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Starting up when the economy's down: A snapshot of Minnesota's new entrepreneurs

By Michou Kokodoko

The recent recession and its widespread job losses have hit millions of families hard. Yet even during the toughest period of the recession, new businesses and employment opportunities were created, often by entrepreneurs who launched small-scale enterprises. In other words, at a time when most people tightened their belts and took fewer financial risks, thousands of entrepreneurs across the country mustered their courage and decided to try business ownership. Their decision raises some interesting questions: What do these new businesses look like? How were they financed? Why start a business during an economic downturn? And how do businesses started in downturns fare?

To answer these questions, we reached out to our banking and community development partner organizations that assist entrepreneurs with technical expertise or funding. We asked the partner organizations to identify entrepreneurs who started new businesses in Minnesota in 2008 or 2009. We focused on Minnesota because among the six states in the Ninth Federal Reserve District, it has the highest concentration of community development financial institutions (CDFIs) that are involved in fostering entrepreneurship.[1]

PHOTOGRAPH BY MARC NORBERG

Marilyn Schroeder, owner of Maris Hearing Center in Ivanhoe, Minn., is one of many entrepreneurs who founded businesses during the recent economic downturn.

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Ethics as a building block of economic growth: Global insights and Indian Country models

By Sue Woodrow

Over the last few decades, the movement by Native nations in the United States to rebuild complete systems of self-determined government has been impressive, and it continues at a remarkable pace. This article builds on work the Federal Reserve Bank of Minneapolis has been engaged in with partners across Indian Country to help provide tools to enhance and develop tribal governance and commercial law. It discusses another crucial aspect of good governance: an effective institutional framework to encourage and manage ethical behavior in both the public and private sectors. It offers insights about ethics management gleaned from studies from developing countries and highlights some model ethics infrastructure enhancements from Indian Country.

The case for ethics management

Hardly a day goes by without news of persons in business or the public sector who are embroiled in scandals over alleged ethics violations, sometimes rising to the level of criminal activity (i.e., corruption). Whether single incidents or longstanding practices, uneth-

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Research examines the receipt of earned income tax credits among welfare recipients

By Donald P. Hirasuna

Earned income tax credits are tax credits for individuals who work but have relatively low earnings. The credits serve as a work incentive by raising after-tax earnings, lowering income taxes owed, and in some cases resulting in a refund check that may help individuals pay for expenses.

This article highlights some of the supporting efforts and research dedicated to earned income tax credits, with particular emphasis on research into receipt rates among welfare recipients in Minnesota, where a substantive body of research has been conducted on state earned income tax credits and where the diverse economy and varied rural-metropolitan populations combine to form a microcosm of conditions in many other regions of the nation. The research suggests that lower incomes and other characteristics of welfare recipients who work make them less likely to receive the credit, compared to eligible individuals not on welfare. Nonetheless, according to data from the 1990s, most Minnesota welfare recipients eventually left welfare and received the earned income tax credit along the way, even though the typical speed of these transitions differed by education level, family structure, and other demographic variables.

A network of support

As of the 2010 tax-filing season, the federal government, 23 states, the District of Columbia, and two local governments offered earned income tax

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Research examines the receipt of earned income tax credits among welfare recipients

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credits.[1] Of the six states in the Ninth Federal Reserve District, Michigan, Wisconsin, and Minnesota currently offer credits of this type.

In a small storefront office in Minnesota's capital city of St. Paul, a young mother and welfare recipient named Tania works on her taxes with a volunteer preparer. The office, known as a VITA (Volunteer Income Tax Assistance) site, offers free tax preparation services to eligible individuals, including people with low earnings. Tania has come to the site to seek help in filing her tax returns and receiving federal and state earned income tax credits.

In addition to the volunteers who staff VITA sites, a large network of individuals is working to help make earned income tax credits an effective policy for people with lower earnings. Across town from the site where Tania is working on her taxes, representatives from nonprofit organizations; city, county, state, and federal agencies; and local universities form a working group that meets to consider ways to raise awareness and utilization of earned income tax credits. In state and federal legislative offices, legislators meet with staff to decide on the level of earned income tax credits. Throughout the country, researchers from universities, government offices, and nonprofit organizations provide information about the costs and benefits of earned income tax credits in order to support policymakers and, ultimately, help low-income individuals like Tania.

