News & Views

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FEDERAL RESERVE BANK OF CHICAGO

Wisconsin Department of Commerce Fills in the Gaps

Ask Brenda Blanchard, Secretary of the Wisconsin Department of Commerce about doing business in the Badger State, and you will undoubtedly be greeted with enthusiasm.

The Wisconsin Department of Commerce offers an array of business loans, grants, and technical assistance programs to help Wisconsin businesses start up, expand, and entice out-of-state businesses to choose Wisconsin over other states.

The Department's seven divisions encompass specialized business services such as environmental and regulatory services, community development, export development, and marketing and technology.

The Department's commitment is paying off. A 1998 study of Wisconsin manufacturers revealed that 70 percent of the Badger State's manufacturers plan to expand or make major changes in production capacity within the next three years.

Doing Business in Wisconsin

"One reason for our strong business climate is a low cost of doing business," Blanchard says. "Wisconsin's workmen's compensation rates have dropped by 25 percent over the past four years. Wisconsin employers pay the lowest allowable unemployment compensation rates. The state offers property tax exemptions for computers and computer equipment used in doing business; for manufacturing machinery and equipment, inventories, and pollution-control equipment; and for tax credits for energy used in manufacturing and for R&D."

Assistance for the Unemployed

Although Wisconsin continues to enjoy record levels of employment (only 3.5 percent unemployed at year-end 1998), the Department of Commerce participates in a creative initiative matching employees with jobs. The Department is working with other agencies and with local development organizations to rapidly match laid-off employees with new positions, and to help new workers, such as former welfare recipients, enter the labor force. Blanchard also said Wisconsin has established a network of 67 Job Centers across the state. The centers combine state, county, technical college, and private-sector resources to serve every job seeker and every business looking for workers. The award-winning Job Net computer system uses the Internet to link workers instantly with jobs in a specific region of Wisconsin or across the state.

Wisconsin's Welfare to Work (W-2) program is also working well. The state leads the nation with an 87 percent drop in its welfare caseload over the past five years. Governor Tommy Thompson's budget will help W-2 workers enter and succeed in the labor force by expanding eligibility for childcare subsidies, providing assistance to parents of disabled children, and creating get-well havens for sick children. The governor has also created a cabinet-level position to direct initiatives for building the workforce of the 21st century.

Wisconsin Department of Commerce *continued from page 1*

Brenda Blanchard

"Thanks to Wisconsin's strong economy, unemployment continues to be at record low levels," says Blanchard. "However, certain parts of the state have a dearth of employees to fill jobs. So our challenge is, how can we create technology to help fill these jobs in less-populated areas of the state where there are not enough workers? We don't want to lose these companies to other states with larger labor pools, so it is in our best interest to keep these jobs in Wisconsin."

Growing and Attracting New/Emerging Industry

In spite of all of the good news, the Department of Commerce is not resting on its laurels. Brenda Blanchard and her staff are constantly looking for opportunities to attract new industries to Wisconsin.

"We believe that in order for Wisconsin to stay competitive, we've got to grow and attract emerging industries - and we've been effective in creating a climate in Wisconsin that is hospitable to business," says Blanchard. "These 'high tech' industries are not 'the future' — they're here now, and Wisconsin wants to capture them.

A particularly interesting growth industry in Wisconsin is biotechnology. The University of Wisconsin-Madison is among one of the nation's leading biotechnology universities.

"The State of Wisconsin Investment Board has agreed to invest $50 million of state pension funds in order to leverage venture capital from both the east and west coasts - this will entice expansion and growth in the biotech industry," says Blanchard.

The Department of Commerce's Technology Development Fund program (TDF) provides loans to existing Wisconsin businesses researching and developing technological innovations with the potential to provide significant economic benefits to the state. Loan proceeds can be used to offset costs such as those for personnel, third-party service providers, new equipment, and supplies and/or materials. Since 1984, the TDF pro gram has provided more than $11 million in financial assistance.

Wisconsin's Department of Commerce also helps small, medium, and even large businesses access training dollars to help employees become adequately prepared for changing technology. Through the Customized Labor Training Program, companies investing in new technologies or manufacturing processes can receive grants of up to 50% of the cost of training employees on the new technologies. According to Department of Commerce data, almost 200 companies have been provided more than $52 million in grant money since the program's inception in 1983.

Minority Business Advocacy

"We recognize that minority communities are disproportionately affected by unemployment, so we work closely with minority organizations, such as the Hispanic Chamber of Commerce, that support local business development," Blanchard said. "These organizations know their communities and can provide us with the best input of what their constituents need. Subsequently, we've added components to assist organizations that provide advocacy for minority businesses."

The Department of Commerce offers a comprehensive program for fostering minority-owned businesses throughout the state. The Minority Business Development unit provides grants (the Early Planning Grant) of up to $15,000 for minority entrepreneurs or existing minority-owned businesses. These grants are used to hire consultants who can help the businesses with feasibility studies, planning, marketing, or financial statements.

"We make about 60 grants per year using this program," says Oscar Herrera, director of the DOC's Bureau of Minority Business Development. "The

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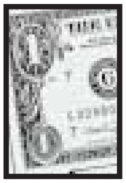
Finance

Hammond Urban Enterprise Association



A Renaissance on the Lake

Hammond is at the right place at the right time.

The Indiana city borders Chicago on its southeast side. Its location at the crossroads of major Midwestern transportation systems makes Hammond a desirable spot for business relocation and/or expansion.

To entice growth, the State of Indiana created the Indiana Enterprise Zone Program in 1983, with a special Hammond Zone designated in 1984 and managed by the Hammond Urban Enterprise Association. The program aims to revitalize Hammond's economically depressed areas through business development and enhancement.

Enterprise Zone incentives establish and promote a favorable business climate for private sector investment by providing relief from various state and local taxes. Additionally, the Indiana Zone Program mandates reinvestment and accountability by those businesses that choose to participate, making it a national model.

Businesses that choose to participate in the Indiana Zone Program are required to reinvest an amount equal to or greater than their savings in: cash or in-kind assistance to local Urban Enterprise Associations (the non-profit organizations that manage Indiana's Enterprise Zone development), new capital investment, and/or an increase in Zone employee wages.

The program has resulted in increased economic activity and job growth. Since the Zone was established, Hammond has seen a $300 million increase in private sector investment.

"…through the tax relief offered by the Enterprise Zone, it's relatively inexpensive to operate businesses here."

The strategic location has attracted a variety of industries. Covering just three square miles within the city limits of Hammond, the Zone is home to an estimated 740 businesses. These companies range from automotive and steel manufacturers to machining facilities. The Zone also supports a healthy mix of retail operations.

The American Business Center offers a prime example of the Zone's success. As a multi-tenant industrial facility, the business center reached capacity just one year after opening.

"The tenants are thrilled with the space," says Peter Yanson, property leasing manager with Quadress Realty Services. "The employment base in Northwest Indiana continues to be strong, and through the tax relief offered by the Enterprise Zone, it's relatively inexpensive to operate businesses here."

Local companies also point to the community's pro-business attitude as a major drawing card. New and expanding industries enjoy a wide range of business assistance programs, along with a full menu of financial incentives.

"Working in cooperation with the Mayor's Office of Economic Development, we can ensure that all of a company's relocation or expansion needs are met in a timely manner," says Patrick J. Reardon, executive director of the Hammond Urban Enterprise Association. "With the continued support of the City, the Enterprise Zone is helping to make Hammond the place where businesses can prosper." ■

For more information on the Hammond Urban Enterprise Association, contact Patrick J. Reardon, Executive Director, 219/853-6512, or FAX 219/853-6334.

Collaborative Workshops Teach Banking ABCs

Consumers interested in learning how to manage their finances recently benefited from workshops sponsored by the Chicago CRA Coalition and the First National Bank of Chicago, a Bank One company. The workshops, entitled "ABCs of Banking," were held on Chicago's south and west sides.

These workshops are part of a larger, ongoing effort between the Chicago CRA Coalition and First Chicago to expand financial literacy education and access to financial services in low- and moderate-income communities. "These community workshops are but one example of the many positive benefits flowing from the Community Reinvestment Act," said coalition member Dory Rand of the National Center on Poverty Law.

"We are very pleased with First Chicago's efforts to reach out to people in all the communities within the Chicago region with programs that enable them to assess their financial service alternatives," said Marva Williams of the Woodstock Institute. "Establishing an ongoing relationship with a mainstream financial institution like First Chicago is the first step in developing money management skills that transform dreams of home ownership-or starting a small business-into reality."

Participants gathered to hear from a variety of panelists including Marva Williams and O. S. Owen of the Consumer Credit Counseling Service.

First Chicago supplied written materials and free calculators. The materials included sample spending plans and a comparison of the costs of using a bank checking account and a currency exchange.

"By helping residents of our communities understand banking, credit, money management, and budgeting, we're giving them a greater understanding of their rights as consumers," Said Deonna Wheeler of First Chicago's Community Outreach and Education Division (COED). "We want to give our customers the tools they need to be financially successful. COED helps businesses and consumers make wiser banking decisions and achieve their economic goals." ■

For additional information on the Chicago CRA Coalition or the workshops, contact Marva Williams or Katy Jacob at the Woodstock Institute, 312/427-8070.

