ECONOMIC DEVELOPMENT WHERE IT'S NEEDED

Directing SBA 504 Lending to Lower-Income Communities

by
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and
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About the Authors

Daniel Immergluck is vice president of the Woodstock Institute. Dan has conducted research and written widely on community and economic development topics, including the Community Reinvestment Act, economic development finance, employment policy, empowerment zones, and small business lending programs. Prior to joining the Institute, Dan was with the Greater North-Pulaski Development Corporation in Chicago and, before that, the Ohio Department of Development. Dan holds a Masters in Public Policy from the University of Michigan and a PhD in Public Policy Analysis from the University of Illinois - Chicago.

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Introduction

With a portfolio of approximately $36 billion, the U.S. Small Business Administration is the largest single financial backer of small businesses in the nation. Since its beginning in 1953, the agency has provided over 700,000 general business loans totaling $94 billion. In fiscal 1996, the agency backed more than 52,000 loans, up from approximately 26,000 in 1992.[1]

While not as large as the agency's 7(a) guaranty loan program, the SBA's 504 development company program is a substantial source of government-backed development financing for small businesses. In fiscal 1996, the program totaled $2.5 billion in financing, up from $1.6 billion in 1995.[2] The 504 program provides long-term, 10- or 20-year financing for real estate, equipment and other fixed assets. The average size of 504 loans approved in fiscal 1996 was about $360,000. Due to its higher fixed costs and its long term, the program is used more for larger, fixed-asset projects than the 7(a) program, which is often used to finance working capital. Another difference between the 504 and 7(a) programs is the greater focus on job creation in the 504 program. In fact, 504 regulations generally call for job creation and retention impacts while the 7(a) does not. In particular, financed businesses are expected to create one job for every $35,000 of SBA-backed financing. The nature of 504 financing and its job creation requirements result in the program favoring the financing of manufacturers and wholesalers versus service and retail firms, which have fewer fixed assets and may create fewer jobs on a firm-by-firm basis.

The SBA comes under perennial scrutiny by Congress. Much of this scrutiny has concerned the levels of subsidy and loss rates associated with the agency's various programs, including some of its newer initiatives aimed at smaller borrowers. While some of these concerns may be valid, a more fundamental issue receives much less attention: the appropriate rationale for government involvement in supporting financing of individual small businesses. This report analyzes data on 504 lending for the entire nation and for the Chicago metropolitan area to discern whether this SBA program is serving sound economic development purposes.

Sound Economic Development and the SBA

The SBA is expected to continue to play an important role in providing credit enhancements for individual small businesses across the country. The agency will most likely remain the single largest provider of such enhancements. Given this continued role, it is important to recognize that the most defensible rationale for federal government involvement in the financing of individual small businesses is an economic development rationale. If policies and programs support the creation and/or retention of jobs and economic activity in places and among communities in real need of economic development, then they are easily justified.

The available evidence shows that minority-owned firms, particularly African-American-owned firms, have more difficulty obtaining bank loans than nonminority-owned firms, even after controlling for the education and age of the owner as well as other business characteristics. Moreover, establishments located in minority neighborhoods have more difficulty obtaining credit than those located in nonminority neighborhoods.[3] Beyond the problems of access to credit in such markets, these communities are most in need of businesses and jobs. Lower-income, minority neighborhoods are appropriate targets for development finance that can spur jobs, physical improvements, and the availability of essential goods and services in an area. Minority-

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[1] The SBA fiscal year ends September 30.

[2] The program is not necessarily expected to increase in volume in 1997, due in part to some new fees and terms that make the program somewhat less attractive. These fees include increases in the guaranty fee and the addition of a participation fee charged to senior lenders.

[3] For evidence on the effects of race on access to business credit see Timothy Bates, *Banking on Black Business*, Joint Center for Political and Economic Studies, Washington, DC, 1993; Frank Ford, *Survey of Small Business Lending in Denver*, University of Colorado at Denver, Colorado Center for Community Development, Denver, Colorado, 1996; and Faith Ando, *An Analysis of Access to Bank Credit*, Center for Afro-American Studies, University of California at Los Angeles, 1988. For evidence on geography, see Bates, *Banking on Black Business*, 1993.

owned businesses are appropriate targets for economic development policies because they have been shown to employ minorities at substantially higher rates than white-owned firms. Recent research demonstrates that employment discrimination persists, particularly affecting the hiring of African Americans.[4] Thus, minority business development programs are a logical component of a broader strategy for improving the employment prospects of African-Americans, who continually suffer from unemployment rates more than two or three times those of whites.

At the same time, metropolitan areas continue to be plagued by problems of excessive decentralization or sprawl. The growing spatial isolation of those living in distressed urban and older suburban neighborhoods from the relocation of jobs and investment to distant suburbs has been recognized as a critical problem for the future of the American city. The number of high poverty neighborhoods has grown in most large cities, suggesting an increasing polarization of income and opportunity across metropolitan areas.[5]

Recognizing such problems, sound economic development policies should follow two general principles:

1. They should result in improved business development and employment opportunities for those who are arbitrarily denied access to economic opportunity, including minorities who may face barriers to financing or business relationships. The existence of bias in private markets is inefficient and counterproductive to the welfare of the entire economy.

2. They should result in a net increase in economic activity in locations where there is a greater need for such activity and where other policies have unintentionally discouraged investment. Moreover, they should benefit lower-income areas at rates higher than they benefit upper-income ones. This means encouraging the development of jobs, stores and service providers in areas that have borne the brunt of suburban sprawl and disinvestment, such as minority and lower-income neighborhoods. Creating jobs and economic activity in communities that need them most actually fosters a more efficient regional economy.

Timothy Bartik, a leading researcher on economic development policies, argues that federal economic development policy should promote targeted policies that further job growth in areas of high unemployment.[6] This might mean encouraging development in high-unemployment rural areas or in inner-city communities that suffer from poor access to employment in job-rich suburbs. Similar arguments might be made to promote the development of businesses that provide critical goods and services in lower-income areas.

In recent years, however, some have questioned the degree to which to the SBA serves those segments of the market which have been most neglected by private financial institutions: minority-owned businesses and firms in low- and moderate-income communities.[7] A 1995 report by the Congressional Office of Technology Assessment pointed out that:

It is difficult to justify the public purpose of SBA loans that are not targeted sectorally, spatially, or demographically. SBA and other publicly assisted business finance programs are often justified for their job creation benefit. However, it is not clear that providing funds to any and all business serves that goal.[8]

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[4] See Margery Turner, Michael Fix, and Richard Struyk*: Opportunities Denied: Opportunities Diminished: Discrimination in Hiring*. Urban Institute Press, Washington, D.C., 1991; and Harry Holzer, *What Employers Want: Job Prospects for Less Educated Workers*, Sage, 1996.

