Enhance entrepreneurship and small business development in Indiana, with a focus on entrepreneurs of color and minority-owned businesses

Problem

Entrepreneurship is a powerful tool to counter recessions, but unfortunately Indiana lacks the levels of growth-driving entrepreneurship found in other states. At the same time, inequalities, particularly across race, have deepened the downturn in communities across the state.

The unique nature of the COVID-19 crisis has put thousands of restaurants, retail stores, and other Main Street employers out of business. But the economic impacts of COVID-19 have not been equal. Minority-owned businesses, which face challenges that white-owned businesses do not, and which tend to be concentrated in the industries most heavily impacted by the COVID-19 crisis, such as retail, food service, and personal services, have been significantly more disrupted than white owned businesses.[i]

This has not only led to a loss of jobs, but it has also devastated already-stressed downtowns across the state, reducing employment options for thousands. To be sure, manufacturing initiatives can help create jobs with an advanced sector-orientation, which are important for job growth. But even so the state badly needs to take action to help generate Main Street jobs that provide localized services and can help revitalize commercial corridors.

A variety of structural gaps still exist across race and gender lines when it comes to entrepreneurship and small business opportunities in Indiana. This is problematic, because entrepreneurship and business ownership are some of the most important sources of wealth creation, and can also provide important pathways to employment for individuals with barriers to being hired. These gaps are exacerbated by substantial disparities across race and gender in public contracting in Indiana.

And while Indiana has a small business infrastructure that looks good on paper, it has been too underfunded in recent years to address the problems of the magnitude that the state is now facing. Given that, it's a crucial time for the state to make proactive investments in enhancing its entrepreneurship and small business development infrastructure.

Background

While Indiana generally ranks well on ease of doing business rankings, unfortunately those rankings have not translated into real results in terms of business or job creation. Indeed, Indiana lags the national average in measures of business dynamism.

For example, Indiana fares poorly in measures of young firm creation, a key indicator of a state's entrepreneurial capacity. Nationwide, 36% of firms are five years old or younger, and these firms account for over 10% of U.S. employment. However, in Indiana just 30% of firms are five years old or younger, and these firms account for less than 8% of jobs in the state.

At the same time, Indiana has a significantly higher share of jobs at the oldest firms in the state. Nearly 40% of firms in Indiana are 16 years old or more, employing over 80% of the state's workforce (nationally, just 31% of firms are 16 years old or more, employing less than 74% of workers). In fact, Indiana has more firms that are 16 years old or older than it has firms less than five years old, a trend that runs opposite to the country as a whole, indicating a relative lack of dynamism in the state.

These dynamism issues are in part due to the state's industry mix: Indiana is a manufacturing-heavy state, and manufacturing has the highest share of older firms among all industries. Indeed, while 39% of all firms in Indiana are 16 years old or more, the share of manufacturing firms that are 16 years old or more is a full 20 percentage points higher, at 59%. Research suggests that early-firm failure rates and rising market concentration may be factors leading to the slow start-up rate in manufacturing.[ii]

However, industry mix does not explain all of the problem. For example, even within manufacturing, Indiana's share of firms 16 years or older still outpaces the nation as a whole by nine percentage points, 59% to 50%. This indicates that, in addition to other obstacles, Indiana's entrepreneurship and small business formation supports are lagging other states. This is a problem because entrepreneurship and firm creation are crucial to economic recovery. Evidence shows that entrepreneurship has a variety of economic benefits for states.

Scholarship has shown that higher levels of entrepreneurship can enhance regions' resilience, or their ability to rebound from economic downturns. For example, Cambridge University economic geographer Ron Martin has found that a region's rate of entrepreneurship and new firm formation affects its ability to reconfigure and adapt its structure of firms, industries, technologies, and institutions in the wake of economic shocks.[iii] Likewise, policies to promote entrepreneurship and new business formation can have an impact on localities' economic structures.[iv] When done correctly, entrepreneurship policies can help places recover more quickly from economic downturns.