For additional information on the Community Reinvestment Act contact the Consumer and Community Affairs Division of the Federal Reserve Bank of Chicago, 312/322-8232.

Turning Dreams into Reality

By Gerri Norington

Gerri Norington

Gerri Norington is currently the financial consultant for the Cosmopolitan Chamber of Commerce and is responsible for services rendered through the Minority Business Development Center operated by the Chamber.

Ms. Norington is a business coach, author, and entrepreneurial training specialist with over thirty years experience working with small and micro business owners, helping them to be efficient and profitable in operating their businesses.

The Cosmopolitan Chamber of Commerce is turning small entrepreneurs' dreams into reality.

After being turned down by five different banks, Conrad Moore was able to secure financing, with the help of the Cosmopolitan Chamber, for his gift shop under the "Low Doc" SBA guaranteed loan program. The financing was made available through the Community Bank of Lawndale, a community development financial institution in Chicago.

Prior to opening his gift shop, Moore often shopped for gifts at the last minute and resented having to go to several different stores to find a gift, a card, and fresh flowers. For years he promised himself that he would one day own a store that carried all these items and more. It took him nearly eight years to save the more than $40,000 he used to start Casual Elements, an eclectic retail shop located in the Webster Place Plaza on Chicago's north side.

As he saved, he developed relationships with shop owners who shared much information with him about operating a retail store. Conrad had worked as a clerk in a retail store so he had some knowledge of the business.

Additionally, he had worked in manufacturing and had dealt with shipping and order processing. Networking with his friends in retail, he was able to find and hire an experienced retail store manager. His new manager had previously owned and operated his own store.

Armed with $40,000 from personal savings, love of beauty, and the desire to succeed, Moore opened Casual Elements in April of 1998. He was able to establish credit with a number of vendors but quickly realized that he needed additional capital to maintain the inventory and to be properly stocked for the Christmas season. In June of 1998 he contacted the Cosmopolitan Chamber of Commerce for assistance. With the help of the Cosmopolitan Chamber, Moore was able to secure $100,000 of financing for his gift shop.

The 1750 square feet of space Casual Elements occupies is filled with the gifts, cards and fresh flowers Moore had dreamed about. Items include, Swarovski's crystal collectibles, jewelry, candles, portable fountains, "Beanie Babies," miscellaneous furniture items, and much more. First year revenues were $400,000 and the second year looks even brighter. "It was a struggle, but the support of friends, my mother, and the Cosmopolitan Chamber helped me to keep going," said Moore.

Cosmopolitan Chamber of Commerce

The Cosmopolitan Chamber of Commerce is the oldest minority business association in Chicago and the second oldest in the nation. Established in 1933 by several Black business men, the Cosmopolitan Chamber of Commerce has been a mainstay in the small business community, providing a variety of services to its members and helping to create economic development throughout the city.

Over the years, the Chamber has initiated numerous programs geared toward increasing and sustaining the number of minority businesses in the marketplace. The Chamber has been an advocate in the fight for equity, helping minority businesses receive contracts in construction, services, retail operations and manufacturing. It has operated a School for Business Management, a Construction Trade School and a variety of business workshops for many years to better prepare business owners for the competitive marketplace.

Loan Packaging Assistance

Loan packaging assistance creates an opportunity for the Chamber to work with the business owner to make sure the business plan is comprehensive, the financial projections are realistic, and that the business itself is viable. Often this means delving into the strengths and weaknesses of the owner, making sure that skills exist to implement the plan and effectively utilize the funds. Should it be indicated, small business training programs are recommended prior to or in conjunction with the submittal of a loan application.

Partnerships

The submittal of a loan application brings into play the partnerships the Cosmopolitan Chamber has forged over the years with a number of banks in the area. The Chamber has come to understand what banks are looking for and what kind of projects they are likely to fund. This knowledge and these relationships have allowed the Chamber to be effective in helping clients secure loans.

Many financial institutions support the Chamber as members, including LaSalle National Bank, Harris Trust & Savings Bank, Bank of America NT & SA, Community Bank of Lawndale, Highland Community Bank, Sable Bancshares, First Chicago, Chicago City Bank & Trust, Seaway National Bank, Northern Trust, Old Kent Bank (three locations), and South Shore Bank. The Illinois Development Finance Authority also supports the Chamber. Over 66 percent of these institutions are represented on the Chamber's Board of Directors.

Turning Dreams *continued from page 4*

Access to Capital

Access to capital for a small business is not as easy as it sounds. Traditionally, new businesses with no track record find it almost impossible to get a loan. Add to this the fact that poor credit history is often a reality, and the prospect of getting a loan at all seems insurmountable. With the help of the Small Business Administration (SBA), more and more small and minority business owners are able to access the capital need to start and grow their businesses. While access is still a problem, more banks are taking advantage of the SBA guarantee program which provides them with assurance that 70% to 80% of the loan value will be paid in case of default by the borrower.

Even with the guarantee in place, too many banks do not participate in the program unless the borrower has a proven (profitable) track record of at least two years, has solid credit, and meets stringent requirements. "The Chamber helps to facilitate a higher approval rate by having some insight as to who is likely to fund through the SBA programs and who might be inappropriate based on the borrower's circumstances," says Consuelo Pope, President of Cosmopolitan Chamber.

The fact that Moore was turned down by five banks before this business was funded highlights the challenge faced by most small minority business owners in need of a loan. Without the support of an agency such as the Cosmopolitan Chamber of Commerce, most business owners would have given up by the second or third rejection. Continued advocacy for small businesses is needed to help more of them stay alive. Even in a booming economy the small business owner is in jeopardy of failure. In light of the downsizing of corporate America, due to the high-tech explosion, one often has to create his own job just to have one. Without an increase in the number of loans being funded, more and more businesses will be impeded from thriving and the economy will suffer. Small business now provides the majority of jobs in the marketplace, quite the reverse of even ten years ago. ■

For additional information about Cosmopolitan Chamber of Commerce or Minority Business Development Center programs contact Ms. Gerri Norington, 312/786-0212.

Detroit Entrepreneurship Institute Honored at the White House

The Detroit Entrepreneurship Institute (DEI) was among five recipients of the Presidential Awards for Excellence in Microenterprise on February 5th at the White House. It was the culmination of years of hard work and dedication by Cathy McClelland, DEI's founder and CEO.

The DEI was formed in 1990 - long before welfare reform - to help those on welfare achieve independence through entrepreneurship. McClelland started DEI as the Detroit Self Employment Project through Wayne State University. However, wanting more flexibility and direct control, McClelland moved DEI to a renovated downtown Detroit office building in 1996, and at the same time, received non-profit status. DEI has a $1.5 million dollar budget and 20 permanent employees. The organization gets about 65% of its funds from government sources, and the rest are from donations, grants, and profit.

DEI provides an 11-week business training program along with direct loans of up to $10,000 for serious entrepreneurs who have completed the program. Services are available to anyone and are free to those who meet U.S. Department of Housing and Urban Development guidelines.

To augment its graduates' new "business savvy," DEI has created a business reference library, complete with a graphics department, an individual counseling service, and a tax preparation service. Other free services provided to clients include:

- A 500-page manual that explains issues germane to small businesses such as: tax preparation, marketing, and even managing stress.
- Counselors to help DEI clients achieve their goals. Clients have access to these counselors and the Center for up to two years, but can certainly go beyond two years if necessary.
- Computer training
- Accountants to assist DEI clients with bookkeeping and/or taxes.
- Graphics services for letterheads, logos, and business cards.
- DEI acting as a liaison between clients and banks in order to procure business loans.

Since 1990, DEI has helped 442 new entrepreneurs turn their ideas into businesses. Overall, 775 people have graduated from DEI, reflecting a 54% success rate. DEI has fostered businesses as varied as a chocolate maker, an auto parts store, a janitorial service, and an auto repair shop.

> *"…Doug Rothwell, CEO of the Michigan Jobs Commission recently praised DEI in Crain's Detroit Business, saying that DEI is a role model he would like to see replicated in other cities throughout Michigan."*

Additionally, many of these small businesses have created additional jobs. Six recent graduates, for example, have started businesses that resulted in the creation of more than twenty new jobs.

President Clinton isn't the only one who's been impressed with DEI. Doug Rothwell, CEO of the Michigan Jobs Commission recently praised DEI in Crain's Detroit Business, saying that DEI is a role model he would like to see replicated in other cities throughout Michigan.

Besides the various programs and services DEI provides, it also runs The Clothes Closet, a resale clothing store in a downtown office building. The Clothes Closet serves two purposes: it provides a "training ground" for DEI clients who would like to learn retailing, and it provides a source where women can purchase professional-looking clothing at reduced costs.

In Detroit, there is certainly no shortage of entrepreneurs-to-be. "The demand for the educational programs and technical assistance offered through DEI is high," says McClelland. "In fact, I could easily add more classes if I had the opportunity to expand my budget." ■

For more information on the Detroit Entrepreneurship Institute, call 313/961-8426.

Strengthening Microenterprise Development

The Illinois State Microenterprise Initiative's (ISMI) members, partners and colleagues from Illinois and across the country recently gathered to discuss how to strengthen microenterprise development throughout Illinois and how to help ISMI grow.