[5] See Paul Jargowsky, *Poverty and Place: Ghettos, Barrios and the American City*, Russel Sage Foundation, New York, 1997; and Myron Orfield, *Metropolitics: A Regional Agenda for Community and Stability*, Brookings Institution, Washington, D.C., 1997.

[6] Timothy Bartik, "Eight Issues for Policy Toward Economic Development Incentives," *The Economic War Among the States*, Federal Reserve Bank of Minneapolis, June 1996.

[7] See Alan Fisher, Chan U. Lee, and Patrick Zak, *No Credit for Those Who Need It: Uncle Sam Ignores Small and Minority Business*, California Reinvestment Committee, San Francisco, 1994; and Daniel Immergluck, *Moving to Economic Development: A New Goal for SBA Loan Programs*, Woodstock Institute, Chicago, 1995.

[8] *The Technological Reshaping of Metropolitan America*, Office of Technology Assessment, Washington, D.C., September, 1995, p. 40.

SBA loans, of whatever form, involve the use of government subsidy to benefit private businesses. The public purpose of such subsidy should be clear. Merely subsidizing small businesses, without regard to public purpose is not good policy. For example, if a firm obtains an SBA loan that allows it to produce its product at a lower price, the firm's principal competitor may be hurt. Jobs created at the first company may be largely shifted from the competitor firm. If the firm receiving the subsidy is located in a relatively affluent area and the competitor is located in a high unemployment area, the guaranty may have enabled employment to be shifted from a job-poor area to a job-rich one, an inefficient, inequitable, and probably unintended outcome. From a federal policy perspective, more is required to justify business subsidies than merely pointing to activity at specific firms that would not have occurred otherwise. It is important to look at the results of policies and programs and at which communities are served by these results.

SBA programs can and must be evaluated by the degree to which they foster efficient and equitable economic development, i.e., the development in communities that have relatively greater needs for economic activity, including lower-income neighborhoods and minority-owned businesses. Programs that primarily foster the expansion of nonminority-owned businesses into distant, more affluent suburban areas, where jobs, goods, and services are already in abundant supply, work against efficient and equitable economies.

The SBA 504 Program

The SBA 504 loan program provides small businesses with long-term, fixed-rate financing for fixed-assets, including the purchase and improvement of real estate and the purchase of equipment. The financing provided through the program generally covers up to 40 percent of project costs, with a bank covering 50 percent, and the borrowing firm contributing 10 percent. In some cases, borrowers are now required to provide 15-20 percent of project costs. The SBA is generally subordinate to the bank in terms of collateral position. Typical project sizes range from $400,000 to over $2 million. Technically, the loan is made by an SBA Certified Development Company, or CDC, which raises the funds through a sale of debentures which are guaranteed by the SBA. However, the CDC does not handle funds directly; funds flow through a fiscal agent for the SBA. The CDC is responsible for packaging, approving and submitting the loan to the SBA for final approval. After closing, the CDC is responsible for servicing the loan, including monitoring payment and collateral, but does not receive loan payments. Again, another party receives payments, and distributes payments and fees. CDCs, which are nonprofit entities whose primary business is economic development financing, earn fees based on loan packaging, review, and servicing.

SBA CDCs are local organizations, whose boards are required to be comprised of a certain mix of local economic development actors, including small business persons. Originally conceived under the pre-decessor SBA 502 loan program, CDCs were designed to be local so that services would be delivered in a way deemed most appropriate for the local area.

Referrals to CDCs for financing typically come from banks, particularly loan officers. High volume CDCs develop close relationships with lenders and rely on such lenders for their business. Banks have an incentive to utilize the 504 program because it provides them with excellent collateral coverage, leaving them exposed for only 50 percent of a project's costs. The 504 also provides affordable, fixed-rate financing to their customers. In the more highly competitive market for small business customers of recent years, lenders want to be able to offer many attractive financing options to their customers.

The fees generated by a CDC from 504 activity are significant; they include a processing fee of up to 1.5 percent of the 504 loan and a monthly servicing fee of up to 2 percent of the outstanding principle per year. Active CDCs with large portfolios have earned substantial revenues, in excess of $1 million annually. While CDCs are nonprofits, they can contract with for-profit firms, which can then extract sizable portions of these revenues through management fees. In many cases, CDC profits are used to support other important economic development purposes, especially when CDCs are affiliated with charitable-purpose, nonprofit community and economic development organizations. But in other cases, CDC revenues can be extracted by for-profit firms as simple profits. And because CDCs are given their franchise by the SBA, entry into the industry is not free and fees are not set based on competitive pressures, but by SBA action.

Trends in Lending to Minority-Owned Businesses: Progress in Recent Years

One goal of SBA programs should be to serve minority-owned businesses well and to encourage minority business development. The combination of minority-owned businesses' poor access to credit and their higher propensity to employ minority workers make them an ideal target for SBA programs. Indeed, the agency administers programs specifically targeted to serve minority-owned firms, including the Specialized Small Business Investment Company (SSBIC) program. It also administers a microloan program, through which it funds many microloan funds throughout the country, many of which focus on minority-owned businesses.

At the same time, however, the SBA's main loan programs -- the 7(a) and 504 -- continue to serve predominantly nonminority-owned businesses. In 1996, more than 80 percent of loans approved under these two programs went to such firms. The percentage of loans going to minority-owned businesses appears to

have increased, however, over the last four years.[9] The proportion of 7(a) loans going to minority-owned firms increased from 15 to 20 percent from 1992 to 1996. For 504 loans, the percentage increased from 9 to 15 percent. By way of comparison, according to the Census Bureau's Survey of Minority Owned Businesses, minority-owned firms accounted for no more than 13 percent of U.S. firms in 1992.[10] Thus, both the 7(a) and 504 programs appear to be serving minority-owned firms at rates exceeding their proportion in the economy.

Increases in lending to minority-owned firms may be due to one or more of three factors. First, Census Bureau data show that from 1987 to 1992, the number of minority-owned firms increased by 60 percent. If such trends continued past 1992, the pool of small businesses that might seek SBA loans would also have increased, creating an increased demand for SBA loans by such firms. Second, banks could have increased their attention to the minority-owned business market. Finally, the SBA itself could have directed more attention to minority-owned firms. These latter two factors are supply-side responses. Examining the breakdown of SBA 504 minority lending suggests that the first, demand-side explanation may be as or more important than the supply-side factors. Figure 1 and Table 1 show that, while minority lending has grown as a proportion of total 504 lending from 1992 - 1996, the bulk of the increase has been concentrated in the Hispanic (3.1 percent to 4.8 percent) and Asian (3.8 percent to 7.8 percent) categories, with little increase in the proportion of loans going to African-American-owned firms (1.4 percent to 1.6 percent). This is consistent with larger increases in business formation among Hispanics (76 percent) and Asians (61 percent) over the 1987 - 1992 period, suggesting the importance of the demand-side explanation.