Strong entrepreneurship also enhances workers' and firms' productivity. Evidence shows that while most young businesses do not survive, those that do tend to be the strongest growing, bringing with them above average productivity. Indeed, productivity at successful young firms tends to be higher than mature incumbents in an industry.[v]

While there is extensive literature showing that entrepreneurship and small businesses are the *core* driver of U.S. job growth, the reality is more complicated. In particular, the high failure rate young businesses means that a significant number of young firms must be formed in order to sustain even a small number of jobs in the long term.[vi] At the same time, the jobs created by many young firms and small businesses tend to not be as good as those at larger firms. So while some young firms may grow to become gazelles that drive significant regional or even statewide growth, the median start up or small business is likely to only have a marginal impact when viewed from an economy-wide level.

Nonetheless, young firms and small businesses still play an important role in Indiana employment. For example, while these companies do not employ the majority of Hoosiers, they still employ a significant share of Indiana workers. Young firms with less than five years in business account for nearly 8% of jobs in Indiana, while small businesses with fewer than 200 employees account for 36% of jobs in the state (there is a significant amount of overlap between those two numbers, with many young firms also being small firms). This makes small business support important for preventing unnecessary job *destruction*, particularly during economic downturns.

Entrepreneurship, young firms, and small firms likewise create important pathways to the labor market and can help close existing racial and other gaps. Small, localized businesses act as crucial entry points to the labor market for individuals with barrier to the labor market, such as those who lack a vehicle, have language barriers, or are returning citizens. An analysis by the JP Morgan Chase Institute found that small businesses account for between 60% and 80% of jobs in economically distressed city neighborhoods.[vii] And evidence suggests that those workers who have been unemployed, worked in low-wage jobs, or have changed jobs frequently, are more likely to enter self-employment.[viii] Evidence also shows that entrepreneurship can foster positive impact among peers and across generations.[ix] This means supporting entrepreneurship in an area can influence entrepreneurship rates within the communities in which they operate, and across generations of families.

Main Street businesses are likewise important for improving neighborhood and community vitality. When enough firms collocate and sustain a presence in a community, it can revitalize that community's commercial corridors, which in turn boosts local residential property values, helping families build wealth.

All of these effects can help bolster Indiana's fiscal position, and that of its municipalities. Indiana and its communities rely heavily on a combination of sales tax and property taxes. When Indiana's small businesses are healthy and numerous, it boosts state sales tax collection. And when these businesses have a significant community presence and boost real estate values, it grows property tax collections for communities.

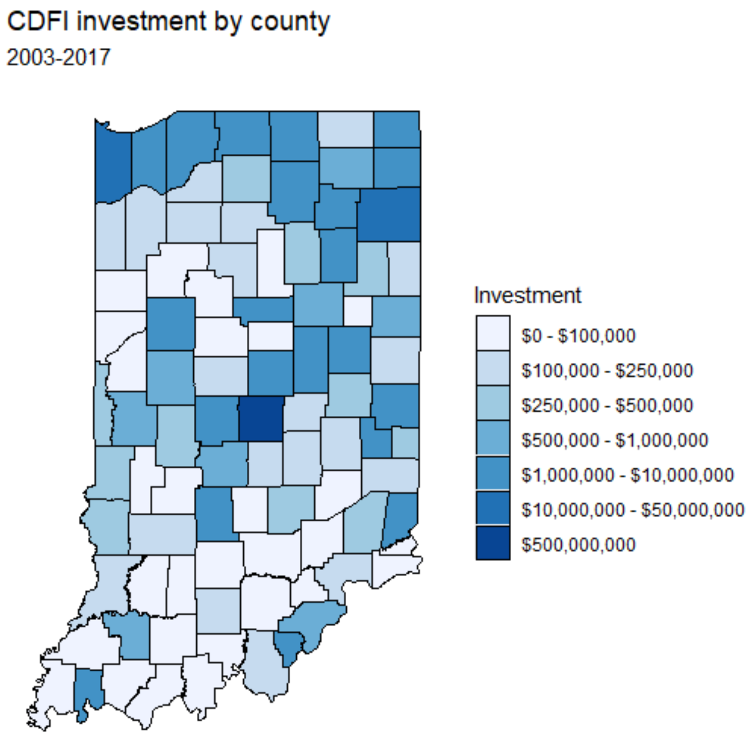
Unfortunately, Indiana has significant entrepreneurship gaps, particularly across racial lines. For example, Black Hoosiers own businesses at just 15% of the rate of their overall share of Indiana's population. That ranks Indiana 26th out of the 40 states (including DC) with data available. And cities within Indiana likewise lag their peers. For example, among the 85 largest U.S. metros with data available on racial breakdown of business ownership, Indianapolis ranks 55th, with Black business ownership accounting for just 14% of the Black share of the Indianapolis metro area's population.[x] Closing these gaps would have important economic benefits for Indiana.