The gathering, ISMI's 1999 ISMI Membership Breakfast, was held in conjunction with the Association of Enterprise Opportunity's (AEO) Ninth Annual Training Conference and Meeting. The AEO Conference brought more than 500 people from throughout the U.S. and around the world to study and discuss microenterprise. The conference, entitled "Microenterprise: Small Investment, Big Return", included workshops, panels and plenary sessions addressing numerous aspects of microenterprise.

ISMI is a membership organization of microenterprise development practitioners; community and economic development service providers; financial institutions; and state, local and private agencies. ISMI's mission is to provide an organized voice to advocate community economic empowerment and to create growth opportunities in microenterprise development.

At the breakfast, there was a presentation by Lourdes Ortiz, Assistant Director of the Illinois Department of Commerce and Community Affairs (DCCA). Caroline Goldstein, CRA Market Coordinator for Bank One and the Chair of ISMI's Information Committee introduced Ms. Ortiz. Ms. Ortiz presented DCCA's vision for increasing the state's support for small businesses and microenterprises, a vision that includes a partnership with ISMI and support of legislation currently advancing through the Illinois legislature.

Together, these efforts support the following goals:

1. Creation of a State Microenterprise Council housed within DCCA with representation from ISMI;

2. Development of an internet site linked to DCCA's web site with comprehensive information about services available to microenterprises throughout the state; and

3. Completion of a survey of micro-credit in Illinois.

Following Ms. Ortiz' presentation, there was a panel discussion entitled "Lessons from Across the Country." The panel featured Rene' Bryce-Laporte, from the Corporation for Enterprise Development (CFED), Kendall Scheer, from the Nebraska Enterprise Opportunity Network; and Welthy Soni, from the Virginia Micronenterprise Network. It was moderated by Frieda Schreck, ISMI member and director of the Small Business Development Authority at Lincoln Land Community college in Springfield, Illinois.

The panel was an opportunity for ISMI members to learn how microenterprise associations in other states work together to advance and support microenterprise. Bryce-Laporte of CFED detailed the support that they have provided for the creation of state microenterprise associations across the country. He gave examples of the creative partnerships that state associations, including ISMI, have created with state governments, banks, and Federal Reserve Banks. Soni and Sheer gave examples of how these partnerships were working in Nebraska and Virginia.

Some of the compelling ideas that the panel presented included:

- Working with banks, the Federal Reserve Bank, and other partners to create curriculum materials and provide training for microenterprise providers throughout the state,
- Advocating for state funding for microenterprise, and
- Creating a new directory of microenterprises throughout the state.

As ISMI begins their planning efforts for next year, it is reported that ISMI will consider incorporating these and other ideas in order to advance the field of microenterprise development in Illinois.

Finally, there was a brief policy update and discussion of ISMI's pursuit of its own independent legal status. ISMI said it was excited to announce that the process is moving ahead with pro bono legal assistance provided by ISMI member, Debra Osborn of the Community Economic Development Law Project.

The breakfast and panel discussions were supported financially by the following ISMI sponsors:

- Bank One
- Firstar Bank
- Illinois Department of Commerce and Community Affairs
- LaSalle Bank
- National City Bank of Michigan/Illinois
- Northern Trust Bank
- Women's Self Employment Project

The breakfast and the conference, has helped ISMI attract a number of new members and partners. This is especially important as ISMI enters a new phase of growth and independence. ISMI invites all interested parties to join them. ■

If you have any questions about microenterprise development or ISMI, please contact ISMI Coordinator, Tamar Frolichstein-Appel, or ISMI Chair, Jenice Jones-Kibby at 312/606-8255. ISMI's e-mail is ismiwsep@interaccess.com.

Editor's note: *Economic Development News & Views wishes to thank Ms. Tamar Frolichstein-Appel, ISMI Coordinator, for her assistance in preparing this article.*

Real Answers to Small Business Questions

Since February 1996, more than one million callers have received small business advice from the customer service representatives who answer calls to the U.S. Small Business Administration's (SBA) nationwide toll-free hotline.

Calls to the SBA Answer Desk (1-800-U-ASK-SBA) come from people across the country who are seeking help in starting or expanding their own businesses.

Knowledgeable SBA advisors staff the Answer Desk. They offer advice and referrals on questions ranging from "How do I get money to start my own company?" to "How do you measure the size of a small business?"

SBA Administrator Aida Alvarez says an efficient and user-friendly Answer Desk is important because it is frequently SBA's first point of contact with small business owners and aspiring entrepreneurs.

"The improvement in customer service at the Answer Desk is an important achievement for SBA," Alvarez said. "Even though we're using technology in lots of innovative ways, it can be comforting to talk to a 'real live person' who can get answers for you."

Here are the ways the SBA's Answer Desk has improved the delivery of small business information in the past year:

- Replaced an automated response system with small business specialists
- Improved the response time with 98 percent of all calls answered on the first ring
- Integrated the SBA Answer Desk with SBA's Internet Web site http://www.sba.gov
- Made assistance available in English and Spanish

The SBA has also added a direct mail center that distributes more than 20,000 free publications nationally per month. Publications include: How to Start a Business, How to Finance Your Business, Programs and Services Guides and Are you Y2K OK?

"Not all Answer Desk questions are easy ones," said Gary Cook, regional director of an SBA district office. "The frequently asked questions such as 'How do I start a business?' or 'How do I get a loan?' are answered immediately. But some issues require research, such as raising venture capital or dealing with environmental regulations."

Aida Alvarez

The U.S. Small Business Administration, established in 1953, provides financial, technical and management assistance to help Americans start, run, and grow their businesses. With a portfolio of business loans, loan guarantees and disaster loans worth more than $45 billion, the SBA is the nation's largest single financial backer of small businesses. Last year, the SBA offered management and technical assistance to more than one million small business owners. The SBA also plays a major role in the government's disaster relief efforts by making low-interest recovery loans to both homeowners and businesses. America's 23 million small businesses employ more than 50 percent of the private workforce, generate more than half of the nation's gross domestic product, and are the principal source of new jobs in the U.S. ■

The SBA Answer Desk's 10 Most Frequently Asked Questions:

- **How do I get a small business loan?**
- **How do I get a small business grant?** (note: SBA has no grant program)
- **How do I get started in business?**
- **How do I get a business license?**
- **How do I get a tax identification number?**
- **How do I write a business plan?**
- **What type of collateral do I need for a loan?**
- **Is there any small business assistance in my area?**
- **What classifies a business as 'small'?**
- **How can I get my business certified as woman or minority-owned?**

Business Access to Capital and Credit Symposium

The Community Affairs Officers of the Federal Reserve System recently sponsored a research conference, **Business Access to Capital and Credit,** in Washington, D.C. Distinguished economists and scholars presented and discussed 16 papers on topics such as the effects of financial industry consolidation on lending, credit scoring and securization for small business loans; access to credit for minority-owned businesses; and microlending. The conference was designed to stimulate additional research. The papers presented are "working papers," preliminary studies that are potentially subject to revision. Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, presented the keynote address and a luncheon address was given by Edward M. Gramlich, Member, Board of Governors of the Federal Reserve System. ■

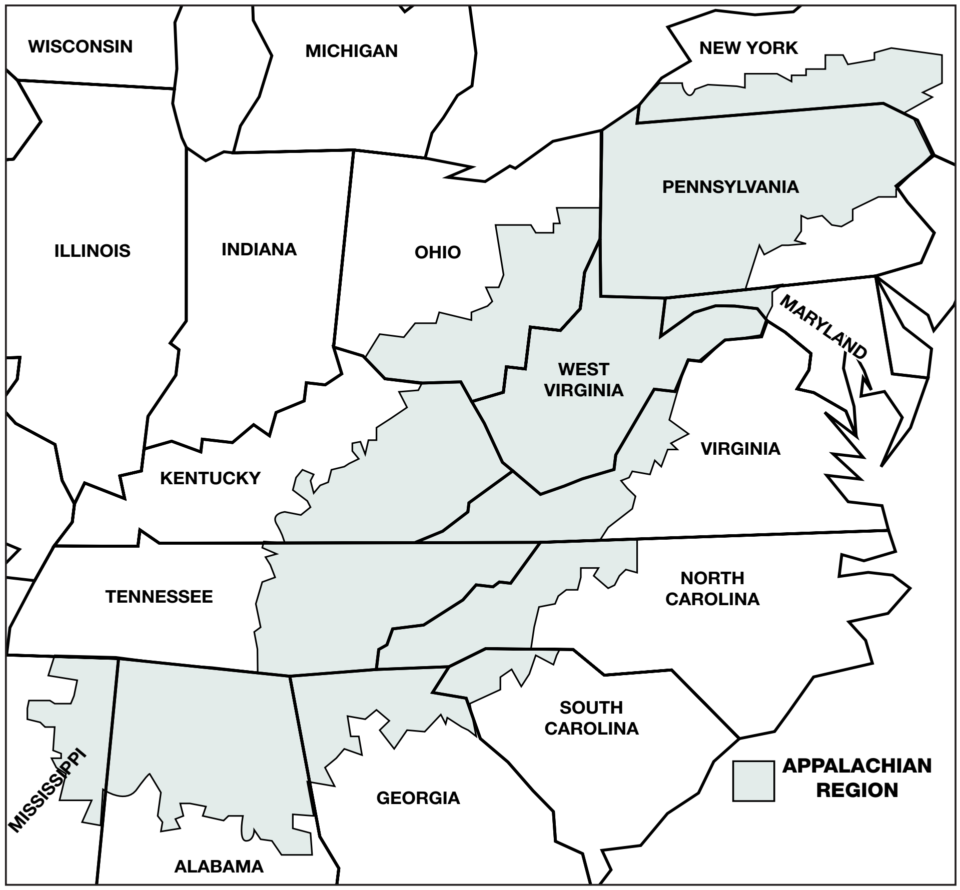
For additional information contact the Consumer & Community Affairs division of the Federal Reserve Bank of Chicago at 312/322-8232. The full text of the ***Business Access to Capital and Credit*** *proceedings is available at the Federal Reserve System website at www.bog.frb.fed.us.*

Your Views

The Challenge of History in Appalachia

by Jesse L. White, Jr.,
Federal Co-Chairman, ARC

While the 13-state Appalachian Region has made enormous economic progress over the past 35 years, more than 100 of the region's 406 counties remain economically distressed with unemployment rates well above the national average. A new entrepreneurship initiative, launched recently by the Appalachian Regional Commission (ARC), seeks to bring new wealth into the region by giving poorer communities the tools and access to capital they need to become more self-reliant.