A continuing incentive to work

As noted above, earned income tax credits raise the incentive to work by lowering income taxes owed or, in some cases, resulting in a refund check. The credit begins at zero dollars for individuals without earnings. It then increases as earnings increase until it reaches a maximum, where it stays until earnings reach a threshold. The credit then diminishes back to zero. Researchers have found that federal and state earned income tax credits and their accompanying incentive to work have raised the employment rate of single mothers, reduced the rate of child poverty, and helped reduce welfare caseloads in the post-welfare reform era. Some of the research on Minnesota's earned income tax credit, the Working Family Credit (WFC), has focused on how many welfare recipients like Tania actually receive the credit.[2] Earned income tax credits may be especially relevant for Tania and other parents on welfare, since they are still eligible for the credit even after they have too much in earnings to qualify for welfare. Therefore, the credits provide a continuing incentive to work, even after parents leave welfare.

Historically, about 3 out of every 4 eligible individuals receive the earned income tax credit, which is a higher participation rate than that of most other programs aimed at low-income people, such as the former Food Stamp Program (now known as the Supplemental Nutrition Assistance Program, or SNAP) and Medicaid.[3] However, although earned income tax credits have been found to help parents stay off welfare, parents on welfare are less likely to receive them. For example, in Minnesota, roughly 62–66 percent of welfare recipients eligible for the WFC in a given year actually received it.

Benefits and costs

A significant number of parents on welfare do not receive earned income tax credits even when they are eligible.[4] So what accounts for this? Some researchers suggest that, at least in theory, individuals including parents on welfare will receive earned income tax credits as long as the benefits of receiving the credits outweigh the costs.[5] The benefits are the earned income tax credit dollars, which provide a financial boost for low-income families. The dollars can reduce end-of-year taxes owed, or in states like Minnesota where the income tax credit is refundable, some parents receive a refund, which may help pay for expenses.

The costs of receiving an earned income tax credit include more than the money that individuals pay for tax preparers, software packages, or pencils and pens. They include the work needed to receive the credit, such as finding tax records, gathering receipts, and filling out tax forms. Costs also more broadly include a lack of information about earned income tax credits, including the WFC. If parents on welfare have to expend additional effort to become informed about earned income tax credits, they may be less likely to file income tax returns and receive the credits. Across the nation, tax credit proponents are pursuing efforts to reduce these information costs. For example, the working group in Minnesota disseminates fliers about the federal and state earned income tax credits that are written in multiple languages and inform potential recipients about the amounts of the credits.

Another explanation for why parents on welfare receive earned income tax credits at comparatively low rates is that at any point in time, they have less in earnings than other low-income people, which makes them eligible for less in their state's earned income tax credit and thereby reduces the benefit of receiving the credit. However, this does not mean that all parents on welfare will be eligible for little in state earned income tax credits for the rest of their lives. Welfare recipients' earnings can increase over time. For example, in examining data on 1992 entrants into Minnesota's former welfare program, Aid to Families with Dependent Children, researchers find that the median distribution of real earnings rises from $9,968 in 1996, the fourth year past entry, to $16,641 in 1999, seven years after entry. Perhaps still a modest level of earnings, but nonetheless one where parents with two or more children would be eligible for a larger earned income tax credit even after accounting for inflation.

Picturing the percentages

The graphs on page 3 depict some key facts about WFC receipt rates among welfare recipients. For the period 1995–1999, Figure 1 shows the percentage of current and former welfare recipients who receive the WFC by earnings level and number of children. The graph lists separate amounts by number of children, since the state and federal earned income tax credits pay different amounts based on whether the individual has zero, one, or two or more qualifying children. The highest amounts are paid to parents with two or more qualifying children.