These gaps exist because entrepreneurs of color, and particularly women entrepreneurs of color, face barriers that white entrepreneurs do not. Entrepreneurs of color tend to have more trouble tapping into business and professional networks, which tend to be disproportionately white and male. These networks may also not be geographically proximate to entrepreneurs of color, further isolating them.[xi] Likewise, disparities in educational access harm would-be entrepreneurs of color by preventing them from developing the skills needed to start a business.[xii] Entrepreneurs of color also tend to have less professional experience, and are particularly underrepresented in managerial experience, compared to white entrepreneurs.[xiii] Entrepreneurs of color, in particular Black entrepreneurs, also tend to operate in lower revenue industries, such retail and food service, compared to white entrepreneurs.

Entrepreneurs of color also lack capital access compared to white entrepreneurs. This is a market failure, as many traditional banks either do not offer the sort of financial instruments, such as microloans, that emerging entrepreneurs need, or else they deem entrepreneurs with certain backgrounds as too risky. Discrimination also plays a role. Literature finds that Black-owned businesses pay higher interest rates and experience higher rates of loan denials than white borrowers.[xiv] So-called “mission lending” institutions, such as CDFIs, were established to mitigate these systemic shortcomings.

Unfortunately, Indiana has an inadequate number of these institutions, with insufficient amounts of lending. Indiana has 15 CDFIs in the state, which lags similarly sized states. For example, Missouri has 23 CDFIs, Tennessee has 27, and Massachusetts has 29.[xv] Likewise, 29 Indiana counties received between $0 and $100,000 in CDFI investment during the 15 year period from 2003 to 2017, and just one Indiana county, Marion County, received over $50 million in CDFI investment.[xvi] This is problematic because local and regional economies tend to be the drivers of small businesses, given their importance to supporting local consumers and regional industry ecosystems. When significant swaths of the state lack entrepreneurial and small business financing, it aggravates already-existing regional inequalities.

Figure 1. CDFI Investment by county



Source: Brookings analysis of data from Coalition of Community Development Financial Institutions

Finally, it's not just entrepreneurship where Black and other minority-owned businesses face shortcomings. Similar gaps also exist in government contracting. For example, Indiana's 2016 state disparity study report found that while most minority-owned businesses received the share of contract dollars they'd be expected to receive based on their availability for state contracts and subcontracts, Black-owned businesses were a notable exception. Black-owned businesses received just $0.49 for every dollar they'd be expected to receive.[xvii] However, for Public Works Division contracts, which did not have minority- or women-owned business contracting goals during the period, there were substantial disparities. Nearly every group lagged their share of contract dollars they'd be expected to receive, with Black-owned businesses receiving just $0.44 for every dollar they'd be expected to receive, Native American-owned businesses at $0.89, Asian Pacific American-owned businesses at $0.26, and Hispanic American-owned businesses at just $0.06. Businesses owned by white women received just $0.36 for every dollar they'd be expected to receive.[xviii]

These gaps likewise exist at public universities across the state, with every university showing a disparity in contracting for multiple groups. In fact, the state's 2015 disparities reports show that at no Indiana public college or university do Black-owned businesses receive the share of contract dollars they'd be expected to receive based on their availability for state contracts and subcontracts.[xix]