For too long, rural Appalachia has been controlled by outside forces: the absentee owners of coal mines and vast tracks of land, and branch plants of companies headquartered outside the region. The foundation of the economy has been low-skill, labor-intensive manufacturing and mining, resulting in a region with huge deficits in its human and financial capital base. The region's severe terrain and geographic isolation has exacerbated this structural weakness in the economy.

Created by Congress in 1965, ARC has played an important role in helping bring Appalachia into America's economic mainstream. With ARC's support, more than 2,400 miles of modern highways have been built. Over 740,000 Appalachians now have access to clean water and sanitation facilities. Infant mortality rates have declined sharply, and ARC has supported major improvements in education and job training. Now ARC has embarked on a three-year, $15 million entrepreneurship initiative that seeks to create more homegrown businesses in rural Appalachia and may serve as an effective model for rural communities throughout the country.

ARC views entrepreneurship as a critical element in the establishment of self-sustaining communities that create jobs, build local wealth, and contribute broadly to economic and community development. While the region has several outstanding examples of entrepreneurial organizations, and possesses many entrepreneurial assets, including the self-reliance of its people, it also faces many challenges.

As with other rural communities throughout the country, these shortcomings stem from the region's longstanding dependence on extractive industries and branch plant manufacturing along with the presence of many absentee landlords who have siphoned off value from the region. Furthermore, the culture of entrepreneurship is neither broad nor deep throughout the region, and evidence suggests that there are many gaps in the infrastructure for supporting entrepreneurship, including shortages of technical assistance and development finance. Appalachia needs to cultivate resourceful entrepreneurs who not only create value by recognizing and meeting new market opportunities, but who increase the value-added within the region.

ARC's entrepreneurship initiative is focused on providing support for five key elements of an entrepreneurial economy: access to capital and financial assistance, technical and managerial assistance, technology transfer, entrepreneurial education and training, and entrepreneurial networks. In each of these areas, ARC has convened advisory committees comprised of regional practitioners and state partners to identify innovative programming and bring additional resources and expertise into the region.

Through this Entrepreneurship Initiative, the Commission has so far approved more than 60 projects providing a total of over $3.5 million of support for a range of activities. Funded projects include: support for youth entrepreneurial education projects like the REAL Enterprise program; capitalization of micro-business lending programs and support for state-wide technical assistance intermediaries; targeted support for specific strategic industries like wood products, value added food processing, and ceramics manufacture; and support for business incubators. ■

Equity Capital for Rural Communities

by Ray Daffner, Manager – Entrepreneurship Initiative, ARC

Capital and credit gaps for rural businesses have been identified as a significant regional problem in research conducted by the Federal Reserve Board, the Appalachian Regional Commission (ARC), and the Economic Research Service of USDA. These studies reveal that while the availability of capital for fixed asset financing appears to be readily available, significant gaps exist in the availability of equity capital for start-up firms and for certain types of working capital financing.

In response, ARC has convened an Innovations In Development Finance advisory committee comprised of regional practitioners, including microenterprise lenders, revolving loan fund operators, state development finance authorities, and bankers. This group has met several times to review existing research and develop responses to address identified capital gaps. The committee has prepared a series of recommendations for review by ARC, which include:

- Providing support for the development of regional intermediaries in the field of micro-credit lending. In our region, micro-credit lenders are isolated and not well connected to the national network of microlenders. Support is needed for existing intermediaries (like the Virginia Microenterprise Network and the Tennessee Network for Community and Economic Development) and for the development of new intermediaries in under-served portions of our region.
- Providing support for the development of rural equity investment funds. Unlike traditional venture capital, which is primarily profit-oriented, developmental venture capital (DVC) has both a social and a financial objective — a double bottom line. The social objective of DVCs is to use the tools of venture capital to foster economic development and job creation. In order to succeed in fulfilling this social mission, however, DVCFs must create healthy businesses, and do so while generating enough profit to stay in operation.

In addition to their dual objectives, developmental venture capital funds differ from traditional venture capital funds in a number of ways. Most of the deals

that DVCFs have invested in are early stage or start-up companies, unlike the later stage deals preferred by traditional venture capital funds. DVCF investments range from $50,000 to $1 million per company, which is significantly smaller than the $500,000 to $10 million favored by traditional venture capitalists. DVCFs have higher overhead costs than traditional venture capital funds because of the smaller size of their deals and the need to provide extensive technical assistance to their investees.

Venture capitalists typically exit their investments primarily through Initial Public Offerings (IPOs) and acquisitions. IPOs are a rare exit option for DVCFs, because developmental venture funds focus on firms that have neither the growth rates nor the rates of return to be attractive IPO candidates. Many DVCFs end up exiting deals via "puts" structured into the investment contract, and can take as long as 7 to 10 years to be repaid.

ARC has just made its first two grants to capitalize development venture capital funds in the region. One is to the Mountain Association for Community Economic Development in Kentucky to develop a Strategic Capital Fund. The other grant went to the Conservation Fund in West Virginia to develop a Natural Capital Investment Fund. Both of these funds anticipate leveraging ARC's grants with support from foundations, banks, and other investors.

In order to support the creation of other community development venture capital funds, ARC is reviewing our Innovations In Development Finance committee's recommendations to undertake the following activities to support creation of four or five equity funds capitalized at $10 million to $20 million each. The recommendations include:

- Building partnerships with foundations and bank/investment firms to assess interest in and develop opportunities to invest in developmental equity funds. To be successful, these new funds can not be supported by the public sector alone.
- Improving management capacity in the field by encouraging formation of internship opportunities for development finance personnel to work in venture capital funds. These internships including the placement of traditional venture capitalists on boards of directors of community development venture funds, and developing co-investment opportunities/ linkages between new funds and established funds. The ability to capitalize an investment pool is significantly enhanced once a qualified management team is assembled.
- Expanding existing development finance programs (like Revolving Loan Funds, micro-credit funds, etc.) or creating new entities to manage these funds. ARC is considering providing a pool of technical assistance support to underwrite the costs of forming new equity funds. However, the importance of ensuring that these institutions have the capacity to undertake development venture capital investing can not be over-emphasized; debt fund managers do not necessarily have the requisite skills to invest equity portfolios.
- Supporting fund capitalization by revising ARC's Revolving Loan Funds (RLFs) guidelines to allow transfers of capital from RLFs, on a pilot basis, into approved community equity funds. Another recommendation is to convene a series of Rural Equity Summits throughout the country, co-sponsored with the Federal Reserve System, Federal Home Loan Bank Board, various state banking associations and the U.S. Small Business Administration. This would include participation of the hosting state governors to link new or expanded funds with prospective investors.