From the graph, parents on welfare who have two or more qualifying children and earnings below $5,000 receive the credit at rates below 65 percent. In comparison, between 75 and 80 percent of parents on welfare who have two or more children and earnings between $10,000 and roughly $25,000 receive the WFC. For earnings higher than $25,000, WFC receipt percentages begin to drop off again. Some of the

Figure 1 WFC Participation Rates by Earnings Level and Number of Qualifying Children, 1995–1999

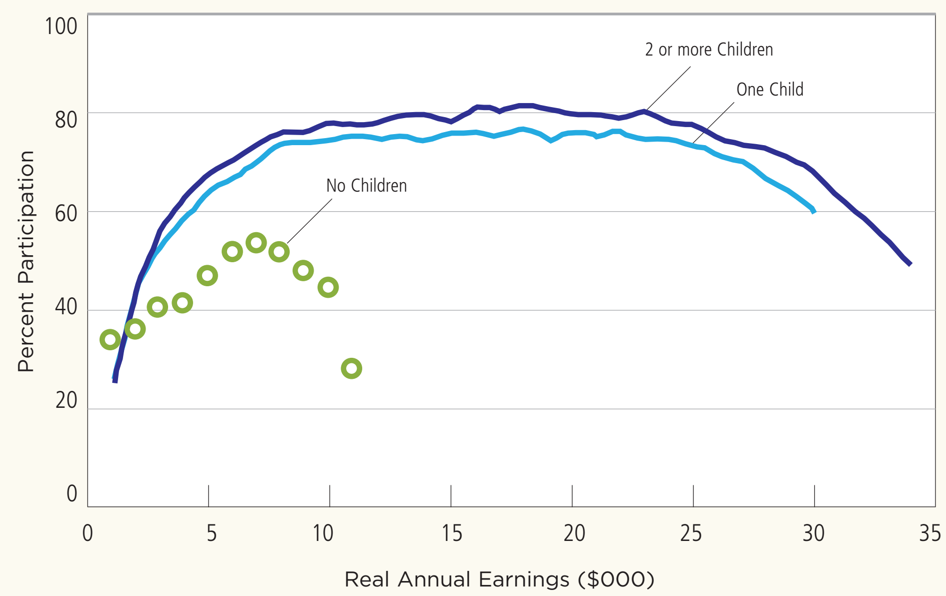
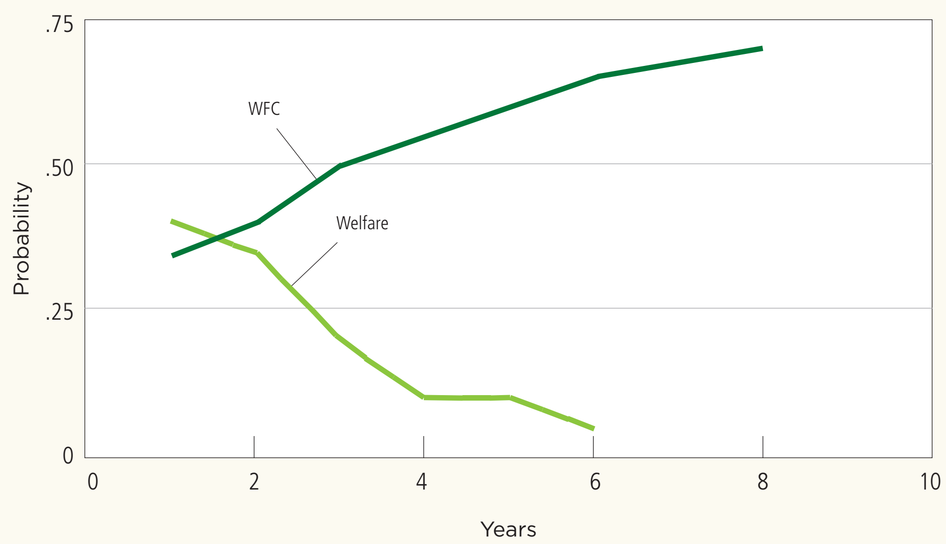


Figure 2 Probability of Staying on Welfare and of Receiving the WFC for Households First Observed Entering Welfare in 1992



drop-off could be due to the effects of other income that may contribute to a parent's ineligibility for the state earned income tax credit.

