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BLACK CAPITALISM:
DUALITY AND DEVELOPMENTAL PROSPECTS

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ABSTRACT

Because Black-owned enterprises vary in size, line of business and a number of other characteristics, it is difficult to make global statements about Black entrepreneurship. Furthermore, conventional standards of firm profitability or viability in the White community may not be directly applicable to firms existing in the environment of an urban ghetto. In this study a set of specific criteria will be proposed that can be used to sort out the marginal Black firms from those which appear to be economically viable: criteria are presented for estimating the profitability of Black firms having various levels of sales, labor input and capital input. Using data collected from offices of the Small Business Administration in Chicago, Boston and New York, multiple linear regression models explaining business profits are estimated for a sample of 285 Black existing businesses. The empirical results suggest that profitability can be accurately predicted and that many Black-owned firms are economically viable in the sense of generating enough profits to provide at least a lower-middle-class standard of living for their owner-operators. Viability in retailing, a most popular field for new and expanding Black firms, typically requires a fairly substantial net investment and the ability to generate an annual sales volume in the $1000,000 range. Entrepreneurs with slender resources should avoid the field of retailing.

The sample data under consideration suggests that the newer Black-owned firms that have been provided access to capital markets are entering lines of business not previously occupied by Blacks. Results of regression analyses support the notion that Blacks have historically concentrated in

narrowly circumscribed fields like laundries, restaurants and barbershops because these were fields in which one could begin and continue operations with very little capital. If Blacks continue to have access to capital markets, Black firms can be expected in almost all lines of commerce and industry. It was primarily lack of access to capital markets which previously prevented Blacks from operating outside of their traditional lines of business.

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Why are there so few Black businesses? Perhaps a representative answer to this question is: 1) lack of capital and contact with financial institutions and 2) lack of managerial skills and attitudes among Blacks.[1]

Authors of articles analyzing Black businesses usually suggest that segregation and discrimination have been instrumental in creating Black enterprises that are typically small scale and inefficient. Most of these authors conclude that government and private corporate enterprise should make one or more of the following aids available to minority entrepreneurs: 1) provide greater credit availability, 2) provide managerial and technical assistance, 3) liberalize bonding and insurance standards and requirements, 4) provide easier access to markets.[2]

A. Attempts to Analyze the Black Business Community

The massive literature about Black entrepreneurship tends to be repetitive and nonanalytic; often an author bases his remarks on a small number of incidents or is busy attempting to promote some policy which he believes will improve the environment for Black business.

The literature on Black capitalism has generally lacked substance because comprehensive financial information on Black firms has not been available. Empirical studies that have appeared to date have relied upon voluntary responses of Black entrepreneurs to survey questionnaires; the nature of this data gathering technique eliminates the possibility of verifying the accuracy of the collected information. Relying on surveys for data, empirical studies in this field have understandably been unable to gather balance sheet information on the type and dollar amount of the assets and liabilities of Black businesses. Because of the nature of available data on the Black business community, articles and books on Black enterprise have often been nonanalytic statements of personal opinion. Many unsubstantiated views have persisted and a number of unanswered questions have plagued those who have contributed to the literature on Black entrepreneurship.

One major series of contributions to this literature has come from the pen of Governor Andrew Brimmer, a member of the Board of Governors of the Federal Reserve System.[3] His analysis has had a broad impact both because of his own influential position in government and because it appeared to be documented with supporting empirical evidence. In a recently published article, I have shown that Brimmer's empirical work is inaccurate; his theoretical interpretation of Black entrepreneurship is similarly deficient because it ignores major burdens that have been imposed on Black businessmen by racial discrimination.[4]

The data analyzed in my research efforts, including the econometric analyses presented in this article, suggest that limited access to capital markets has been instrumental in limiting the size and scope of the past and present Black business community.[5] Because the Black business community has, to date, been restricted from competing effectively in highly capitalized lines of business, government and banking industry programs for opening capital markets to Black entrepreneurs give them good opportunities for creating new firms and expanding existing ones.[6] The industrial composition of Black firms who borrow through these programs differs sharply from the distribution of all Black businesses because most of these loan recipients are moving into new territory, into fields of activity which require considerable amounts of capital.[7] The availability of long-term credit at moderate interest rates makes it possible for Black entrepreneurs to break away from their traditional lines of business.

Brimmer's article and my own publications on Black entrepreneurship have emphasized the dual nature of the Black business community: Brimmer refers to "protected" and "unprotected" enterprise, while I have divided Black firms into "traditional" and "emerging" lines of business.[8] While the terms protected and traditional refer to nearly identical groups of firms, they are derived from lines of reasoning that have quite different, distinct implications concerning the future prospects of Black entrepreneurship. According to Brimmer's "protected markets" thesis, Black businesses exist primarily because White-owned firms simply do not offer a wide range of services demanded by Negroes. "Behind the wall of segregation which cut Negroes off from many public services, there grew up a whole new area of opportunity. Behind this wall of protection emerged the Negro physician, the Negro lawyer, and, above all, the Negro businessman."[9] Most Black businesses supply personal services and public accommodations to this protected market. Furthermore, recent progress toward desegregation in the United States is interpreted as undermining the position of many Black businessmen who were dependent on segregation to protect their markets.[10] My thesis identifying traditional and emerging categories of Black-owned firms is developed from the following line of reasoning: despite a myriad of adverse conditions, a small Black business community has stubbornly managed to survive; because capital was extremely scarce, the overwhelming majority of Black entrepreneurs concentrated in lines of business requiring little capital. When capital markets finally open up, Black businesses will expand into fields in which they heretofore had been unable to compete on an equal basis.[11] Traditional Black firms are concentrated in fields requiring little capital; emerging Black businesses are heavily concentrated in fields of activity requiring considerable amounts of capital. This thesis and the protected markets thesis certainly are not mutually exclusive, as I have explained, in detail, in earlier publications.[12] To understand the present orientation and the future prospects of Black entrepreneurship, one must consider the changing nature of <u>all</u> of the major forces shaping the Black business community. Contrary to Brimmer's views, the erosion of segregation and discrimination may be ushering in a new era of opportunity for Black entrepreneurs.