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From Research

Labor Market conditions in the Seventh District

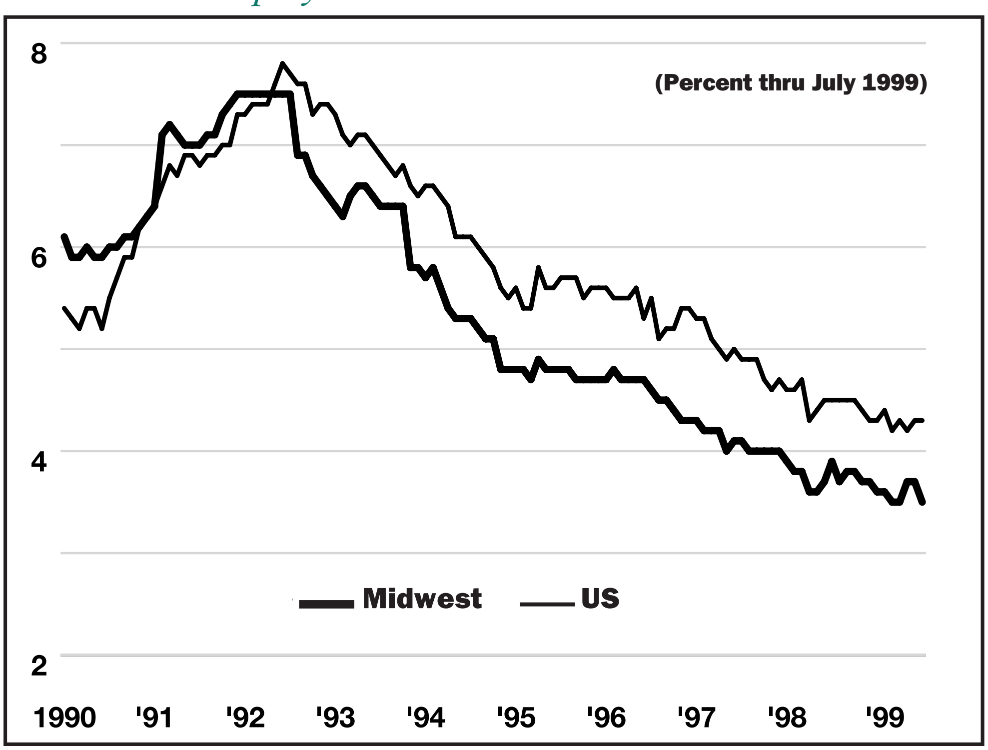
The Federal Reserve Bank of Chicago serves the Seventh Federal Reserve District, which includes the entire state of Iowa along with large portions of Illinois, Indiana, Michigan, and Wisconsin. At the present time, there are 43 Metropolitan Statistical Areas (MSAs) in the Seventh District. The geographic boundaries of MSAs are defined by the U.S. Office of Management and Budget (OMB) as economic areas encompassing communities that are tightly linked by a flow of commuters, migrants, goods and services, and payments.

Unemployment rates are useful indicators of the labor market conditions in local areas. The unemployment rate is defined as the percentage of adults in the work force who are not currently employed but are actively seeking employment. Importantly, the work force, and hence the unemployment rate, does not include workers who are not actively looking for work. This means that workers who have given up looking for work are not counted as unemployed.

Unemployment rates for Seventh District MSAs are derived from data provided by the United States Department of Labor (USDL). Using definitions and guidelines established by the USDL to ensure consistency across state lines, state agencies calculate MSA unemployment rates on the basis of a monthly payroll survey and unemployment insurance records. The rates used here have been adjusted to account for normal seasonal variations.

Currently, labor markets in the Seventh District are much tighter than the nation as a whole. In sharp contrast to the 1980s, the region's unemployment rate has been running below the national average since 1992. While good news for the region's workers, whose wages and salaries are growing faster, the very low levels of unemployment are making it difficult for employers to find quality help. Broad-based labor shortages, across both industry and occupational categories, have contributed greatly to the District's slowing employment growth in the last few years. Earlier in this decade, a strong rebound in our manufacturing industries, as well as robustness in construction and services, led to employment growth in the region that outpaced that of the nation. As labor markets in the region tightened more dramatically in the mid-1990s, the national rate of employment growth caught up to, and has since surpassed, the region's. With few signs of any softening in the Seventh District economy, and relatively unfavorable migration trends, employers can expect little relief from tight labor markets in the near term.

Midwest Unemployment Rate



Labor Market Highlights

The seasonally adjusted unemployment rate for Seventh District states ticked down to 3.5 percent in July from June's 3.7 percent, and remained well below the national average of 4.3 percent. July marked the 87th straight month that the region's unemployment rate has been below the national average.

Of the five District states, only Illinois had an unemployment rate above the national average, at 4.6 percent, and was also the only state to show a year-over-year increase. Indiana had the lowest rate of the five states at 2.4 percent, while Michigan displayed the most improvement since July of last year, down 0.9 percent. This number is somewhat exaggerated since Michigan's unemployment rates were distorted by strikes against automobile manufacturers last summer.

Nearly all of the District's 43 Metropolitan Statistical Areas (MSAs) had unemployment rates below the national average in July. Rates ranged from a low of 1.4 percent in Madison, Wisconsin to a high of 5.7 percent in the Waterloo-Cedar Falls, Iowa metro area. All five of the region's major metropolitan regions—Chicago, Des Moines, Detroit, Indianapolis, and Milwaukee—continued to have tighter labor markets than the nation as a whole.

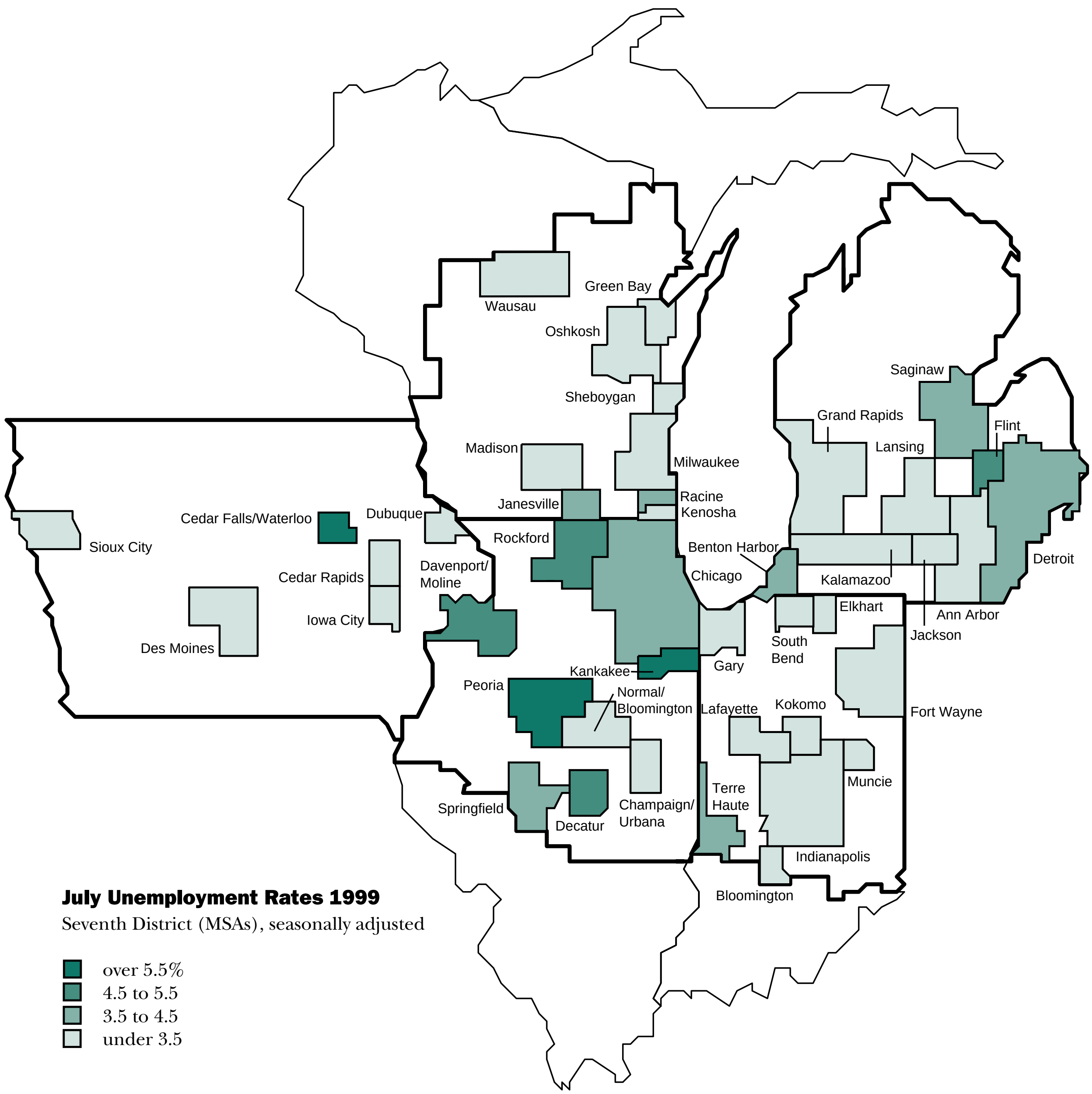
Employment numbers for states and metro areas underwent annual benchmark revisions in the spring, and these revisions showed that payrolls in the region grew slightly faster than previously reported. In addition, while employment growth in the District continued to lag the nation, the gap was not as large as initially reported. Employers throughout the Seventh District continued to report difficulty finding workers in nearly all industry and occupation categories.

Much like our last report, general wage pressures remained subdued for the most part despite taught labor markets and persisting shortages of workers. ■

Richard E. Kaglic
Economist

Seventh District Labor Markets

Unemployment conditions for July 1999



NOTE: All rates are subject to revision.