Given the variety of shortcomings with Indiana's entrepreneurial and small business ecosystem, there are four main challenges that the state should fix to better promote Main Street entrepreneurship:

- An overall scarcity of entrepreneurial and small business-oriented capital in the state
- Persistent gaps that exist across race, gender, and region in levels of entrepreneurship and access to capital
- A lack of robust mentorship, social capital, and other business support services for entrepreneurs, particularly women and entrepreneurs of color
- Public sector contracting opportunities (including at public higher educational institutions) that remain inaccessible to small business owners of color, particularly Black-owned firms

Recommendation

During the 2021-2022 state budget cycle, the state should take four actions to promote entrepreneurship across the state:

- Establish a state CDFI fund modeled on the federal CDFI Fund and New York's state CDFI fund
- Establish a state loan-loss reserve fund for mission lending, with an emphasis on equitable microloans
- Increase transparency around contracting with the state, and commit to meeting contracting goals by state government agencies and public higher education institutions
- Enhance existing Indiana SBDC funding and provide greater support for entrepreneur mentorship

In future legislative sessions, the state should take further action to promote entrepreneurship and small business development in order to promote a more robust and equitable recovery, including:

- Enhance cooperation among existing CDFIs, other SBA microlenders, and traditional lenders in the state who are focusing on underrepresented groups

Implementation Specifics

Establishing a state CDFI fund is one of the most significant actions the state could take to support business formation and close entrepreneurship gaps at a critical time of economic recovery in the state. Such a fund could be modeled on the existing federal CDFI Fund within the Department of the Treasury.[xx]

The federal CDFI Fund certifies CDFIs nationwide and provides two types of grants to CDFIs: financial assistance grants and technical assistance grants.

- Financial assistance grants are grants of up to $2 million given to CDFIs to support lending, investing, enhancing liquidity, or other types of financing. Organizations that CDFIs can finance include commercial facilities that promote revitalization, businesses that provide jobs to low-income individuals, housing available to low-income people, consumer loans, and other business activities

- Technical assistance grants are grants of up to $125,000 that can be used to help CFDIs, and organizations hoping to become certified CDFIs, build the capacity to provide financial services to low-income communities and families.

All grants made by the federal CDFI fund must be matched dollar-for-dollar from a nonfederal source.

In addition to providing grants, a state CDFI fund could develop and enforce state-level minimum prudent standards (MPS) to assess the financial health of CDFIs in the state, encourage greater lending, and assess whether they are meeting their mission.

In 2007, New York became the first state to establish a CDFI Fund, modeled on the existing Federal CDFI fund. The fund was designed to provide financial assistance and technical assistance to CDFIs throughout New York State. Financial assistance can come in the form of deposits, credit union shares, loans, or grants. Technical assistance can be provided directly, through grants, or through contracting with outside community development financial organizations, and would be used to enhance the capacity of state CDFIs.[xxi] While the program was created by legislation in 2007, it has never been funded. However, the New York governor's 2020 budget request calls for allocating $25 million to the state's CDFI program to begin offering financial and technical assistance to CDFIs in the state.[xxii] In recent years, Wisconsin has also considered legislation to create a state-level CDFI fund. However, the legislation was set aside in favor of a tax credit for investment in CDFIs.[xxiii]

Next, the state should move to establish a state loan-loss reserve account fund with an emphasis on equitable microloans**.** Loan loss reserves are funds that lenders set aside to cover uncollected loans and loan payments. Because not all loans will be paid back, federal and state laws require that banks set aside a certain amount of money to account for potential loan defaults and to present an accurate picture of their financial health.

Loan loss reserve requirements are typically higher for loans considered riskier, as they have a higher chance of default. These elevated loan loss requirements can hinder lending to entrepreneurs or businesses that do not meet traditional lending requirements, who tend to disproportionately be low income individuals and entrepreneurs of color. However, states and municipalities can set up loan loss reserve programs to cover a portion of loan loss reserves on behalf of the lender. This lowers the cost to lending and can encourage lenders to make loans that would be considered too risky in the absence of the government support.