Evidence discussed in the next section of this study shows that Blacks in protected, traditional lines of business tend to be overcapitalized while unprotected, emerging enterprises are clearly undercapitalized. Firms in unprotected fields earn a much higher rate of return on net investment and they are larger (as measured by total assets) than protected businesses. The findings suggest that the more traditional, protected lines of Black enterprise have little need for greater access to capital markets because they typically operate with minimal amounts of capital and their estimated rate of return on net investment is extremely low. Unprotected Black-owned businesses would benefit from greater access to capital markets; their estimated rate of return on net investment is approximately 16 percent and their liquid asset positions are typically very weak.

B. Determinants of Profitability for Black Businesses

The body of data analyzed in this study has been collected from the loan applications of business borrowers; audited business balance sheets and income statements have been used as the source of information. Under Project OWN, long-term bank loans to minority firms are insured against default risk by the Small Business Administration (SBA). Because of Project OWN and similar programs for lending to minorities, the SBA possesses a most comprehensive collection of data on Black businesses. Using information provided by SBA's Office of Records, a random sample of Black firms in Chicago, New York, and Boston was selected for analysis.

While the samples of businesses analyzed in the remainder of this article are not a representative cross section of all Black firms, they are particularly useful for several reasons: 1) these data are the most complete and accurate data on Black businesses that I know of; 2) a most interesting aspect of the Black business community is its potential for future expansion and this potential can best be estimated by examining data on firms that are receiving long-term loans to expand their business operations; 3) the existing firms in the sample of SBA borrowers tend to be large relative to all Black firms, which suggests that the SBA data focus upon an elite group of Black entrepreneurs; 4) if lack of access to capital markets has, in fact, severely limited the scope of the Black business community, then the potential of Black entrepreneurship can best be understood by focusing upon new and expanding Black firms that actually do have access to capital markets. This last point is the most important single justification for restricting the remainder of this study to analyzing data collected on the samples of SBA borrowers.

By studying an above average group of Black firms, one risks painting too optimistic a picture of Black entrepreneurship if one makes careless generalizations, on the basis of the samples of SBA borrowers, about the overall Black business community. On the other hand, if Black entrepreneurship has any potential for alleviating ghetto problems, this potential should certainly be most easily identified by studying samples of high caliber Black enterprises. Brief summary statistics are presented in Table 1 and Table 2 to summarize the more important traits of the sample of Black loan recipients. Bank loans guaranteed by SBA are included in the sample and in all summary statistics.[13]

Because Black-owned enterprises vary in size, profitability, line of business, and a number of other characteristics, it is difficult to make global statements about Black entrepreneurship. In this section, criteria are presented for estimating the profitability of Black firms having various levels of sales, labor input, and capital input. Using the SBA loan data collected in Chicago, Boston, and New York, multiple linear regression models explaining firm profits are reported for the 285 Black existing businesses; in addition, separate models have been estimated for the traditional and the emerging lines of Black enterprise.

1. The Variables

Business income statement (flow) variables were recorded in dollar amounts for the most recent full year prior to the filing of the loan application. The net profits figure, which measures annual profits of the firm under consideration, has most commonly been picked up from the borrower's income tax return.[14]

Table 1

Black Existing Business Loan Recipients in Boston, New York, and Chicago: Mean Values for Selected Business Characteristics

Total Sales	$74,101
Net Profits (including owner's withdrawals)	$ 7,000
Current Assets (excluding intangibles)	$17,110
Total Assets (excluding intangibles)	$30,029
Total Liabilities	$19,528
Owner's Management Experience (years)	8.45
Loan Amount	$27,740
Number of Observations in This Group	285

Table 2

Existing Black Business Borrowers in New York, Boston, and Chicago: Mean Values of Sales and Profits by Industrial Classification

(in dollars)

	Number of Firms	Mean Annual Sales	Mean Annual Profits
Retail	99	92,570	7,779
Contracting Services	29	97,836	6,650
Professional Services	22	53,224	10,566
Other Services	89	41,092	6,223
Wholesaling, Manufacturing	46	93,237	5,342
All	285	74,101	7,000

For business balance sheet variables, values in dollar amounts were taken from the most recent business balance sheet available at the time of the SBA loan application. All assets and liabilities are strictly business related. The explanatory variables are straightforward--a complete list of the variables used in regression analysis exercises appears below:

Total Sales	- total annual sales of the business under consideration.
Business Net Worth	- total tangible assets minus total liabilities.
Business Liquidity	- total business cash and accounts receivable minus current liabilities.
Experience	- years of managerial experience.
Employees	- number of business employees, excluding the owner.
Outside Job	- indicates whether the entrepreneur holds a job outside of the business being considered; dummy variable.