Small Business Finance in Two Chicago Minority Neighborhoods: A Summary

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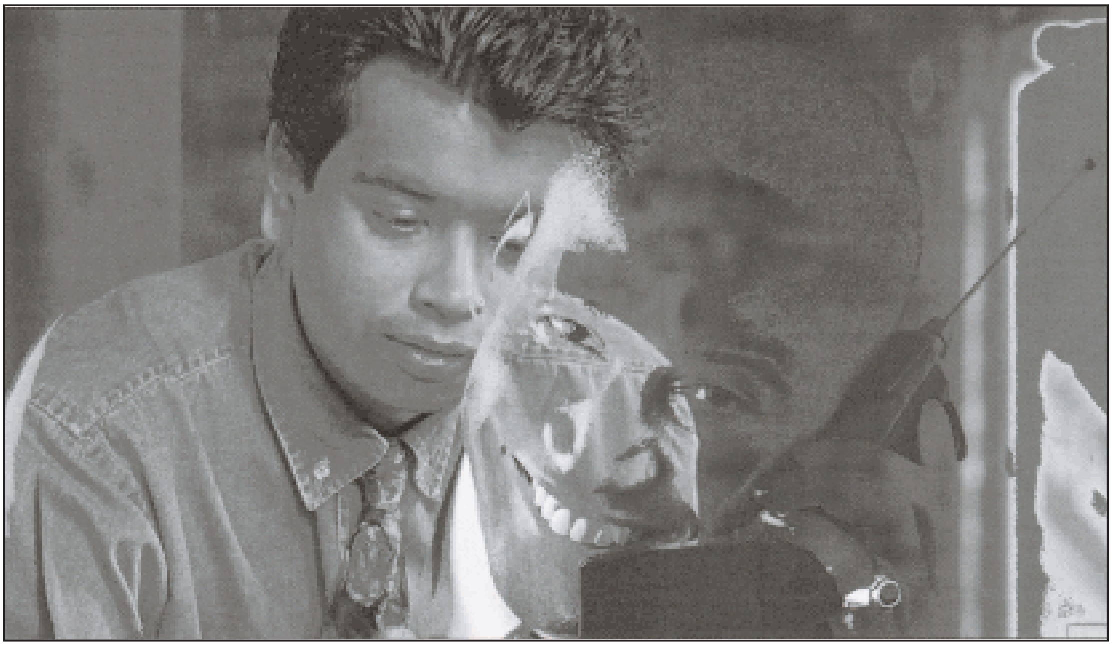
This summary reports some findings from surveys of small business finance undertaken in a predominantly Hispanic community and a predominantly Black community. We find that Black owners start their businesses with significantly less capital than Hispanic owners, even after controlling for industry type and various measures of the owner's human capital. The Black-Hispanic gap in total start-up funding is due to differences in the use of non-personal sources of funding rather than disparities in the amount of personal savings put up by the owner. Black owners are also much less likely to owe their suppliers than owners in the other ethnic groups.

Chicago is enlivened by the presence of many ethnic neighborhoods, which are reflected in the city's small business scene. This variety makes Chicago an excellent location for studying small business finance in ethnic communities. This is an important topic because the availability of capital may depend, in part, on ethnic differences in factors such as the use of informal financing and access to ethnic networks. Despite the importance of these issues, we still have much to learn about business access to capital in an ethnic setting. In order to shed some light on these matters, the Federal Reserve Bank of Chicago and researchers from the University of Chicago cooperated in conducting surveys in Little Village, a predominantly Hispanic community, and Chatham, which is predominantly Black. These communities were chosen as the sites of these studies because they are distinct and well-recognized ethnic neighborhoods with viable small business sectors. Most of the owners interviewed are either Black or Hispanic,



although other ethnic groups are represented. Accordingly, we emphasize the findings that pertain to Black and Hispanic owners in the discussion that follows. One of the important features of the surveys is that they are designed to shed light on informal sources of financing, such as loans or gifts from family and friends, as well as formal sources of funds, such as loans from financial institutions, for both households and businesses.

One reason small business access to capital is an important policy issue is because business owners may face funding limits, known to economists as liquidity constraints. Although many observers might take funding limits as self evident, studies have provided evidence that liquidity constraints affect entrepreneurs both upon start-up and after the business is underway. These constraints deter entry into self-employment and force would-be owners to save for longer periods before launching a business. The effects of start-up constraints extend to ongoing businesses, as starting with more capital increases an owner's prospects for survival and growth. Thus, the ultimate success of an entrepreneur will depend in part on how successful he/she is in solving the problem of obtaining adequate capital and credit.

The provision of loan guarantees and other programs by the U.S. Small Business Administration are examples of government policies aimed at increasing access to credit for small businesses. Considering access to capital and credit across neighborhoods and across ethnic and racial groups raises other policy issues. Owning a successful business builds personal wealth, and self-employment historically has been an important means for raising the economic status of some ethnic groups. Promoting the success of small business is an important part of community economic development strategies, particularly for minority neighborhoods that have suffered from disinvestment. The purpose of the Community Reinvestment Act is to encourage depository institutions to help meet the credit needs, including the needs of small businesses, of the communities in which they operate, consistent with sound banking practices. The effect of racial discrimination on access to capital for minority business owners and neighborhoods is also an important policy issue.

In practice, owners meet the challenge of obtaining capital to start and run their businesses by using informal sources of capital as well as personal assets and loans from formal sources. Informal financing via networks can thus substitute for borrowing in the formal sector, either because formal credit is not offered or because informal financing is preferred. Credit offered by a supplier, which is known as trade credit, is another source of financing that is an alternative to borrowing from financial

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Small Business Finance *continued from page 12*

institutions. Businesses also form networks with their suppliers, and there may be an ethnic dimension to these networks, in that the ethnicity of the supplier may matter for some transactions.

The survey results confirm the importance of personal savings and informal sources of credit in meeting the need for start-up funding. We illustrate the relative importance of the various funding sources with the average proportion of total funding provided by each source. Personal savings is the most important source of funding, as it provides, on average, 66.0 percent of total funding for Hispanic owners and 69.6 percent for Black owners. Highlighting the importance of personal resources, 50.9 percent of Hispanic owners and 55.3 percent of Black owners in the sample started their businesses using personal savings as their only source of funding. Informal and miscellaneous other sources provide 25.4 percent of total funding for Hispanic owners and 17.4 percent for Black owners. By comparison, formal sources provide only 10.5 percent of total funding for Hispanic owners and 12.1 percent for Black owners.

There are pronounced ethnic differences in the amount of start-up funding used by businesses in the sample. In particular, after controlling for industry type and various measures of human capital, we find that Black owners start their businesses with significantly less capital than Hispanic owners. The first step in comparing levels of start-up funding is to recognize that a few businesses started with large amounts of funding, which means that a comparison of averages would put a great deal of weight on a small number of businesses involving large dollar amounts. We avoid this problem by recognizing that start-up funding follows an approximately log-normal distribution. Accordingly, we calculate the average of the natural logarithm of start-up costs and make comparisons after converting to dollar amounts. The results show that average start-up funding for our sample ($14,737) was fairly modest and that Black owners began their businesses with somewhat less funding, on average, ($10,812) than Hispanic owners ($13,164).

These results are incomplete, in that other factors beyond ethnicity may affect the level of start-up funding. For example, a grocery store with a requirement for an extensive stock of inventory on the shelves may require more start-up funding than a business that provides a service largely based on the skills of the owner. The next step is a regression analysis to control for some differences in business type, demographics, and human capital (such as education or prior experience running a business) to see what ethnic differences emerge. In order to illustrate the ethnic differences implied by the regression analysis, we calculate estimated levels of start-up funding for Hispanic and Black owners using the same set of baseline characteristics.[1] The results of this analysis indicates that a Black owner with the baseline characteristics starts his/her business with about one-half the amount of estimated start-up funding as a comparable Hispanic owner.

The Black-Hispanic gap in total start-up funding is due to differences in the use of non-personal sources of funding rather than disparities in the amount of personal savings put up by the owner. We get this result by analyzing the amount of funding provided by personal savings in a similar fashion to the analysis of total start-up costs discussed above. That is, ethnicity, industry type, and various demographic and human capital variables are included in a regression analysis. The results show that the difference between personal funding provided by comparable Black and Hispanic owners is small and statistically insignificant. This finding suggests that we must look elsewhere to explain the gap in start-up funding.

The remaining sources of funding beyond personal savings are informal, formal, and other sources. Unfortunately, the sample size and the relative infrequence with which these sources of funding are used do not allow us to establish conclusively how each source contributes to the Black-Hispanic funding gap. However, the average proportions of start-up costs provided by each source of funding suggest some patterns. Recall that, on average, Black owners used a higher proportion of formal financing and a lower proportion of informal and other sources of funding compared to Hispanic owners. This evidence suggests that less use of funding from informal and other sources may play a role in accounting for lower levels of start-up funding for Black-owned businesses relative to Hispanic-owned businesses.

Once in operation after the start-up stage, a business may need ongoing financing to meet working capital needs or to expand the business. Trade credit is an important source of ongoing credit, and it is widely used by businesses in Little Village and Chatham, as 38.2 percent of them owe one or more suppliers. There are substantial ethnic differences in the use of trade credit. The proportion of Black owners who owe a supplier (20.1 percent) is much lower than that of Hispanic owners (44.4 percent).

Whether or not a business uses trade credit depends on the supplier as well as the business owner because the supplier must be willing to extend credit to a given business. Hispanic owners (57.6 percent) are more likely to be offered credit by a supplier than Black owners (44.8 percent). Business owners must decide whether or not to take up a supplier's offer of trade credit. Compared to Hispanic-owned businesses (75.3 percent), Black-owned businesses (44.9 percent) are less likely to owe a supplier given that credit is offered.