Indiana has an existing loan loss reserve program called a Capital Access Program (CAP). Indiana's CAP program provides state matching funds into banks' loan loss reserves for qualified loans to borrowers that the bank considers a higher risk. The matching funds allow the bank to absorb potentially higher default rates from riskier borrower by putting more money into the loan loss reserves as no additional cost to the bank.

However, Indiana's existing CAP program largely bypasses microlenders, as the way the program is structured makes it impractical to provide loan loss reserves for very small loans like microloans. It also largely excludes CDFIs in the state as well.

Given that, Indiana should establish a parallel program to provide loan loss reserve funding for mission-based lending, including CDFIs and other Small Business Administration (SBA) microlenders, with an emphasis on equitable microloans. The state could consider creating a parallel CAP program dedicated exclusively to supporting microloans. Another model would be to provide state grants to Indiana microlenders. Grants would be issued through a competitive application process, and winners would be granted funds to use as loan loss reserve funding. These grants could be provided to traditional financial service firms, as well as mission lenders like CDFIs.

To further support minority-owned businesses the state should increase transparency around minority- and women-owned business contracting with state agencies and public colleges, and commit to meeting its existing contracting goals. Every five years the state conducts a Disparity Study assessing how the state Department of Administration and each of Indiana's public colleges and universities are doing toward implementing the state's Minority and Women's Business Enterprises plan. As part of this process, the state calibrates its participation goals for minority- and women-owned businesses in state contracts, which are then confirmed yearly by the Governor's Commission on Supplier Diversity.

While the state publishes its current participation goals publicly on the IDOA Division of Supplier Diversity's webpage, it does not publish annual progress toward those goals. Similarly, the Governor's Commission on Minority and Women's Business Enterprises publishes a semi-annual report in March and October of every year, evaluating progress made toward helping minority- and women-owned businesses in the state. While this report contains important information around company certifications, Division of Supplier Diversity compliance, and business outreach, it does not contain any information about progress toward participation goals.

To increase transparency around minority- and women-owned business contracting, the state should maintain a single, public-facing website showing progress that the Division of Supplier Diversity and each of the state's public universities are making toward meeting participation goals for minority- and women-owned businesses. The data should be updated at least every six months in March and October, when the Governor's Commission on Minority and Women's Business Enterprises publishes its semi-annual report.

Finally, the state should enhance existing Indiana Small Business Development Center (SBDC) funding to provide greater support for entrepreneur mentorship, with a focus on entrepreneurs of color. While SBDCs have been criticized at times for not being as effective as they could be in supporting entrepreneurs, this is due in part to how woefully underfunded they are. In 2019, Indiana's SBDC received just $2.3 million total in appropriations, all of which was passthrough funding from the federal government. These inadequate appropriations exacerbate the already-significant inequalities across regions in Indiana. Just as many regions outside of Central Indiana have less access to capital due to the lack of CDFIs and other SBA lenders, they likewise have fewer supports for other essential aspects of entrepreneurship, such as mentorship. Given its existing, regionally oriented structure, a more robustly funded SBDC could help close some of the existing disparities that exist across regions in Indiana.

Indiana should scale up its SBDC funding, with a focus on providing dedicated support to minority business accelerators and other minority- and women-owned business supports statewide. Focus should go toward bridging the education gap on what is needed to secure financing, and significantly enhancing mentorship and other social capital initiatives to help entrepreneurs access strategic guidance and build their professional networks. The state should likewise provide more resources for efforts like:

- Legal assistance with establishing an LLC
- Accounting assistance for setting up business financials
- Setting up strategic advisory boards that include well-connected existing business owners
- Connecting entrepreneurs across historically marginalized communities

<u>In future legislative sessions, the state should take further action to promote entrepreneurship and small business development in order to promote a more robust and equitable recovery:</u>

To expand lending coverage in Indiana, the state should enhance cooperation among existing CDFIs, other SBA microlenders, and traditional lenders in the state who are focusing on underrepresented groups. This effort would consist of several components:

- To start, the state should fund the creation of a single portal for loan applications, which could route potential borrowers to the most applicable lender depending on their location and capital needs and solicit participation from existing lenders across the state. To incentivize lenders to use the portal, Indiana could make access to some of its lending support programs, such as the Capital Access Program, conditional on using the single-access portal.