Four additional explanatory variables were created by multiplying total sales by four dummy variables representing types of business, including 1) retail sales, 2) contracting services, 3) professional services, 4) other services: sales in retailing, sales in contracting services, sales in professional services, sales in other services.

2. Hypothesized Relationships

In the business community, the term "profits" refers to the sum available to a firm after all payments for factor unit services and other current obligations such as taxes have been covered. In a given time period, a firm obtains a certain sum from the sale of its products and it makes various contracted payments for labor services, materials, transportation, power, etc. The firm must meet rent, insurance, interest and tax obligations; because capital equipment owned declines in value during the period, depreciation charges must be charged against receipts as a cost. The excess of total receipts over all of these payments and charges is considered to be the profit of the firm. For businesses being analyzed in this study, reported net "profits" consist of payments for the use of labor and capital services provided by the owner of the enterprise. For small firms, a large portion of business profits is a noncontractual wage payment for work performed by the entrepreneur. The remainder consists of (1) income which would have been earned if the entrepreneur-owner had invested his capital in some other enterprise, and (2) a reward for risk exposure.

When the theory of the firm is derived from assumptions of certainty, factor divisibility, and competitive markets, business profits can be identified as returns to entrepreneurial inputs of human capital and physical capital.[15] However, in the real world, small businessmen operate with lumpy factors in an environment of imperfect markets and are exposed to considerable uncertainty. Data collected from the SBA do not permit precise measurement of the quantity and quality of entrepreneurial inputs to the firms under consideration.

Business profits are expected to be a function of five variables: (1) the owner's nonhuman capital inputs, (2) the owner's human capital inputs, (3) the value of annual production, (4) the business's liquidity and (5) the number of its employees. The value of annual production should be measured by value added, but the unavailability of this information necessitates using annual sales as a proxy for annual value added. Hypothesized relations between profitability and these five factors are explained in detail below. While all hypotheses about business profits reflect an assumption of ceteris paribus, one should note that it is impossible to have ceteris paribus changes in cash and accounts receivable minus current liabilities, because any change in this variable will necessarily change the value of business net worth.

1. Firms having larger inputs of owner's nonhuman capital, as measured by business net worth, will tend to have higher profits.

2. Firms having larger inputs of entrepreneurial human capital will tend to have higher profits. In an attempt to measure both the qualitative and the quantitative aspects of human capital input, owner's experience is interpreted to describe quality and outside job to describe quantity.

Years of management experience could influence reported profits in different ways. Experience should help one to be more successful in business. While owner experience should bring about higher business profits, experience may also enable one to fill out tax forms in a manner that lessens a firm's income tax liability. Because the value of profits was most often picked up from income tax returns, the experienced entrepreneur may tend to show lower reported profits because he is seeking to minimize the burden of income taxes. Finally, experience is positively correlated with age of the owner and older entrepreneurs perhaps operate their firms more conservatively or, in the extreme case, they might be a bit senile; in either case, entrepreneurial experience could lower business profitability. A positive coefficient for the experience variable would suggest that experience enables one to operate more profitably, but the interpretation of a negative coefficient would be ambiguous.

Businesses owned by entrepreneurs holding an outside job are likely to show lower profits because less labor input is being rewarded through profits.

The variables for experience and outside job are incomplete measures of entrepreneurial human capital input for several reasons. The intelligence and drive of the business-owner tend to be directly related to profitability but no direct measures of these traits are available. The experience variable does not measure relevant work experience in nonmanagerial capacities. A grocer with one year of managerial experience and five years of work experience at the check out counter may, for example, be better prepared for the grocery business than a grocer with one year of managerial experience only. The entrepreneur who is willing to work relatively longer hours will tend to have a more profitable business operation, but hours of labor input are not recorded in the sample data.

3. The value of a firm's production, ceteris paribus, will be positively related to its profits. While value added is the desirable measure of the value of a firm's production, total sales is a good proxy for intra-industry data because value added should be a fairly constant proportion of total sales <u>within</u> a given industry. Total sales by major industry group will be used to test for inter-industry differences in value added; in industries where value added is a high proportion of sales, the coefficient for total sales should be high. The explanatory power of total sales will tend to be greater if measures of inputs of physical and human capital by the entrepreneur are inaccurate. It is well-known that measures of net worth are subject to arbitrary accounting conventions. Because the proxies measuring quality and quantity of owner input of human capital are rather crude, the total sales variable should also partially pick up the

effects of intelligence and hard work by entrepreneurs. Holding other factors constant, relatively low sales by a firm in a given industry is assumed to be prima facie evidence that the entrepreneur does not work as hard and/or lacks business acumen relative to the other entrepreneurs in the field. Firms having higher total sales may have higher profits if they also have a wider range of products; diversification of lines of activity reduces the need to maintain unprofitable precautionary cash balances, etc. In retailing, for example, larger stores carrying more diverse product lines may be able to insulate themselves from the dangers of shifting consumer tastes.