[9] The magnitude of these increases is somewhat unclear due to substantial changes in the proportion of loans for which minority status is not known. From fiscal 1993 to 1995, the agency's reports show that the agency made progress in reducing the proportion of loans for which minority status was "undetermined." In the 7(a) program the proportion was 2.8 percent in 1992 and dropped to less than 0.2 percent in 1996. In the case of the 504 program, the proportion of approvals with undetermined minority status dropped from 4.9 percent of approvals to less than 0.1 percent. If many of the undetermined firms in 1992 were actually minority-owned, the reported increase in the proportion of loans going to minority-owned firms would be substantially overstated.

[10] Because this survey excludes regular C-corporations, it is likely to overestimate the proportion of all small businesses owned by minorities.

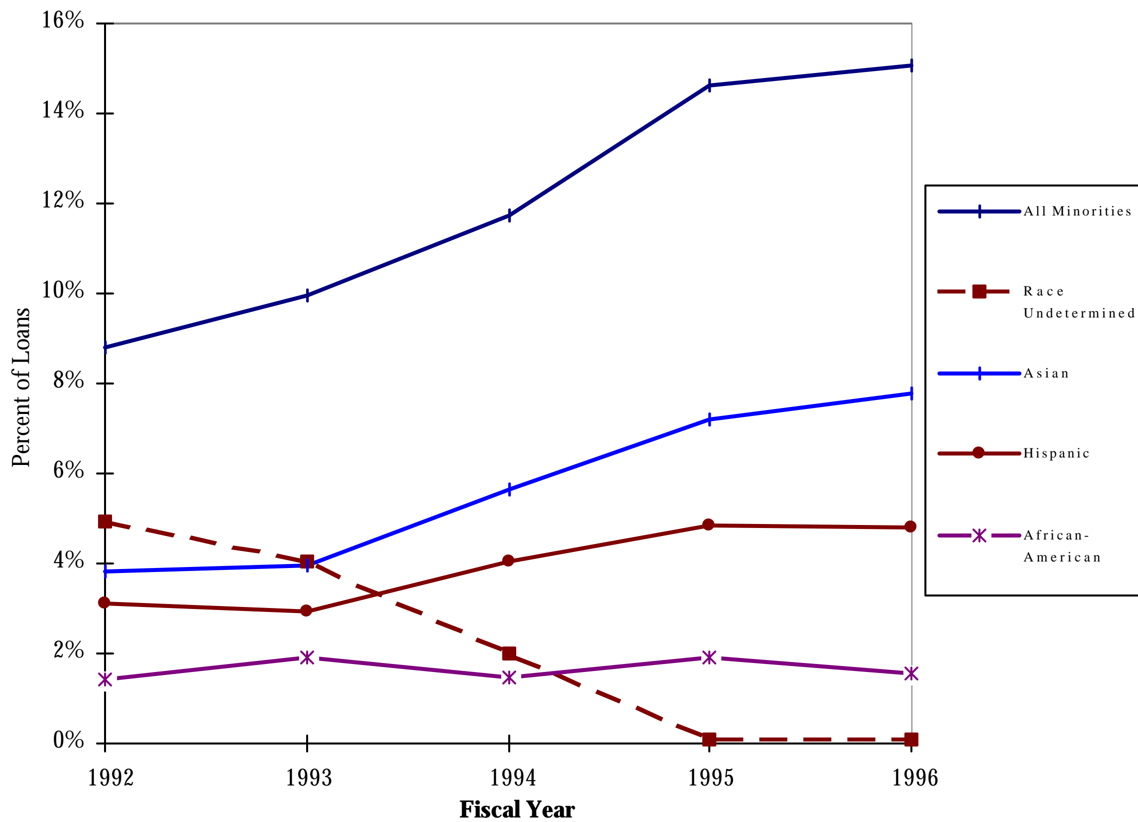

Table 1
SBA 504 Loans by Race, 1992-1996

	Number of Loans					As a Percentage of Total Loans				
	1992	**1993**	**1994**	**1995**	**1996**	**1992**	**1993**	**1994**	**1995**	**1996**
African-American	30	49	57	86	107	1.4%	1.9%	1.5%	1.9%	1.6%
Hispanic	65	75	157	219	329	3.1%	2.9%	4.1%	4.9%	4.8%
Asian	80	101	219	324	535	3.8%	4.0%	5.7%	7.2%	7.8%
All Minorities	185	254	455	660	1,036	8.8%	9.9%	11.7%	14.6%	15.0%
White	1,809	2,196	3,340	3,845	5,841	86.3%	86.0%	86.2%	85.3%	84.8%
Race Undetermined	103	103	78	4	7	4.9%	4.0%	2.0%	0.1%	0.1%
Total	2,097	2,553	3,873	4,509	6,884	100%	100%	100%	100%	100%

One major reason to support the targeting of development financing to minority-owned firms is the fact that such firms tend to employ minorities at high rates. This is an especially important justification for financing African-American firms, since African-Americans suffer from the highest unemployment rates of any minority group and suffer from significant employment discrimination. Unfortunately, the 504 loan program does not serve this segment of the market at a substantial rate, with loans to African-American firms accounting for less than 2 percent of all loans. (African-American firms accounted for as much as 3.6 percent of all firms in 1992.) While not as large as increases in other minority business sectors, the increase in African-American-owned firms has been substantial, exceeding 46 percent over the 1987-1992 period. If such trends have continued, we might expect more than the modest growth in 504 lending to such firms from 1992 to 1996.

In short, more 504 loans are going to minority-owned firms than in the past. Some of this may be due to increased attention to minority businesses by the SBA or by banks. However, a substantial portion of the increase is likely due to demand-side, demographic factors. Moreover, the program is not particularly effective at reaching African-American-owned firms.

The 504 program continues to serve predominantly nonminority-owned firms. While the agency has increased its lending to minority-owned firms, the program does not fulfill the goals of sound economic development solely by its record in supporting minority-owned businesses. This requires us to look at the program's spatial patterns to determine whether the program, in general, meets our second criteria of sound economic development -- supporting business development in places in need of jobs and economic activity.