Eventually, the majority of parents who are on Minnesota's current welfare program, the Minnesota Family Investment Program (MFIP), end up exiting it. And eventually, the majority of parents who received MFIP benefits receive the WFC at least once. Figure 2 compares the estimated probability of a parent remaining on welfare with the estimated probability of that parent receiving the WFC after his or her first day of entrance into the MFIP.[6] The graph indicates that as time passes, parents are less likely to remain on welfare and more likely to receive the WFC. Eight years after their first entrance into welfare, roughly 75 percent of the parents will have received the credit.

However, it takes some parents more

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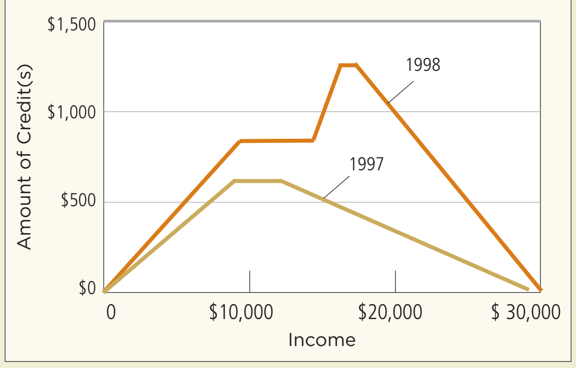
A costly credit?

Although earned income tax credits are a potentially useful tool in helping welfare recipients and other low-income individuals find employment and raise their income levels, some observers note that earned income tax credit programs pay out a considerable amount of money that could be used for other purposes. For example, for tax year 2008, over $172 million was claimed in Minnesota's earned income tax credit—the Working Family Credit (WFC)—by more than 297,000 returns, which averages to $581 per claimant's return. However, WFC proponents note that since individuals are more likely to be employed and have taxable earnings because of earned income tax credits, at least some of the credit dollars Minnesota paid out would not have been collected in the first place if the WFC program did not exist.

The shape of earned income tax credits

Minnesota Working Family Credit for a Single Parent with Two or More Children, 1997 and 1998



The size of earned income tax credits usually follows three stages, which are illustrated by the lower curve on the graph above. First is the phase-in stage, in which eligibility for the credit begins as parents begin to have earnings. The credit then increases at a constant percentage as earnings increase, until it reaches stage two, the phase-out floor, where it remains at a maximum level until earnings reach a designated phase-out point. In the third stage, the credit phases out to zero as earnings continue to increase. The amount of most state earned income tax credits is calculated as a flat percentage of the federal earned income tax credit. For example, Michigan's earned income tax credit is 20 percent of the federal earned income tax credit.

In 1998, Minnesota switched from the usual single-tier shape to one that includes a second maximum tier or bump. This additional tier provides extra income when parents exit other benefit programs, such as the food and cash portions of the Minnesota Family Investment Program. In the graph above, the upper curve represents Minnesota's current, two-tier program.

Research examines the receipt of earned income tax credits among welfare recipients

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years to begin receiving earned income tax credits than others. Among current and former welfare recipients, household heads who are more likely to take the longest time before receiving the WFC include African Americans, American Indians, Asian Americans, males, single parents, teenage parents, individuals without a high school diploma, and parents with children five years old and younger. Many of these are the same characteristics of parents who stay longer on welfare than other parents and who do not receive the state earned income tax credit in any single year.

Where do we go from here?

Three main policy issues arise from the research on Minnesota's earned income tax credit. One, how can policymakers help moms like Tania and other individuals who experience poverty move out of poverty in the quickest and most permanent fashion? Research suggests that legislative enactments to increase the generosity of the WFC may increase utilization, and other research suggests the WFC helps individuals on welfare enter the labor force. However, to minimize the costs of the program and best assist low-income families, it would also be helpful to find ways to make the WFC result in a faster, more permanent escape from poverty. Second, how can earned income tax credits help those who end up never having much in earnings? Since some parents may take a long time to increase their earnings, it may be helpful to find ways to assist those who are stuck at low earnings levels and least likely to ever receive the credits. And third, how can proponents and policymakers raise receipt of earned income tax credits among eligible parents? There is some evidence that VITA sites and other free tax preparation sites may help. For example, holding all other things constant, parents who live in communities with higher poverty rates and high concentrations of free tax preparation sites exhibit higher utilization rates.