4. For a similar reason, firms having greater financial liquidity, as measured by cash and accounts receivable minus current liabilities, will tend to have higher profits. Business liquidity reflects a firm's ability to cover its day-to-day, short-run cash requirements and the effects of liquidity on profits are largely caused by imperfections in capital markets.[16] A firm's ability to meet current liabilities affects profitability in two vital ways: in the short-run, being liquid allows one to take advantage of discounts offered for prompt payment of bills; in the long-run, being liquid gives one greater access to trade credit which is particularly vital to growing enterprises in most lines of business.

5. The relation between a firm's profits and the number of its employees depends upon whether or not a firm expects to grow in the future. An efficient firm expecting no future growth in its operations will hire workers up to the point where wages paid to the last worker hired are equal to the marginal revenue product of that worker: $\alpha Y/\alpha X_9 > 0$ would imply that it would be profitable for the firm to hire an additional worker,

while $\alpha Y/\alpha X_9 < 0$ implies that the firm is overhiring in the sense that profits would be increased by firing one worker.

A profit maximizing Black entrepreneur may tend to overhire labor if he expects that his sales will rise. Since decisions to invest in human and non-human capital are based upon estimates of the most profitable output today and in the future, overcapacity is likely to be optimal for the growing firm. This will be particularly true if factors are lumpy and for smaller firms, a single employee is often a lumpy factor. Hollis Chenery has shown that optimal overcapacity also depends upon a firm's production function, its planning period and discount rate, and uncertainty about future demand for its products.[17] Because the sample population consists of firms receiving long-term loans through the SBA and because most of them are expanding their business operations, they probably should be observed to have an unprofitably large number of workers.[18] Black businessmen might also feel that overhiring is necessary to maintain good will in the community.

The nature of the SBA data on urban businesses raises several statistical problems. The dependent variable, net profits, is taken from the business income statement which reports profits for the most recent full year prior to filing the SBA loan application. Values of the explanatory variable business liquidity, were recorded from the most recent business balance sheet available at the time of the loan application. The business balance sheet has therefore been computed at a date quite close to the end of the time period for which net profits are reported. For firms reporting high profits, the past year's profits are apt to be overrepresented in the cash section of business balance sheets that are drawn up at a time close to the end of the year for which profits have been reported. One should expect some positive bias, therefore, in the coefficient of the business liquidity variable and this bias might similarly influence the business net worth coefficient, but not appreciably. Random measurement errors in the variables tend to bias coefficients toward zero and this phenomenon is undoubtedly exerting some downward bias on the coefficient of the business net worth variable. Accepted accounting practices for valuing business inventories and fixed assets vary widely enough to produce sharply different balance sheet values for similar assets. When arbitrary differences in asset values are added to the errors, understatements and overstatements that characterize the balance sheets of many small businessmen, the business net worth variable understandably becomes a classic example of a variable subject to random measurement error. Heteroskedasticity plagues the models examined in this study, but this problem appears to be minor because when the dependent variable, the constant, and every explanatory variable are divided by total assets, heteroskedasticity vanishes and the model results are not appreciably altered.[19]

3. Empirical Analysis of Black Enterprise: the Entire Sample

When explanatory variables are analyzed and discussed in the remainder of this article, a .05 cutoff point will be used to determine statistical significance.

The coefficients based upon sales can be used as estimates of the marginal profitability of an additional dollar of sales for different firm types. Because the regression model is linear, coefficients of these variables can be thought of as profit margins having the following values:

Margin A - 4.70 percent (retail sales)

Margin B - 5.58 percent (contracting services)

Margin C - 6.99 percent (professional services)

Margin D - 9.94 percent (other services)

Margin E - 5.99 percent (manufacturing, wholesaling)

Margin A should be interpreted as ($\alpha Y/\alpha\$1$ sales for a retailer) and Margin A is calculated by adding the coefficient of sales in retailing to the coefficient of total sales. Margins in the various industry groups are, except for other services, not significantly different across industries. The other services category--which includes firms in transportation, automotive services other than gasoline stations, laundries, beauty and barber shops, miscellaneous personal services, and three minor categories--consists of small businesses where value added is a very high proportion of total sales. The significantly larger coefficient for the sales in other services variable indicates that, relative to the other industries under consideration, value added is a higher proportion of total sales in the other services group.

The coefficient for business net worth measures the rate of return on the owner's net investment in the business, 14.43 percent for the sample of Black borrowers.

Cash and accounts receivable minus current liabilities (business liquidity) measures a firm's ability to meet its short-term liabilities and for most Black firms, the value of this variable is negative. This fact suggests that many Black-owned businesses are highly illiquid and desperately in need of cash.[21] There is a very high penalty for being illiquid; results of the regression model indicate that business profits drop by 23 cents for every dollar that current liabilities exceed cash and accounts receivable.

Multiple Linear Regression Model Explaining Profitability

Black Existing Businesses:[20]

Variable	Regression Coefficient	Standard Error
Constant	3797.7861*	832.7782
Total Sales	.0599*	.0106
Sales in retailing	-.0128	.0092
Sales in contracting services	-.0041	.0138
Sales in professional services	.0100	.0199
Sales in other services	.0395*	.0144
Business net worth	.1443*	.0315
Business liquidity	.2302*	.0332
Experience	-72.0116	69.4413
Employees	-74.8442	57.9291
Outside job	-1979.6919*	1023.9021

R^2 = .548; F-ratio = 35.39; standard error of estimate = 7819.91; n = 285

*statistically significant at the .05 level.