Geographic Patterns of 504 Lending: Findings from Chicago

The chief concern of this report is the geographic distribution of SBA 504 loans. Does the program favor areas most in need of economic development? In metropolitan areas, this means communities in need of jobs, physical investment, and basic retail goods and services. This is not to suggest that SBA programs should focus exclusively on such areas, or that the agency should back imprudent ventures in communities that cannot support them. Rather, the agency should work to find ways to support business development that provides jobs and economic activity where they are needed. At a minimum, the agency should ensure that its programs do not subsidize or exacerbate development patterns that work to the detriment of lower-income communities and their residents. There is cause for concern here. An earlier Woodstock Institute study of 7(a) lending in the San Antonio area, where the agency's LowDoc program was introduced, found that, in a one-year period following the introduction of the LowDoc program, nonmanufacturing firms in lower-income zip code areas received only 34 percent of the 7(a) loans and 33 percent of loan dollars, despite these zip codes accounting for 55 percent of the nonmanufacturing establishments and 54 percent of the sales and receipts, per the 1987 U.S. Economic Census.[11]

In order to examine the geographic patterns of the 504 loan program, we obtained and examined data for 504 loans approved over a four-year period, from fiscal 1992 through fiscal 1996.[12] We then organized loans for the 6-county Chicago metropolitan area by sector and zip code. The 340 SBA 504 loans made in the 6-county area over the 4-year period break out by industrial sector as shown in Figure 2. The dominant sectors include manufacturing, services, wholesale and retail, accounting for 91 percent of all 504 loans. It is useful to compare this breakout to the mix of businesses with at least one employee in the 6-county area, as shown in

[11] Manufacturing firms were excluded due to a lack of detailed data on firm locations. See Immergluck, *Moving to Economic Development: A New Goal for SBA Loan Programs*, Woodstock Institute, Chicago, 1995, for more information.

[12] The SBA fiscal year ends September 30.

Figure 3. The mix of 504 borrowers is much more heavily concentrated in manufacturing and wholesaling, and less concentrated in retail and services, than are firms in the area overall. This difference in industrial mix is somewhat expected due to the nature of the financing, which is well suited to industrial plants and warehouses, and due to job creation and retention requirements.

Figure 4 shows the locations of 504 loans approved over the four-year period in the Chicago area, as well as 1989 median household income by zip code.[13] Less than 15 percent of all loans went to firms in the city of Chicago, even though the two CDCs accounting for 90 percent of Chicago area 504 loans are certified to do loans throughout the city as well as in the suburbs.

The distribution of loans in Figure 4 shows that most loans are approved in higher-income areas. The greatest concentrations of loans across the metropolitan area lie in middle- and upper-income suburbs in DuPage and Kane counties. In all counties throughout the region, loans tend to be made in higher-income areas within them. Of the relatively small number of loans approved in low- and moderate-income areas, most are located on Chicago's North and Northwest sides. In general, it appears that the program is not well targeted to lower-income communities.

To identify whether the 504 lending patterns shown in Figure 4 underlie a bias toward either lower- or upper-income communities, we compared the distribution of 504 loans to the distribution of businesses in the region. However, because the 504 program is not designed to serve all types of businesses uniformly, but especially suits those with substantial fixed asset financing needs, it is not appropriate to compare the locations of all 504 loans directly to the locations of all businesses. If one were to do this, one would see the SBA serving businesses better in areas that happened to have an industrial mix similar to that of the 504 program as a whole. A better approach is to analyze 504 patterns one sector at a time for the four sectors that constitute a substantial segment of 504 activity: manufacturing, retail, service, and wholesale.

If 504 lending patterns favor lower-income over upper-income areas as we suggest they should, we should be able to detect this by comparing the distribution of loans across zip codes for each sector to the distribution of businesses in that sector. To determine the distribution of firms by sector across Chicago area zip codes, we used 1996 Dun and Bradstreet data. Because many small firms are essentially self- employed individuals and very unlikely to require 504-type loans, we only considered businesses with at least one employee, not counting the owner. We also compared loan distributions to the distributions of firms with nine or more employees to examine whether excluding very small firms, which are less likely to need fixed-asset financing, affects our analysis.

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[13] Each loan is indicated by a dot which was placed at random within a zip code. Zip codes which are "Not in Study" have zero loans and/or zero businesses in that sector.

Figure 2
Distribution of SBA 504 Loans Approved in the Chicago Area by Number of Loans, 1992 - 1996

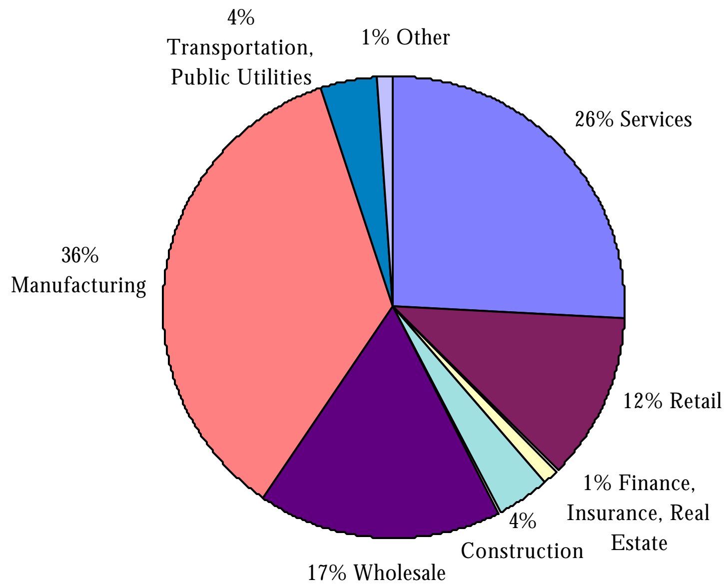

Figure 3
Distribution of Businesses in the Chicago Area by Number of Firms, 1996

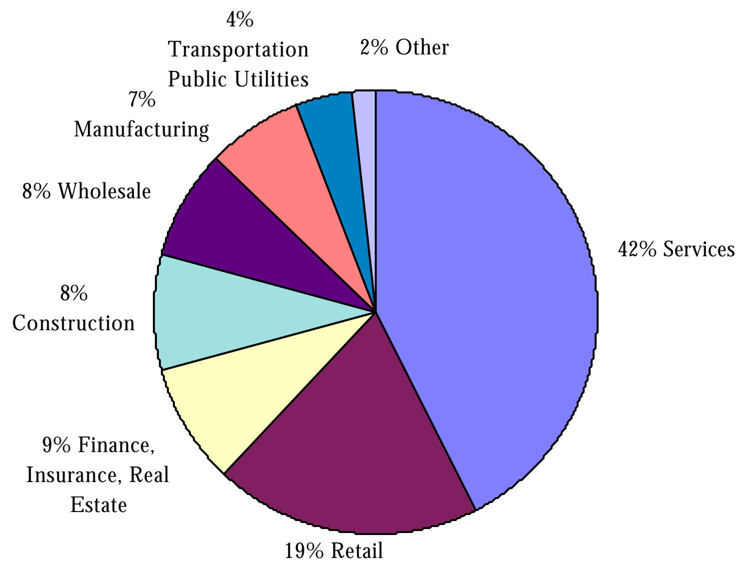

Figure 4: Median Household Income and SBA 504 Loans
1992-1996

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Figures 5 through 8 show the distribution of 504 loans across lower- and upper-income zip codes for each sector, and compare these distributions to those of businesses with at least one employee and to the distribution of those with nine or more employees. Table 2 provides the raw data associated with these figures. Also shown in Table 2 are lending rates per 1,000 businesses. For all but the service sector, lending rates in higher-income zip codes are generally two to three times higher than those in lower-income zip codes. In the service sector, lending rates are roughly similar across different types of communities, with a slight favoring of lower-income areas.

