family member's business has a large positive effect on business outcomes. Working in a family member's business may provide opportunities for acquiring valuable specific and general business human capital. Regression estimates also indicate that inherited businesses are more successful on average than noninherited businesses, but their limited representation in the population of small businesses suggests that they are not a major determinant of business outcomes.

8. We also find evidence that other forms of human capital and business human capital—the owner's education level and prior work experience in a business whose goods and services were similar to those provided by the owner's business—are important determinants of business outcomes.

9. Estimates from the CBO indicate a strong positive relationship between startup capital and business outcomes. Firms with higher levels of startup capital are less likely to close and are more likely to have higher profits and sales and to hire employees. The estimated positive relationship is consistent with the inability of some entrepreneurs to obtain the optimal level of startup capital because of liquidity constraints.

10. The median level of wealth for blacks is $6,166, compared with $67,000 for whites. We find that black-owned businesses start with substantially lower levels of financial capital than white-owned firms. Using a nonlinear decomposition technique, we find that the black/white disparity in startup capital is the largest single factor contributing to racial disparities in closure rates, profits, employment, and sales.

11. Estimates from the CBO indicate that black business owners have a relatively disadvantaged family-business background compared with white business owners. Black business owners are much less likely than white business owners to have had a self-employed family member owner prior to starting their business and are less likely to have worked in that family member's business. We do not find sizeable racial differences in the inheritance of businesses.

12. We find that the relatively low probability of having a self-employed family member prior to business startup among blacks does not generally contribute to racial differences in small business outcomes. Instead, the lack of prior work experience in a family business among black business owners, perhaps by limiting their acquisition of general and specific business human capital, negatively affects black business outcomes. We also find that limited opportunities for acquiring specific business human capital through work experience in businesses providing similar goods and services contribute to worse business outcomes among blacks.

13. Only 17.6 percent of blacks have a college education compared with 28.2 percent of whites. Black business owners are also found to have lower levels of education than white business owners, on average. Estimates from our decomposition technique indicate that these racial differences in education contribute significantly to the observed racial disparities in business outcomes.

14. The most important factor in the higher survival rates, profits, employment, and sales of Asian-owned firms is that Asian Americans

invest more startup capital in their firms than whites. This factor alone explains 57 to 100 percent of the difference in outcomes between Asian and white firms.

15. Nearly half of all Asian American business owners are college educated, which follows the pattern of high levels of education in the Asian American population more generally. Higher levels of education among Asian business owners, who are 80 percent foreign born, explain a large fraction of the better outcomes in Asian- compared with white-owned businesses.

16. The relative success of Asian-owned businesses is not due to having advantaged family-business backgrounds. In fact, Asian business owners are less likely than white business owners to have a self-employed family member prior to business startup and are less likely to work in that family business.

Overall, our findings indicate that large racial disparities exist in business ownership and business outcomes in the United States. There is also no evidence suggesting that these patterns will disappear in the near future. Our analysis of the confidential and restricted-access CBO reveals several important determinants of success in small business ownership. The analysis focuses on the business and owner characteristics that are likely to be the most important inputs into the firm's production process as suggested by economic theory. In addition to more traditional explanations, such as the owner's education level and access to financial capital, we find evidence suggesting that family-business backgrounds are important. In particular, prior work experience in a family business has a positive effect on business outcomes, possibly through the acquisition of specific and general business human capital.

Turning to explanations for disparities in business outcomes, we find that racial differences in these factors are important. The relative lack of success among black-owned businesses is attributable in part to owners who have less startup capital, disadvantaged family backgrounds, and less education. Conversely, the relative success of Asian American-owned businesses in the United States appears to be mainly due to their relatively high levels of startup capital and owner's education.