The coefficient of experience is insignificantly negative but is consistent with a view that experienced businessmen tend to report lower profits for tax purposes. Many writers have stressed that lack of business experience among Blacks is a major obstacle to plans for expanding the size and scope of the Black business community. Regression analysis exercises reported in this article suggest that entrepreneurial experience has no clearcut impact on business profits. Although the insignificance of the experience variable cannot be interpreted unambiguously, it is clearly possible that prior managerial experience on the part of the owner may have very little impact upon the level of profitability of a small business enterprise.

The negative value of the employees coefficient does suggest that sample firms are overhiring labor, but the relationship is not statistically significant.

The coefficient for "outside job" indicates that owners holding outside jobs lose nearly $2,000 in profits relative to the rest of the sample and this relation is statistically significant.

4. Empirical Analysis of Black Enterprise; Traditional and Emerging Lines of Business

The first section of this article briefly reviewed two explanations of the past and present orientation of the Black business community. Governor Brimmer claims that Black firms are typically "small, service-oriented businesses which owe their existence to a protective barrier of segregation,"[22] and I have stressed the role that scarcity of capital has played in restricting most Black entrepreneurs to their traditional lines of small scale enterprise.

Acceptance of the Brimmer thesis does not imply that lack of capital has been a trivial consideration, and vice versa. If one assumes, though, that lack of access to capital markets is a minor consideration, and that racial discrimination has been beneficial for Black entrepreneurs, then Brimmer's position suggests that Blacks in "protected" fields would earn a rate of return on net investment that is likely to be higher, but certainly not lower, than Blacks in unprotected fields facing stiff competition from White competitors. If my thesis is correct, then firms that are in the unprotected category should tend to be undercapitalized and illiquid relative to the protected firms. Because protected firms are traditional lines of Black enterprise requiring little capital, they should be adequately capitalized. Undercapitalized businesses whose access to capital markets has been severely limited should tend to have a higher, and certainly not a lower, rate of return on net investment than adequately capitalized firms.

Relying primarily upon Andrew Brimmer's concept of protection (the previously discussed "protective barrier of segregation" notion) the sample of Black existing businesses was split into two groups: 1) traditional, protected lines of Black enterprise, 2) emerging, unprotected Black firms.[23] After carefully combing through all of Brimmer's writings on Black entrepreneurship, I could not determine whether Black-owned laundries should be classified as protected or unprotected. Although the precise manner in which Brimmer employs the concept of protection leaves the categorization of laundries somewhat ambiguous, laundries have certainly been a major category of firms within the traditional Black business community.[24] The traditional, protected group contains 71 firms and is dominated by three lines of Black entrepreneurship: beauty and barber shops account for 14 of the observations, restaurants appear 18 times and laundries account for 23 of the 71 firms in this sub-sample. The linear regression model presented on page 16 was re-estimated for each of these groups of Black firms. The relevance of Brimmer's protective barrier of segregation notion for understanding contemporary Black entrepreneurship is inversely related to the degree to which rate of return on net investment for emerging, unprotected firms exceeds the rate of return for traditional, protected ones.

For traditional firms, the coefficient of business net worth suggests that the rate of return on net investment is 0.28 percent; for emerging firms the corresponding coefficient implies a 15.94 percent rate of return. For the sample of traditional businesses, mean values of total assets and net worth are $23,585 and $12,211 respectively while emerging firms reported corresponding mean values of $32,166 and $9,933.

For traditional firms, the coefficient for business liquidity is .0070, not significantly different from zero at the .05 level. Mean values of business liquidity for traditional and emerging firms are -$3,291 and -$6,016 respectively.

The regression coefficients indicate that emerging firms would earn 24.31 cents in annual profits, holding cash and accounts receivable constant, if current liabilities are reduced by a dollar, and profits would increase 15.94 cents for each additional dollar in net investment. Such large increases in net profits for injections of capital and reductions in liabilities suggest that emerging firms are <u>undercapitalized</u>.

Profits of traditional firms, on the other hand, will not be significantly affected by increases in business liquidity and/or business net worth; such firms appear to be overcapitalized.

Multiple Linear Regression Model Explaining Profitability for Black Emerging Businesses:

Variable	Regression Coefficient	Standard Error
Constant	3826.0000*	998.1100
Total sales	.0657*	.0124
Sales in retailing	-.0220*	.0104
Sales in contracting services	-.0004	.0148
Sales in professional services	.0012	.0215
Sales in other services	.0482*	.0167
Business net worth	.1594*	.0414
Business liquidity	.2431*	.0378
Experience	-145.8500	85.7330
Employees	-121.1400	64.4160
Outside job	-1184.2000	1246.2000

R^2 = .585; F-ratio = 28.66; standard error of estimate = 8181.06; n = 214.

*Statistically significant at the .05 level.

Multiple Linear Regression Model Explaining Profitability for Black Traditional Businesses:

Variable	Regression Coefficient	Standard Error
Constant	4917.2271*	1100.9922
Total sales	.1141	.1133
Sales in retailing	-.0561	.1125
Sales in professional services	.1432	.1187
Sales in other services	-.0437	.1118
Business net worth	.0028	.0388
Business liquidity	.0070	.0794
Experience	-73.1820	85.7145
Employees	260.1999	188.0888
Outside job	-4276.6075*	1242.8559

R^2 = .758; F-ratio = 21.28; standard error of estimate = 4684.43; n = 71.