- To help entrepreneurs navigate the application process, Indiana should establish an Office of the Collaborator General to help connect entrepreneurs and small business owners to existing state resources. While such an office could be formally housed under the IEDC, it should be a cross-government agency that has deep knowledge of, and relationships with, both state and local government offices and private sector actors that support entrepreneurship in Indiana. In this way, the office would truly facilitate public-private partnership for entrepreneurs.

- From there, Indiana should provide funding to lenders to scale up their operations to unserved areas. There are already some mission lenders with a statewide presence for certain financial products. One example is Bankable, which offers credit builder loans, microloans, and community advantage loans ranging from $500 to $250,000. Indiana could leverage a state CDFI fund to expand the lending capacity and physical presence of lenders like Bankable, or to help other mission lenders provide similar financial products to unserved areas of the state.

- Once the state has solicited buy in from a variety of lenders, developed a single portal, and expanded coverage to more areas of the state, it should look to fund a significant ad and awareness campaign targeted toward entrepreneurs and small businesses across the state. Without increased awareness, potential entrepreneurs may not know what resources exist, and take-up rates may remain low.

Budget Implications

While this initiative would work better as a comprehensive suite of policies, each program within this it could be enacted as a standalone policy. Likewise, each component of this initiative could be started with relatively little funding, and scaled up with more funding as the state's budget situation improves:

- To establish a **state CDFI fund**, a $10 million initial investment. This would allow the state to increase its number of CDFIs from 12 to 30, to bring it to par with other comparably sized states, and provide each with average funding equal to twice their disbursement from the federal CDFI fund.
- A **state loan-loss reserve fund** for equitable microloans could receive an initial investment of $6 million.
- **Increasing transparency** around minority- and women-owned business contracting with the state, and committing to meeting contracting goals, would have little-to-no cost. For example, it would be helpful to have a dedicated staff member within IDOA's Division of Supplier Diversity to analyze existing data collection and update the website
- To **enhance the existing Indiana SBDC**, the state should look to increase funding for SBDCs from $2.3 million to $20 million
- Creating a single, **coordinated platform for small businesses** could cost around $5 million.
    - To coordinate with existing lenders and manage the process of enhancing cooperation, the state could fund two to three state employees in a dedicated office. This office could be the same as, or in addition to, the Office of the Collaborator General to help connect entrepreneurs and small business owners to state resources. Budgeting for a director plus two associates would likely cost $500,000 over a two-year budget cycle, plus another $500,000 for associated office stand-up costs.

- Creating a single application portal online would likely require an external IT contractor to be hired, and bids could be solicited through an RFP, which could run $1 million or more.
- If the state decided to conduct a statewide ad campaign, it could allocate $3 million, depending on the size of the campaign.

Economic Implications

A 2014 analysis by the Opportunity Finance Network, an association of CDFIs, found that one FTE is created or retained, either directly or indirectly, for every $21,000 in CDFI lending or financing. An analysis by Opportunity Finance Network looked at the Create Jobs for USA initiative, an effort launched in 2011 by Opportunity Finance Network and Starbucks, to raise funding for CDFIs nationwide. The Create Jobs for USA initiative raised over $15 million for CDFIs across the country. That $15 million was in turn leveraged to create $106 million in lending or financing over two years, a 7-to-1 ratio. At $21,000 per job created or preserved, the report estimated that the $106 million in lending or financing created or retained over 5,000 jobs.[xxiv]

Applying those numbers to Indiana, a $10 million state CDFI fund could be expected to generate over $70 million in lending or financing in the state. At $21,000 per FTE, that $176 million would be expected to create or preserve over 3,300 jobs.

At a 5:1 loan-to-reserve ratio, a $6 million loan loss reserve pool could be reasonably expected to support $30 million in microloan funding. At an average of $15,000 per loan, that could support 2,000 small businesses in the state.

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