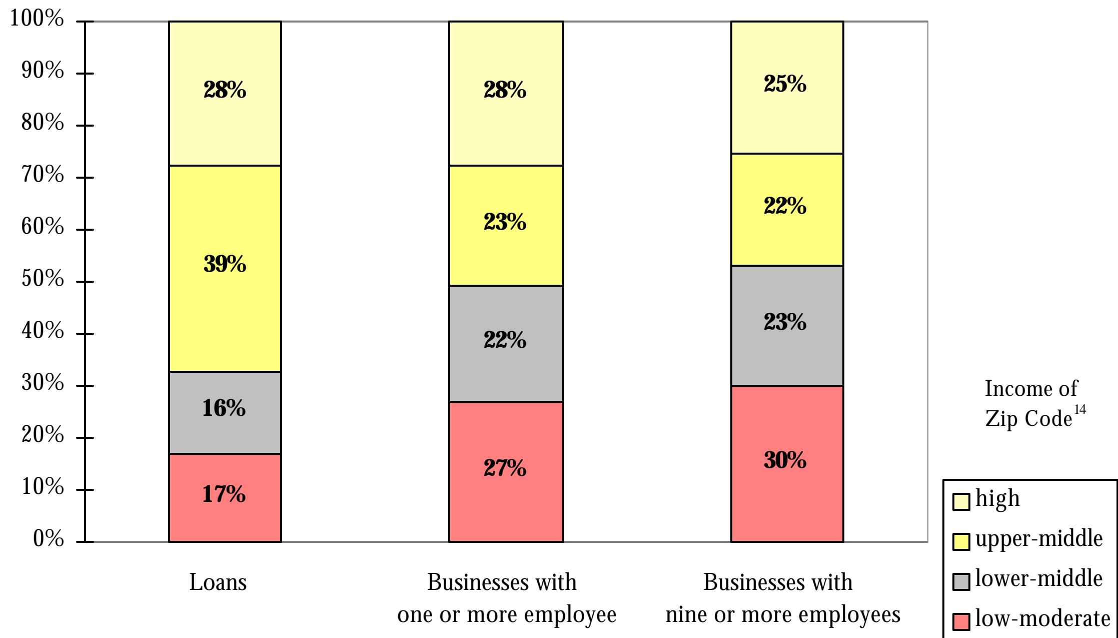
In the case of manufacturing loans, 33 percent of all loans were approved to businesses in low-moderate and lower-middle income zip codes, those with median household incomes below $39,788 in 1989. Yet businesses in these areas account for 49-53 percent of all small businesses, depending on whether firms employing fewer than nine employees are counted. Only 17 percent of 504 loans to manufacturers are approved in low- and moderate-income areas, while these areas contain 27-30 percent of manufacturers in the 6-county area. Figure 9 shows the spatial distribution of 504 lending rates for the manufacturing sector. The highest lending rates are in upper-income Kane and DuPage counties and in parts of Will and McHenry counties.

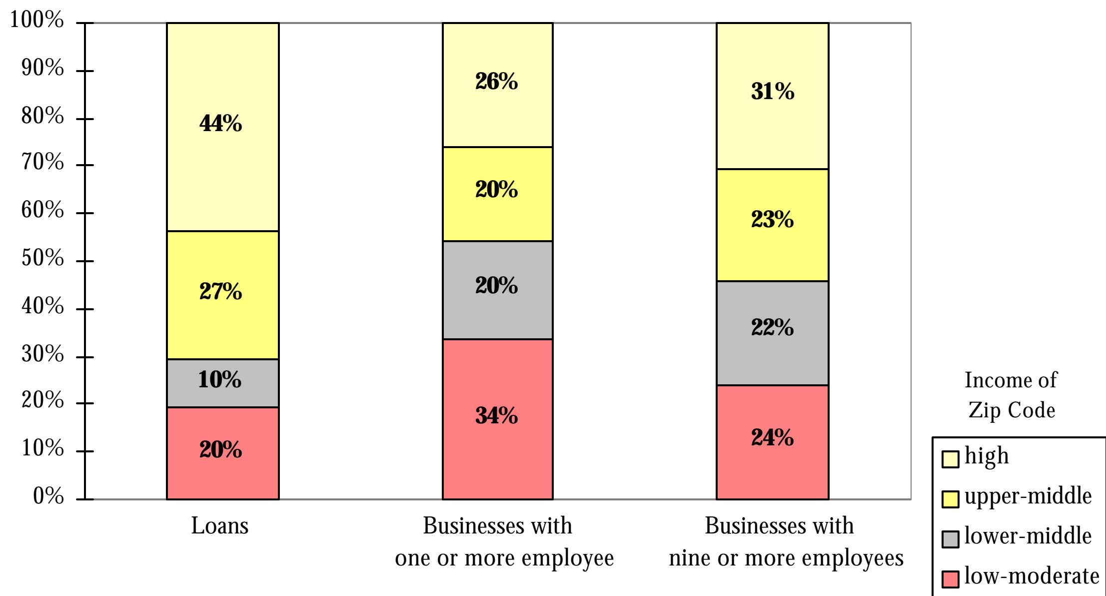
In the retail and wholesale sectors, the patterns are similar to those in the manufacturing sector. Only 30 percent of 504 loans were approved to retail businesses in low-moderate and lower-middle income areas, while these areas account for 46-54 percent of retail firms. A significant portion of these loans are eating or drinking establishments (29 percent), businesses which tend to locate in higher-income areas. Seventy-five percent of restaurants receiving loans are located in zip codes with 1989 median incomes ranging from $41,000-$64,000. As shown in Figure 10, lending rates are highest in Kane and DuPage counties.