*Statistically significant at the .05 level.

It is clear from a profile of the sample data that the newer Black-owned firms that have been provided access to capital markets are entering lines of business not previously occupied by Blacks. Results of the above regression analyses provide strong empirical support for my affirmation that Blacks concentrated in narrowly circumscribed fields like laundries, restaurants and barbershops for such a long time not primarily because these kinds of businesses were left to them by White businessmen, but, more importantly, because these were fields in which one could begin and continue operations with very little capital. If Blacks continue to have access to capital markets, Black firms can be expected in almost all lines of commerce and industry. It was primarily lack of access to the capital markets which previously prevented Blacks from operating outside of their traditional lines of business.

In the model explaining profits for traditional firms, profit margin variables have little meaning because only five firms fell into the professional services category, three wholesalers or manufacturers were observed, and no firms fell into the contracting services category. This lack of observations for certain types of businesses makes accurate estimation of profit margins an impossible task. For businesses in the retailing and other services industries, margins were not significantly different for the samples of traditional and emerging firms.

While management experience and other job variables performed rather similarly for the groups of traditional and emerging Black firms, the employees variable produced strikingly different results. For traditional firms, the employees coefficient is negative and borders on the cutoff point for statistical significance. These results suggest that emerging firms tend to overhire labor, which is consistent with a profit maximization strategy if one expects that sales will be rising in the future. The clear cut differences in results for the employees variable suggests, following Chenery's argument, that entrepreneurs in the emerging lines of business are gearing their businesses for future growth to a greater extent than the firms in traditional fields.

To test the value of estimating separate models to explain net profits for the samples of traditional, protected and emerging, unprotected firms, the residual sums of squares from the model based on the pooled sample of 285 firms were compared to the summed residual sums of squares for the separate models (analysis of covariance), and the separate models explain net profits more accurately than the pooled model ($F = 4.34$); this difference in explanatory power is statistically significant at the .01 level.

Because Black economic development programs call for the expansion of existing businesses and the creation of new ones, the above findings on the emerging lines of Black enterprise have interesting policy implications. Writers on Black entrepreneurship have often assumed that emerging Black firms would be replicas of the existing species, but the empirical analyses cited herein suggest that it is invalid to assume that new and expanding Black firms will conform to the stereotype of the small, undercapitalized, inefficient Black firm of the past. The erosion of segregation and discrimination may be ushering in a new era of opportunity for Black entrepreneurs; if capital markets remain open to Blacks, the future Black business community may be characterized by a relatively greater number of large firms competing effectively in all lines of business. The large difference in rates of return between traditional businesses and the emerging lines of Black enterprise suggests that financial capital may not be utilized efficiently within Black inner-city areas. Establishment of financial intermediaries to facilitate the flow of funds from overcapitalized to undercapitalized segments of the Black business community should increase the prosperity of ghetto areas.

C. Evaluating the Viability of Various Black Firms

A business may be considered "viable" if it generates a level of profits adequate to justify the full-time efforts of a capable individual. No single number can describe the income level that is adequate because entrepreneurs are a heterogeneous group--a skilled plumbing contractor may feel that an annual return of $12,000 does not justify his remaining in business while a barber may be living contentedly on $5,000 per year. The linear regression model discussed on page 16, though, is useful for policy purposes if an agency like SBA decides that it does not want to perpetuate, knowingly, marginal firms which produce low incomes for their owners. These models are perhaps most useful for showing potential entrepreneurs the levels of profits typically associated with various scales of operation in different fields. One of the great tragedies of Black capitalism promotional programs has been the frequency with which the availability of loan funds has induced Black wage earners to become owners of businesses that are not viable.

Assume, for example, that a potential entrepreneur with eight years experience decides to open up his own retail clothing shop. If he has $3,000 in personal savings, he can qualify for a maximum loan of $20,000 from SBA. Assume that the projected business will have $50,000 in annual sales and no liquidity problems; the entrepreneur hires three employees and invests his personal $3,000 plus $20,000 from SBA into the business. If everything goes as planned, then this entrepreneur should expect profits (including owner's salary) of $5,780 per year, which is probably much less than he could be earning in some nonentrepreneural capacity. If this hypothetical entrepreneur took an outside job in addition to running his clothing store, then expected profits would be less than $3,800 per year. If the clothing store encountered liquidity problems, typical for small retailers, then profits would be still lower. To establish a viable business, this entrepreneur should double his investment and generate an annual sales volume of $100,000; expected annual profits should then be about $8,600, barring unforeseen problems.

Using the mean values of the explanatory variables total sales, business net worth, business liquidity, experience, and employees by business type for the sample of 285 Black existing firms, levels of profits were estimated for the various lines of business. Profit estimates were calculated using the linear regression model described earlier; entrepreneurs, by assumption, hold no outside jobs.

	Mean Business Net Worth for This Category	Mean Sales for This Category	Estimated Profits for Firms having Mean Values of the Explanatory Variables
Retailing	$13,231	$92,570	$8,190.03
Contracting Services	$5,549	$97,836	$7,751.11
Professional Services	$15,400	$53,224	$10,427.44
Other Services	$6,210	$41,092	$6,988.15

The manufacturing, wholesaling cateogry has been excluded because it is difficult and possibly misleading to generalize about such a heterogeneous group of businesses. Viability in retailing, the most popular field for new and expanding Black firms, requires a fairly substantial net investment and the ability to generate an annual sales volume in the $100,000 range. Potential entrepreneurs having less than $10,000 to invest would most likely succeed in the labor intensive service industries where profit margins are highest and business viability can be established by generating annual sales in the $50,000 range. Entrepreneurs with slender financial resources should avoid the field of retailing.