Thus, Black owners are much less likely to owe their suppliers than Hispanic owners in part because they are somewhat less likely to be offered credit by their suppliers, and also because they are much less likely to use trade credit if it is offered. Trade credit can be a

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The Use of Formal and Informal Financial Markets Among Black Households[1]

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Summary

A fundamental understanding of consumer financial behavior is necessary for the development of effective policy. The paucity of information about the financial choices made among minority households prompted the Federal Reserve Bank of Chicago to conduct a unique survey in Chatham, a predominantly Black community in the city of Chicago. This article documents the use of banking products and services, the patronage of alternative financial service (AFS) businesses and the role of informal financial markets in this community. These findings are offered to fill some of the information gaps and to encourage additional research about the use of formal and informal financial markets within minority communities.

Based on this survey, we find that roughly one out of every five households is without a checking and/or savings account. Check cashing outlets and currency exchanges (AFS businesses) are patronized by a majority of all households in this community.[2] Interestingly, these businesses also are patronized by over half of all households with a pre-existing relationship with a bank. By comparison, informal financial networks appear to play an important role among households who either are faced with financial distress or in need of additional financial assistance in purchasing a home.

Overview of Financial Markets

A household gains several advantages from holding a deposit account with a financial institution. In terms of time and actual expense, payments for home production and personal transactions often can be made at a lower cost. Households are shielded from risks associated with holding uninsured cash reserves and are availed with approximately 20 consumer protection laws and regulations safeguarding individuals from unfair, discriminatory and predatory lending practices. (Board of Governors of the Federal Reserve System, 1997).

Despite the potential benefits from holding a deposit account, a large number of households remain unbanked, especially among lower-income or minority families. For example, Hogarth and O'Donnell (1997) find that almost 37 percent of all U.S. Black households are without either a checking or saving account. Among White households, however, they determine that less than 8 percent fall into this category. To meet financial transactions and credit needs, unbanked households often rely on check cashing outlets, currency exchanges or pawnshops (Swagler, et al., 1995). The cost of these alternative financial services has been shown to be almost twice as large as comparable banking services offered in the formal financial markets (Green and Lechter, 1998). As evidenced by the increase in class action lawsuits against major check cashing companies for alleged full disclosure violations, it is unclear that consumers patronizing AFS businesses are adequately protected against unfair lending or predatory business practices (e.g., Chicago Defender, 1999).

As pointed out by Bond and Townsend (1996), credit services can be provided by a diverse set of institutions ranging from informal networks of family, friends and social organizations to mainstream financial markets. Informal networks provide relationship-based financing often predicated on criteria different than

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Table 1
Formal Financial Sources by Household Income Quartile

	Total Number of Households	Percent of Sample	1st Income Quartile	2nd Income Quartile	3rd Income Quartile	4th Income Quartile
Financial Instruments						
Checking and/or Savings Accounts	153	79%	58%	82%	84%	92%
Checking Account	121	62%	23%	64%	71%	85%
Savings Account	126	65%	42%	64%	71%	85%
No Checking or Savings Account	41	21%	42%	18%	16%	7%
CD, IRA, Mutual Funds, etc.	36	19%	8%	13%	24%	35%
Credit Accounts - Last 5 years						
Credit Card	95	49%	16%	31%	60%	72%
Home Mortgage/Refinance	18	9%	3%	8%	18%	15%
Home Equity Loan	11	6%	0%	8%	8%	10%
Home Expansion Loan	6	3%	3%	0%	3%	7%
Appliance/Furniture Loan	10	5%	3%	10%	10%	2%
Student Loan	6	3%	0%	0%	3%	10%
Car Loan	50	26%	8%	23%	29%	45%
Sample Size	194	100%	24.5%	25.2%	24.5%	25.8%

Notes:
Income Quartile 1 includes households with family income < 17776 (n = 38). Income Quartile 2 includes households with family income, 17776 <= family inc. < 35000 (n = 39). Income Quartile 3 includes households with family income, 35000 <= family inc. < 50000 (n = 38). Income Quartile 4 includes households with family inc. > = 50000 (n=40). Percentages may not add up to 100 due to rounding.

The Use of Formal and Informal Financial Markets *continued from page 14*

formal financial markets. Cost advantages in information gathering, ability to utilize effective enforcement mechanisms and potential willingness to share greater risks related to implicit or explicit credit contracts are factors associated with informal markets unlikely to be present in formal financial markets. Informal networks also may be particularly well suited as a source of short-term or smaller dollar amount of financing often unavailable from formal sources.

Survey Description and Results

Chatham was chosen as the site of this study due to its distinct and well-recognized ethnic neighborhood. Located on the south side of the city of Chicago, Chatham became predominantly Black during the 1950s (Chicago Fact Book Consortium, 1995). The Federal Reserve Bank of Chicago conducted the survey in Chatham between 1997 and 1998.[3] The fieldwork resulted in the completion of 194 randomly selected household interviews. Median family income was $35,000, classifying Chatham as a middle-income community.

The household's link to the formal financial market is captured through information collected about the use of a checking and savings account, various investments and longer-term savings accounts, and holdings of various loan products. In Table 1 we highlight the use of these financial instruments by household income to ascertain whether this relation varies at different income levels. As shown, 79 percent of all respondents reported having either a checking and/or a savings account. The proportion of households using a checking and/or a savings account increases from 58 percent among households in the lowest income quartile to 92 percent of the households at the highest income levels. By contrast, 21 percent of the respondents had neither a checking nor a savings account. The proportion of households without a checking and/or savings account decreases with household income from 42 percent of

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Table 2
Household Characteristics by Selected Financial Services

	Total Sample (1)	Checking or Savings (2)	No Checking and No Savings (3)	AFS Users without Checking (4)	AFS Users with Checking (5)
N	194	153	41	68	80
Percent of Total	100%	79%	21%	46%	54%
Gender					
Male	71	83%	17%	47%	53%
Female	123	76%	23%	45%	55%
Marital Status					
Married	71	84%	15%	33%	67%
Not Married	123	76%	24%	53%	47%
Age					
18-24	9	55%	44%	89%	11%
25-34	29	76%	24%	46%	54%
35-44	50	72%	28%	47%	53%
45-59	49	88%	12%	39%	61%
60-64	16	87%	13%	36%	64%
65 up	41	80%	20%	43%	57%
Education					
Less than HS	15	80%	20%	36%	64%
HS or equivalent	109	81%	19%	47%	53%
College and Above	43	91%	9%	20%	80%
Household Income					
1st Quartile	38	75%	25%	82%	18%
2nd Quartile	39	86%	14%	45%	55%
3rd Quartile	38	93%	7%	44%	56%
4th Quartile	40	89%	11%	20%	80%
Employment Status					
Employed	120	84%	16%	40%	60%
Retired	44	84%	16%	39%	61%
Other/Not employed	18	56%	44%	67%	33%
Unemployed	10	40%	60%	80%	20%
Assets					
Home/land/other	84	93%	7%	28%	72%
Car	127	90%	10%	31%	68%
Credit Cards	95	96%	4%	67%	32%

Notes:
The percentages reported in columns 2 and 3 are based on the total number of households in the sample, N = 194.
The percentages reported in columns 4 and 5 are based on the total number of AFS user households, N = 148.

Formal and Informal Financial Markets *continued from page 15*

households in the lowest income quartile to 7 percent among those in the highest income quartile.

We find that respondents did not make wide use of home-related financing during the previous five-year period. While the age profile of this community (relatively older population) may have contributed to the lackluster activity in these credit markets, it remains unclear that life-cycle effects alone can fully explain the level of credit activity observed. As shown in Table 1, 9 percent of all households had a home mortgage or refinance loan, 6 percent had a home equity loan, and 3 percent had a home expansion loan over the previous five-year period. Car loans were the most frequently reported loan type possessed, ranging from 8 percent among households at the lowest income quartile to 45 percent of the households at the highest income quartile. Finally, almost 50 percent of all respondents held at least one credit card, reaching 72 percent of all households in the highest income quartile.

Table 2 compares the characteristics of households based on their use of selected formal and alternative financial services. AFS businesses include services from either currency exchanges or check cashing outlets. Column 2 displays the characteristics of households holding a checking and/or a savings account, while Column 3 reflects households with neither type of account. Households with a checking or saving account tended to have higher incomes and were more likely to be employed, more highly educated, older, male, married, and owners of a home, car or other large assets (Column 2). Conversely, unbanked households were inclined to have lower incomes and were more likely to be unemployed, less educated, younger, female, unmarried, and without a home, car or other large assets (Column 3).