In the wholesale industry, 32 percent of 504 loans were approved in low-moderate and lower-middle-income areas, while these areas account for 42-43 percent of wholesalers. Figure 11 shows that the highest lending rates are concentrated in the western suburbs where DuPage, Kane and Cook counties border each other. Portions of Lake County and a few zip codes scattered around the city of Chicago also have high rates of wholesale lending.

The service sector is the one sector in which more 504 loans are approved for firms in lower-income areas than would be expected based on the spatial distribution of firms. Fifty percent of loans are approved for firms in low-moderate and lower-middle income areas, while these areas contain 44-47 percent of all service firms. The difference between the actual distribution of loans and expected distribution based on location of firms, however, is not very large. The highest lending rates as shown in Figure 12 are located in Will County, with smaller concentrations in all other counties.

These maps make it clear that 504 loans are not being made in lower-income and central city communities at substantial rates. The high lending rates in middle- and upper-income suburbs and in newly developed areas suggests that this SBA program may actually be subsidizing central city job loss and suburban sprawl.





[14] Income categories for all figures: Low-moderate = under $33,152; Lower-middle = $33,152-$39,787; Upper-middle = $39,788-$47,024; High = over $47,024.

Figure 7
Distribution of 504 *Wholesale* Loans and Businesses by Income of Zip Code

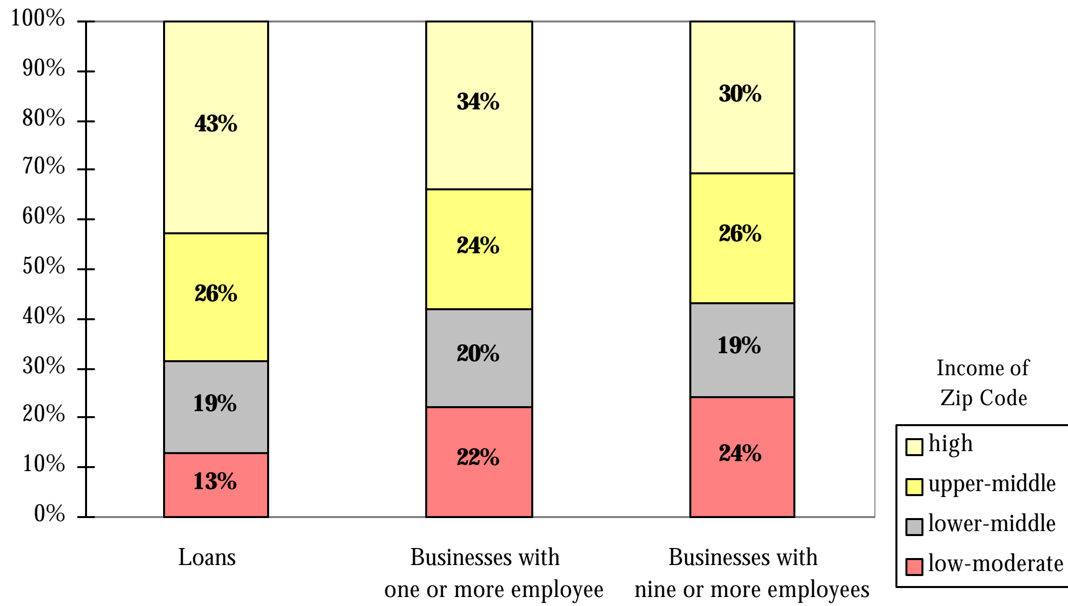


Figure 8
Distribution of 504 *Service* Loans and Businesses by Income of Zip Code

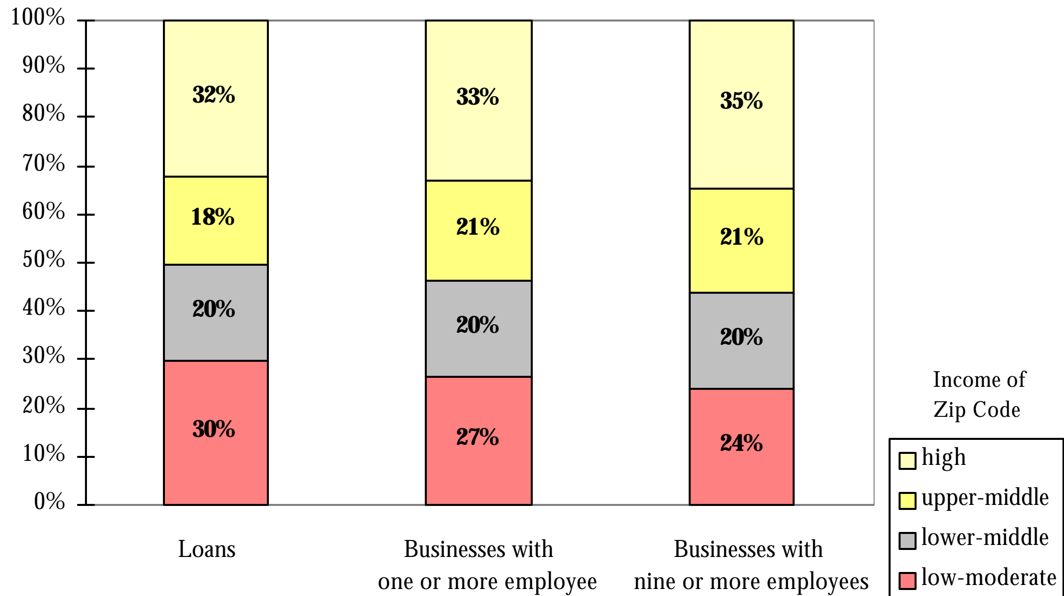


Table 2
SBA 504 Loans and Businesses by Income of Zip Code in Chicago Metropolitan Area

	Low-Moderate	Lower-Middle	Upper-Middle	High	Total
Manufacturing					
number of loans	20	19	47	33	119
number of firms*	4,902	4,071	4,207	5,073	18,254
number of firms**	2,637	2,033	1,894	2,219	8,783
number of loans per 1,000 firms*	4.08	4.67	11.17	6.50	6.52
number of loans per 1,000 firms**	7.59	9.35	24.81	14.87	13.55
Retail					
number of loans	8	4	11	18	41
number of firms*	16,117	9,710	9,553	12,430	47,810
number of firms**	2,834	2,555	2,744	3,601	11,735
number of loans per 1,000 firms*	0.50	0.41	1.15	1.45	0.86
number of loans per 1,000 firms**	2.82	1.56	4.01	5.00	3.49
Service					
number of loans	26	17	16	28	87
number of firms*	26,194	19,334	20,708	32,563	98,799
number of firms**	4,359	3,564	3,867	6,282	18,073
number of loans per 1,000 firms*	0.99	0.88	0.77	0.86	0.88
number of loans per 1,000 firms**	5.96	4.77	4.14	4.46	4.81
Wholesale					
number of loans	7	10	14	23	54
number of firms*	4,353	3,842	4,777	6,614	19,585
number of firms**	1,185	935	1,293	1,497	4,911
number of loans per 1,000 firms*	1.61	2.60	2.93	3.48	2.76
number of loans per 1,000 firms**	5.91	10.69	10.82	15.36	11.00