FOOTNOTES

[1]Robert B. McKersie, "Vitalize Black Enterprise," Harvard Business Review 46 (September 1968):88-99.

[2]See, for example, Lewis L. Allen, "Making Capitalism Work in the Ghettos," Harvard Business Review 47 (May 1969):83-92; Theodore Cross, Black Capitalism (New York: Atheneum Press, 1969); and Gerson Green and Geoffrey Faux, "The Social Utility of Black Enterprise," in Black Economic Development, G. Douglas Pugh and William F. Haddard, eds., pp. 21-37 (Englewood Cliffs, New Jersey: Prentice-Hall, 1969).

[3]This theory is explained most fully in Adrew Brimmer, "The Negro in the National Economy," in American Negro Reference Book, edited by John David, (Englewood Cliffs, New Jersey: Prentice-Hall, 1966); pp. 291-292 of the Spring 1971 Public Policy article by Brimmer and Henry Terrell contain a brief summary of Brimmer's theory of the Black business community. The Brimmer and Terrell article in Public Policy is of special interest because it attempts to support empirically Brimmer's theoretical works on Black capitalism.

[4]See, Timothy Bates, "The Potential of Black Capitalism," Public Policy 21 (Winter 1973):135-148.

[5]See, Timothy Bates, Black Capitalism: A Quantitative Analysis (New York: Praeger, 1973), chapters 1, 2, and 4.

[6]For a general overview of the major government and banking industry programs for lending to Black businesses, see, Timothy Bates, "An Econometric Analysis of Lending to Black Businessmen," The Review of Economics and Statistics 55 (August 1973):272-283.

[7]This is expressed in detail, in Bates, "Potential of Black Capitalism," pp. 143-145.

[8]Ibid., p. 145.

[9]Andrew Brimmer, "desegregation and Negro Leadership," in Business Leadership and the Negro Crisis, edited by Eli Ginsberg, p. 34 (New York: McGraw-Hill, 1968).

[10]Brimmer, "The Negro in the National Economy," p. 291.

[11]Bates, "Potential of Black Capitalism," pp. 144-146.

[12]See, Bates, Black Capitalism, chapter 1.

[13]The mean values reported in Table 1 are intended to describe a "typical" Black firm; one extremely large Black firm was therefore not included when the mean values were calculated; standard deviations and median values for these variables are reported in part C of the appendix to chapter 1, of Bates, Black Capitalism.

[14]When corporations were encountered in the process of data collection, owner's salary from the business was added back into net profits in order to make the profits figure comparable for proprietorships, partnerships and corporations. Net profits, the dependent variable, is therefore equivalent to returns to owner in this study. For a more detailed description of the explanatory variables, see part B of the appendix to chapter 1 of Bates, Black Capitalism.

[15]Joseph Schumpeter has identified innovation as a source of business profits over and above usual implicit factor costs but for one-owner firms, profits from innovation are synonymous with returns to innovative owners; profits from innovation are returns to the human capital input of the entrepreneur.

[16]Capital market imperfections relevant to small business borrowers include transaction costs, uncertainty, racial discrimination and legal ceilings on interest rates.

[17]Hollis Chenery, "Overcapacity and the Acceleration Principle," Econometrica 20 (January 1952):1-28.

[18]Overcapacity is expected to appear in the form of labor rather than phsyical nonhuman capital because, as suggested earlier, Black entrepreneurs have had limited access to capital markets. Evidence presented on pp. 16-22 of this article empirically demonstrates that most Black firms are undercapitalized. Black businessmen have virtually free access to local labor markets and limited access to the sources of nonhuman productive capital; the undercapitalized Black entrepreneur would therefore tend to expand by hiring additional employees, and overcapacity would most likely appear in the form of labor.

[19]Dividing through by total assets, though, leads to multicollinearity among a number of the explanatory variables. When the dependent variable, the constant, and every explanatory variable are divided through by total assets, the equation explaining net profits for Black existing firms becomes:

$$\begin{aligned} Y = \underset{(315.79)}{3600.197^{*}} &+ \underset{(.010)}{.066X_1^{*}} - \underset{(.012)}{.007X_2} + \underset{(.028)}{.001X_3} + \underset{(.015)}{.014X_4} \\ &+ \underset{(.028)}{.092X_5^{*}} + \underset{(.061)}{.134X_6^{*}} + \underset{(.081)}{.374X_7^{*}} - \underset{(19.484)}{84.138X_8^{*}} - \underset{(69.026)}{57.260X_9} \\ &- \underset{(349.151)}{1{,}262.525X_{10}^{*}} \end{aligned}$$

(standard error is in parentheses)
$R^2 = .79$, $F = 96.18$, $n = 285$.

*Statistically significant at the 5 percent level.

Y, X_1, X_2, X_3, X_4, X_5, X_6, X_7, X_8, X_9, and X_{10} correspond, respectively, to net profits, total sales, sales in retailing, sales in contracting services, sales in professional services, sales in other services, business net worth, business liquidity experience, employees and other job--all divided by total assets.