Households that patronized AFS businesses are separated according to whether or not they also possessed a checking account. As shown in Column 4 of Table 2, 46 percent of the AFS-user households were without a checking account. As expected, the proportion of these households declines at higher income levels, falling to 20 percent of all households in the highest income quartile. Interestingly, the majority of households patronizing AFS businesses also have a relation with the formal financial sector. Specifically, 54 percent of all households utilizing AFS services also have a checking account (Column 5). This suggests that having physical access to a formal financial institution does not necessarily preclude use of AFS services. Additional research is presently underway to gain insights into the extent by which particular AFS products or services are utilized by these households.[4]

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Table 3
Primary Sources of Home Financing

	n	Mean Interest Rate (%) (nominal)	Mean Loan Amount ($1996)	Median Purchase Price ($1996)	Mean Household Income ($1996)
Formal					
Bank	22	7.3 (19)	82211 (21)	102210 (19)	43589 (21)
Mortgage Company	13	10.4 (11)	82613 (13)	97006 (13)	67380 (10)
Finance Company	3	10.7 (3)	61948 (3)	74221 (3)	57500 (2)
Government Agency	3	6.7 (3)	57340 (2)	76829 (3)	47500 (2)
Other Formal	5	30.5 (2)	61370 (3)	116896 (5)	37429 (4)
Undeclared Formal	1	-	-	144928 (1)	76000 (1)
Total Formal	47	9.6 (38)	78215 (42)	92734 (44)	50622 (40)
Percent of Homeowners	61				
Informal					
Relatives	3	0 (1)	72962 (2)	160861 (3)	39500 (2)
Social Organization	2	4 (2)	111532 (2)	11532 (1)	1185 (1)
Undeclared Informal	3	-	-	119595 (2)	34333 (3)
Total Informal	8	2.7 (3)	92247 (4)	50272 (6)	30531 (6)
Percent of Homeowners	10				
Personal Savings	12	-	-	137818 (11)	50986 (8)
Percent of Homeowners	16				
No Source Reported	10	-	-	82870 (3)	49750 (8)
Percent of Homeowners	13				
Total Homeowners	77				
Percent of Sample	40				

Notes:
Median year of all house purchases is 1970. Figures relate only to the single largest loan used by each household.
Number in parentheses indicates reported observations used to construct means.

Formal and Informal Financial Markets *continued from page 16*

Table 4
Household Responses to Financial Setback

	All Sources of Financial Setback	Illness or Death	Unemployment	Increase Expenses
Responses				
Formal Financing	8	3	6	5
Informal Financing	16	17	17	6
Use Existing Assets	20	12	11	9
Increase Labor	8	2	13	9
Reduce Consumption	13	5	12	7
Delay/Fail to Pay	16	7	16	3
Total Number of Households Responding	**56 (100%)**	**23 (41%)**	**29 (52%)**	**14 (25%)**

Notes:
Sum of responses is greater than total number of households responding due to multiple responses. Number in parentheses indicates percent of total households that experienced financial setbacks. There were 5 households that cited responses as "other."

To better understand the use of formal and informal markets as a source of financing, we turn to information about the primary (largest) financial sources used by households in the home purchase process. As shown in Table 3, 40 percent of all respondents are homeowners, with the majority of home-buying activity financed primarily through the formal sector (61 percent). Personal savings also represented an important primary source of funds, with 16 percent of the households purchasing their home entirely from personal savings. Only 10 percent of the homeowners used the informal market as a primary home financing source. Because the number of primary informal loans is relatively small, caution should be exercised when making direct comparisons. Even so, we observe that some of the loan terms differ between the formal and informal markets (e.g., lower interest rates for informal loans). In addition, households receiving a relatively large loan through informal sources also had a much lower mean income level than households financed by the formal sector. It is reasonable to believe, however, that informal financial markets are most often used as a secondary source for home financing. In fact, 23 percent of all homeowners utilized informal sources to finance some portion of their home purchase.[5]

A unique feature of our survey is its collection of information about a household's response to events that occurred over the previous five-year period causing financial distress. As shown in Table 4, these household responses include seeking financial assistance from formal and informal sources, changes in labor market activity and other behavioral responses. The most frequently cited events resulting in financial distress included substantial unemployment or periods of unusually low income, death or illness of a family member, and large increases in living expenses. Table 4 provides some insights into the response patterns of households facing financial distress as well as the response pattern conditioned on a specific financial setback. Overall, 29 percent of all households (56 of 194) reported having experienced at least one financial setback over the previous 5-year period. The most common reaction by households was the liquidation of existing assets (e.g., savings and checking accounts). Seeking financial assistance from informal sources and delaying or failing to pay debts also were frequently utilized responses. Conversely, formal sources were infrequently used when a financial setback occurred.

Policy Implications and Recommendations

While caution must be exercised regarding the policy implications that can be drawn from any one study, our research supports several recommendations. First, educational programs, conveying the benefits from having a deposit relationship and informing consumers about AFS costs, appear to be warranted. In essence, these programs will help consumers, especially lower-income households, make informed choices among financial products and services. Second, our findings confirm the need to learn more about the demand for and use of formal financial products. Community development lending opportunities as prescribed by the Community Reinvestment Act (CRA), flexible consumer loan programs, and low-cost deposit accounts could prove useful in meeting the financial service needs of lower-income and minority households. Finally, this study highlights the potentially important roles that informal markets may play as a source of financing. Continued research is needed to extend our understanding of the circumstances and characteristics inherent to a successful informal network, especially within racial/ethnic communities.

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Endnotes

[1] The opinions expressed in this study are the authors' and do not necessarily represent the opinions of the Federal Reserve Bank of Chicago or the Federal Reserve System. This article is an abbreviated version of an article published in the Consumer Interests Annual, Volume 45, 1999.

[2] As discussed by Caskey (1994), in several states including Illinois, firms that cash customers' checks for a fee are referred to as 'currency exchange' businesses. Hence, a currency exchange firm and a check cashing outlet function in virtually the same way, with the majority of revenues derived from check cashing fees.

[3] The Chatham project also included a random survey of small business owners. See Huck, et al., (1999). The survey instrument was adapted from a survey developed for a study of Little Village, a predominantly Hispanic community situated on the southwest side of the city of Chicago. The Little Village survey was originally developed and funded by the Center for the Study of Urban Inequality at the University of Chicago. For a discussion of the survey instrument, see Bond and Townsend (1996).

[4] As pointed out by Caskey (1997), it is possible that services provided by AFS businesses are uniquely different than the services offered by a deposit institution. Also, consumers may not be fully aware of the cost differential between these two types of financial service providers. This view also is supported by Fontana (1997). Conversely, Koonce, et al. (1996) offer evidence suggesting that consumers do know that price differentials exist between AFS businesses and formal financial markets.

[5] Detailed information about the use of informal sources in the home financing process is available from the senior author. ■

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- Currency received and counted — $39.4 billion
- Unfit currency destroyed — $6.6 billion

Small Business Finance *continued from page 13*

relatively expensive source of ongoing credit, and it is not clear whether using less trade credit indicates a constraint or lack of need. However, being offered credit by a supplier, whether or not it is used, is clearly desirable as a potential source of funds.

One possible explanation for these patterns is that the various ethnic groups may differ in their access to ethnic networks formed by businesses and their suppliers. This explanation can be tested by looking at the use of trade credit in light of the ethnic relation between businesses and their suppliers. In general, suppliers of the same ethnicity as the business owner are not substantially more likely to offer trade credit. In addition, minority business owners are not substantially more likely to take up trade credit if it is offered by a supplier of the same ethnicity compared to a supplier of a different ethnicity. Thus, the differences across ethnic groups in the use of trade credit are not easily explained by the simple fact of how the ethnicity of a supplier matches with that of the business owner.

If these results prove to hold beyond these neighborhoods, the findings have wide impli-cations for our understanding of ethnic differences in business survival and growth, the decision to enter self-employment, and income and wealth accumulation. The importance of informal sources of funding suggests that this type of funding has some features that meet the needs of small businesses in these communities. Informal funding may be more flexible and better suited to providing relatively modest amounts of capital compared to the formal sector. However, an important advantage of formal credit institutions is their ability to efficiently mobilize large amounts of capital. Recognition of the strengths of both informal and formal sources of financing should be a part of programs and policies aimed at encouraging the flow of capital to small businesses. ■

The expanded version of this article, entitled: "Small Business Finance in Two Chicago Minority Neighborhoods," appears in the Federal Reserve Bank of Chicago publication Economic Perspectives, Second Quarter, 1999. For a copy of the expanded article, contact Public Affairs, Federal Reserve Bank of Chicago, 1-800-333-0894.

[1] We chose the following baseline characteristics eating/drinking place, high school education, proficient in English, no previous experience as an owner, aged 37 years, male, business started 12 years ago.

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These recommendations build on meetings the ARC has held with the President's National Economic Council and the U.S. Small Business Administration at the White House regarding President Clinton's proposed New Markets Initiatives. ARC believes the above recommendations will help ensure that the Appalachian region will be positioned to take full advantage of the President's new proposals. ■

For more information about ARC's Entrepreneurship Initiative, please contact Ray Daffner, Manager, Entrepreneurship Initiative, 202/884-7777.

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These upcoming conferences on community and economic development are being offered this fall. Watch for your invitations soon!

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Omamia, Minnesota – September 27-29, 1999 "Walking The Native Path Into The Next Century: Seeking Solutions Through Housing and Economic Development Opportunities." Sponsored by the Federal Reserve Bank of Minneapolis. Contact: 612-204-5075.

Chicago, Illinois – September 28, 1999 "An Interagency Symposium on Community Development Investments." Sponsored by the Federal Reserve Banks of Chicago, Dallas, Richmond, and San Francisco.Contact: Barbara Simms-Shoulders, 312-322-8232.

Des Moines, Iowa – October 5, 1999 "Building Successful Communities through Local Opportunities." Sponsored by the Federal Reserve Bank of Chicago and the Federal Home Loan Bank of Des Moines.Contact: Barbara Simms-Shoulders, 312-322-8232.

Chicago, Illinois – October 7-8, 1999 "It's Not Just Housing Anymore: Financing Community Development Goes Mainstream." Sponsored by the National Association of Affordable Housing Lenders. Contact: NAAHL at 202-293-9855.

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