***Includes firms with one or more employee**
****Includes firms with nine or more employees**

Figure 9: SBA 504 Loans per 1,000 Businesses, Manufacturing Sector
1992-1996

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Figure 10: SBA 504 Loans per 1,000 Businesses, Retail Sector
1992-1996

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Figure 11: SBA 504 Loans per 1,000 Businesses, Wholeslae Trade Sector
1992-1996

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Figure 12: SBA 504 Loans per 1,000 Businesses, Service Sector
1992-1996

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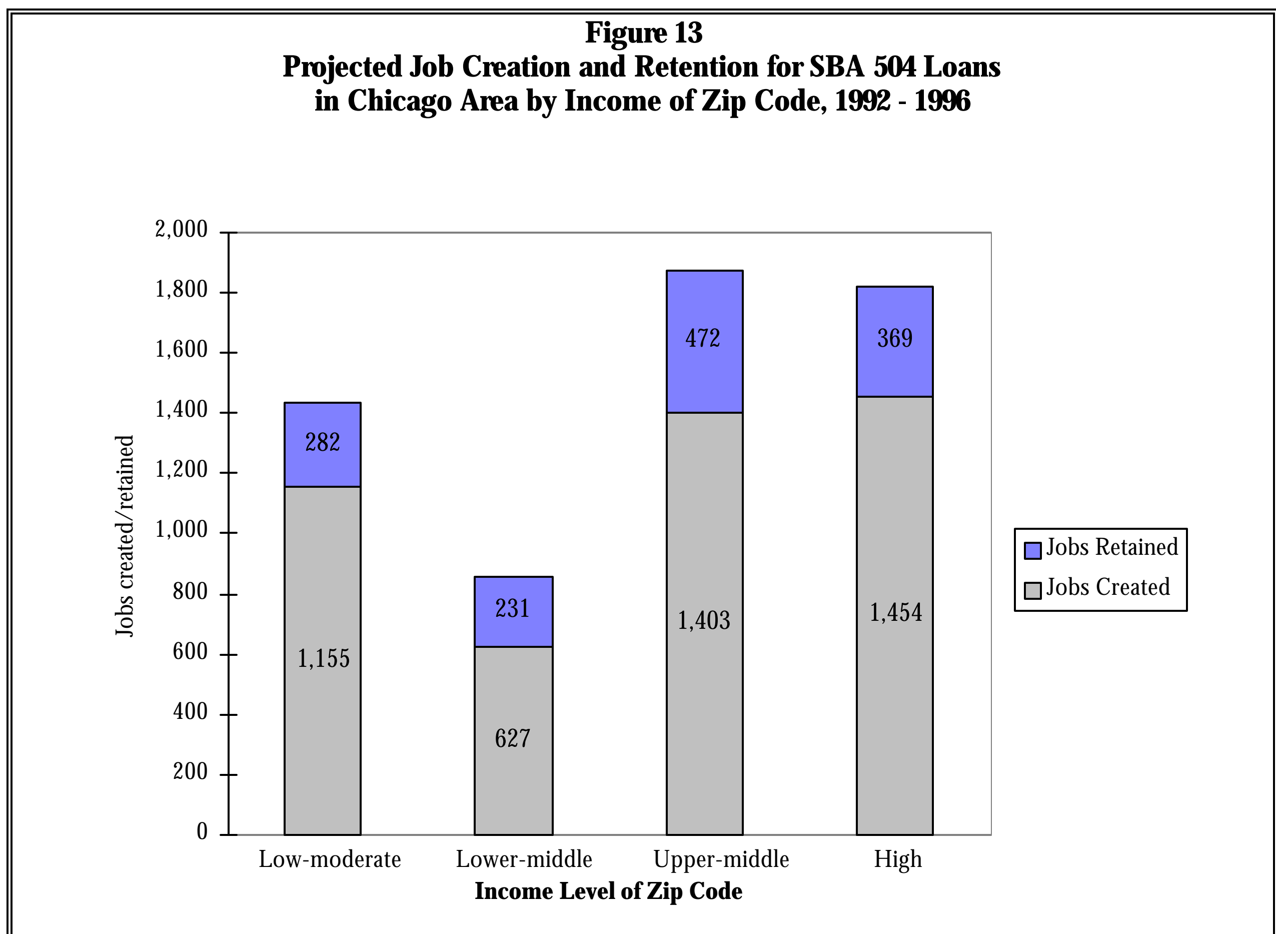
Job Creation and Retention

When firms apply for 504 loans they are asked to estimate the number of jobs that will be created and retained due to the project being financed. Figure 13 shows the distribution of projected job creation and retention for the Chicago area loan approvals examined here, broken out by income of zip code.[15] Projected job creation in low-moderate and lower-middle income zip codes accounted for only 38 percent of all jobs projected to be created by the loans studied. Similarly, low-moderate and lower-middle income areas accounted for only 38 percent of all jobs projected to be retained by the loans studied. Low- and moderate-income communities, those with median incomes below $33,152, accounted for only 25 percent of job creation and 21 percent of job retention. Thus, most of the job creation and retention claimed under the 504 program is occurring in upper-middle and high-income communities, often far from higher-unemployment, lower-income neighborhoods.

Figure 13
Projected Job Creation and Retention for SBA 504 Loans in Chicago Area by Income of Zip Code, 1992 - 1996



[15] Job creation and retention figures are projected at the time of loan application. The validity and accuracy of these projections is not considered here.

Conclusions and Recommendations

The analysis above shows that, while the SBA 504 program predominantly serves nonminority-owned firms, the proportion of loans going to minority-owned businesses has increased in recent years. A continuing problem for the program is its failure to reach African-American-owned firms at substantial rates. The greater problem found with the distribution of loans, however, is a geographic one, with lending-per-business rates being, in general, much higher in upper-income areas than in lower-income ones.

Why is SBA 504 lending skewed away from lower-income urban communities? It is important to recall the source of applications for 504 financing. As described above, CDCs rely on referrals from bank loan officers for their applicants. While CDCs may do direct marketing, they often rely on a network of loan officers familiar with the program as a more cost-effective strategy. Because banks are the source of applications, bank practices are the major determinant of any geographic patterns of 504 lending. We know that banks' small business lending patterns have favored nonminority, more affluent neighborhoods.[16] Only recently has there been any serious attention to applying the Community Reinvestment Act to small business lending, and until later this year, no geographic data on commercial lending patterns will be available.