[20]In the models explaining net profits for Black existing firms, one observation was deleted because its industrial classification was not clear.

[21]Additional evidence presented in Timothy Bates, "Financing Black Enterprise," forthcoming in The Journal of Finance, strongly suggests that many Black firms are desperately in need of cash.

[22]Brimmer and Terrell, "Economic Potential of Black Capitalism," p. 295.

[23]The following direct quotes were relied upon to define those firms which are protected by segregation:

a. "For the Negro community in the United States, the greatest barrier imposed by segregation was not in the market for goods--to which they generally had relatively open access--but in the market for personal services (such as barber and beauty shops and funeral services) and in public accommodations (such as hotels and restaurants). Consequently, a protected market evolved for provision of these services within the Negro community," in Brimmer and Terrell, "Economic Potential," (AEA paper), p. 5.

b. "This parallel structure is the predominantly segregated Negro market. It is basically a market for services. It is the place of practice for the Negro professional (lawyers, physicians, dentists, undertakers). It is the counter for the Negro businessmen (owners of retail outlets, real estate dealers and brokers, life insurance companies, cosmetic manufacturers). And above all, it is the source of personal services purchased by Negroes (barber and beauty shops)," in Brimmer, "The Negro in the National Economy," p. 254.

c. "If we divide the retail trade sector according to the principal types of stores, we see immediately the importance of segregation in providing opportunities for Negro entrepreneurs. For example, in 1960, Negroes operated 2.6 percent of all retail outlets--but 5.6 percent of the eating and drinking establishments," in idem, "The Negro in the National Economy," p. 293. Later on this same page, Brimmer mentions that cosmetics distributors are protected by segregation. In defining the category of traditional, protected lines of Black enterprise, all firms that had been directly labeled protected in Brimmer's writings were included. Additional firms included in the traditional, protected category were laundries, photographic studios and types of entertainment that distinctly qualify as public accommodations. Law firms and convalescent homes, both labeled protected by Brimmer, did not appear in the sample of 285 Black existing businesses.

[24] In 1944, an extensive survey of Black firms in 12 cities found 3,866 Black-owned enterprises; laundries were the fourth most common line of Black enterprise and they accounted for 288 of these 3,866 firms. See, Joseph Pierce, Negro Business and Business Education (New York: Harper and Brothers, 1947), p. 15.

Appendix--Data Handling and Sample Selection

In the spring of 1967 the SBA ordered its regional offices to start classifying all loan applicants into appropriate racial, ethnic groupings. Although loans then in process were generally not classified, by June 1967, racial designations were available for more than 95 percent of the loans reaching final approval status. As the first step in selecting the sample of firms analyzed in this study, a listing (on tape) was received of all loan approvals originating in the Boston, New York and Chicago regional offices of the SBA. This listing covered the period from June 1967 - June 1970, and specificed racial, ethnic group membership of the 3,000+ borrowers. Six minority codes were being used by the SBA: Eskimo, Indian, Puerto Rican, Spanish American, Asian and Negro.

The SBA data listed above were then punched on data cards (from the magnetic tape). These cards were sorted by race (ethnic group) and geographic location so that the following relevant groups were formed:

Loans to Blacks in Suffolk County, Massachusetts;

Loans to Whites in Suffolk County, Massachusetts;

Loans to Blacks in New York City;

Loans to Whites in New York City;

Loans to Blacks in Cook County, Illinois;

Loans to Whites in Cook County, Illinois.

Loans to Eskimos, Indians, Puerto Ricans, Spanish Americans, and Asians were dropped from further consideration.

The above data processing operations produced a group of 1074 loans to Blacks from which a final sample of 559 Black businesses was formed. The following series of steps illustrates the processes by which 515 potential observations were dropped from consideration; the same general pattern is applicable to the White sample of businesses:

<u>Number of observations according to the SBA computer</u>			1074
A. Automatic deletions:			
1. Loan proceeds never disbursed		90	
2. Second or third loan to a business already in the sample; no business was included more than once		69	
3. Loan numbers listed by the SBA computer which corresponded to nothing listed with the regional offices; error in SBA records		15	
4. Loan file never located; these primarily consisted of new businesses that changed names between the date of loan application and final approval		23	
5. Loan repayment deferred; repayment status was therefore irrelevant		10	
6. Miscellaneous; included declined loans, borrowers that were not Black, and borrowers whose businesses had left the geographic area under consideration		6	213
B. Relevant sample for data collection:			
1. 50% of the new businesses in New York and Chicago randomly selected and dropped from further consideration		202	
2. Observations dropped because of missing or inadequte information:		94	
a. personal financial statement	38		
b. profit and loss statement	32		
c. business balance sheet	8		
d. other	16		296
C. Business for which data was collected from loan files and punched onto cards:			565
Observations having unexplainable inconsistencies			4
Non-profit educational institutions			2
Final sample size			559

Data collected on each existing business included balance sheet and income statement items, personal financial statement of the firm owners, loan terms at the time the loan was made and loan repayment status on the date the file was coded. Data that have been collected from the Washington headquarters and from the regional offices of the SBA are, by their nature, highly confidential. These data were made available subject to specific conditions imposed by the SBA and cannot be given to other interested researchers.