By relying on bank marketing and referrals, the 504 program may be subsidizing and exacerbating geographically skewed lending patterns to the detriment of lower-income areas. Proactive SBA policies are needed to target lending more to lower-income communities.

Despite the political rhetoric that often surrounds the future of the SBA, the agency's activities, like those of any government agency, should ultimately be evaluated based on how they affect communities and individuals and not on how they affect some ill-defined set of small businesses. Merely increasing the number of loans the agency guarantees or makes to small businesses is not a sufficient measure of success. In fact, if a program subsidizes the inefficient migration of economic activity out of central cities, or out of minority communities, the program is inconsistent with principles of efficient and equitable economic development. Sound policy requires the SBA to encourage lending to communities that are most in need of businesses and jobs.

Some have argued that any focus on lending to underserved areas will dramatically increase losses incurred by the SBA. Because they have historically been subject to private sector disinvestment supported by public policy, some lower-income communities may be more subject to changing economic conditions than more affluent markets. This is, in fact, reason to target economic development resources to these areas, where public policy can affect private lending and investment decisions and help combat historical patterns of disinvestment. This is not to suggest that double-digit loan loss rates are appropriate for SBA programs; there are many examples of successful small business financing programs that target underserved markets without suffering from large loan losses.[17] However, the SBA should expect somewhat higher losses than conventional bank portfolios; otherwise it is unlikely to be having a significant effect. Congress and the agency must recognize that addressing historically disinvested and underserved markets will carry some costs.

The 504 program has many features which could contribute to sound economic development; it utilizes a local delivery mechanism that can enable financing to be targeted to where it is most needed, it includes some job creation requirements, it finances fixed assets that are relatively immobile, and it requires only a subordinate position on available collateral. The last feature, subordination, is particularly appropriate for sound economic development financing programs. Subordinated debt is needed most in lower-income areas

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[16] Bates, 1993.

[17] See Daniel Immergluck and Samantha Weinstein, "Targeted Small Business Lending: Alternative Approaches and Best Practices in Urban Markets," *Economic Development Commentary*, Volume 20, Number 3, Fall 1996.

which are in need of development, because uncertainty about future property values may make lenders reluctant to lend on real estate. In high-growth and more affluent communities, there is less uncertainty about land values and their appreciation, so that access to subordinate financing is less needed. Despite the fact that many features of the program allow for the promotion of sound economic development, regulations are not sufficient to encourage lending in the lower-income areas most in need of development.

Recommendations to promote the use of the 504 for sound economic development purposes include:

1. Congress and the SBA should affirm an active role in promoting equitable and efficient economic development. Government subsidy or sponsorship should not be based solely on the notion of increasing access to small business credit without regard for the development consequences of the actual lending patterns it supports. While operating procedures for the 504 program include some minimally higher loan limits for loans in higher unemployment areas, in practice the program is not targeted. In fact, in three of four major sectors, the program favors higher-income areas over lower-income ones at substantial rates. *The SBA should set goals and report regularly on its overall progress in increasing the proportion of its lending going to lower-income communities and minority-owned businesses; the latter should be broken out clearly by racial and ethnic category.* This policy follows the approach currently applied to government-sponsored enterprises in the housing secondary finance markets (e.g., Fannie Mae). The agency should seek public comment on appropriate methods for determining goals.

2. The SBA should continue its progress in increasing the percentage of 504 loans going to minority-owned businesses, especially those in job creating businesses. Minority firms employ minorities at substantially higher rates than white-owned firms. Thus, minority borrowers, particularly African-American-owned firms, can have a disproportionate benefit on those suffering from employment discrimination and other barriers to employment. Unfortunately, less than 2 percent of SBA 504 loans go to African-American owned firms, while African-Americans suffer from the highest unemployment rate of any minority group. *CDCs should be required to set lending targets for all major ethnic and racial groups; these targets should substantially exceed each sector's proportion of the local economy. Moreover, CDC board composition should be required to include significant representation from the minority business sector.*

3. The agency should employ a comprehensive strategy to increase the proportion of 504 lending going to lower-income communities. Such a strategy must address three parties: the bank senior lender, the CDC, and the borrowing firm. To address bank senior lender practices, the agency should encourage banks to market the program more aggressively to lower-income urban neighborhoods. *Banks using the program frequently should be required to make a reasonable proportion of their corresponding senior loans to lower-income areas and to minority-owned businesses. After sufficient warning, banks not meeting minimum standards should be restricted from using the program.*

4. To address CDCs, the SBA should require them to serve lower-income segments of their market areas at higher rates. *CDCs should set and report on numerical goals for lending to lower-income communities in their regular annual reports. Reports should also indicate marketing efforts used to penetrate lower-income markets. CDCs meeting distributional goals should receive a relatively larger share of origination fees than those not meeting goals.*

5. To address borrowing firms, lower fees and more attractive terms should be used for areas in need of development. *Borrower fees should be reduced for businesses in lower-income areas. At a minimum, new fees added under the Small Business Programs Improvement Act of 1996 could be rolled back for businesses in lower-income areas. The agency should also consider permitting higher loan-to-value ratios in lower-income communities than for firms in more affluent areas.*

6. *An absolute prohibition should be imposed on the approval of 504 loans to nonminority-owned firms relocating from lower-income central-city neighborhoods to upper-income suburban areas.*

The above recommendations all concern SBA policy and practice. Another area of public policy is also relevant here. Currently, the four federal bank regulatory agencies are implementing Community Reinvestment Act regulations that were revised in 1995. One new feature of the regulations is to consider lending activities that have a "community development purpose" separate from conventional lending activities, thereby rewarding a bank for engaging in more creative and complex community development financing activities. As defined in interagency interpretive questions and answers, "community development" is deemed to include "all financing for small businesses or farms made through Small Business Administration programs, ..."[18] Yet, if SBA programs disproportionately serve upper-income communities, this definition does not fit well within the spirit or the letter of the Community Reinvestment Act. Only SBA loans -- or bank investments or other activities involving the SBA -- serving low- and moderate-income communities or to minority-owned businesses should be counted as community development loans when a bank receives its CRA performance evaluation.

Overall the SBA 504 program has proven to be an important, and generally effective, tool for small business development throughout the country. But the support of specific small businesses without a concern for who benefits from resulting development is not an appropriate role for the federal government. Only when SBA efforts are targeted towards underserved markets and communities will the program become a tool for sound economic development.

[18] See "Interagency Questions and Answers Regarding Community Reinvestment," Federal Financial Institutions Examination Council, Federal Register, October 21, 1996.