These policy issues point to further areas for earned income tax credit researchers to explore. The more researchers do to expand their understanding of the utilization and effects of earned income tax credits, the better they can inform the web of policymakers, advocates, and others who are dedicated to making the credits work for Tania and other low-income individuals. cd

Balancing two approaches to the data

To create an accurate picture of earned income tax credits, it seems logical to use the most current data available. So why does this article rely partly on data from the 1990s and early 2000s instead of more recent numbers? The answer lies in the approaches different groups of researchers take toward the data they use. For researchers who are interested in identifying and tracking recent trends, the timeliness of data is paramount. Researchers in this group rely on recently released data from sources such as the federal government. While these researchers' findings are valuable, the data they are based on do not always undergo extensive review to ensure their reliability. Also, the data are often aggregated in a way that may provide less information on individual-level behavior.

For researchers who are interested in understanding long-term trends, data quality is the top priority. These researchers use extensive checks and reviews to ensure the reliability of the data that underlie their findings. The review process helps ensure a high level of accuracy, but it can take a long time—so long, in fact, that the findings might not be released until years after the source data were originally made available.

Each approach has merits that are useful for understanding the receipt of earned income tax credits. This article aims for a balance between the two approaches by relying on the most recently available findings from both of them.

1 Jason Levitis and Jeremy Koulish, *State Earned Income Tax Credits: 2008 Legislative Update*, Center for Budget and Policy Priorities, October 2008.
2 For the purposes of this article, "receive" involves two actions: An eligible individual first files for an earned income tax credit, and the government then issues the individual a credit.
3 "IRS Marks EITC Awareness Day; Highlights Expanded Tax Credit," *IRS News Release*, January 28, 2010. Earlier reports suggest the range may be slightly higher—between 80 and 86 percent. For example, see Alan Berube, *The Earned Income Tax Credit at Age 30: An Overview*, Brookings Institution, February 8, 2006. Research on SNAP is in its early stages. For example, see Sheila R. Zedlewski, *Recent Trends in Food Stamp Participation: Have New Policies Made a Difference?* Urban Institute, originally published in May 2004 and updated with more recent data.
4 For example, see Jeffrey B. Liebman, "The Impact of the Earned Income Tax Credit on Incentives and Income Distribution," *Tax Policy and the Economy*, Volume 12, edited by James M. Poterba, SB/SE Research; and *Participation in the Earned Income Tax Credit Program for Tax Year 1996,* Fiscal Year 2001 Research Project No. 12.26, Internal Revenue Service, January 2002.
5 Janet Currie, *The Take-Up of Social Benefits*, National Bureau of Economic Research Working Paper No. W10488, May 2004.
6 These probabilities were constructed by examining data on parents who first entered welfare in 1992.

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ical behaviors erode trust in leaders and the institutions they represent.

Trust is at the heart of good governance, and good governance, in both the corporate and public sectors, promotes sustainable business growth. In the absence of good governance, unethical behavior can flourish. The problem is circular; if unchecked, unethical behavior undermines the rule of law, thereby further weakening legal and administrative institutions. The cost of poor ethics management goes beyond padded payrolls or monies siphoned into personal expense accounts. A lack of reliable, transparent, and consistent governance is a powerful disincentive to invest or otherwise do business.

Numerous studies by international development organizations have concluded that even though corrupt practices may offer short-term economic benefits, there is a direct correlation between unchecked corruption and stifled development over the long term. Conversely, studies of markets worldwide indicate that transparent political institutions, sound laws, independent dispute resolution forums, honest bureaucrats, and strong separation of politics from business foster healthy economies. Among economic development researchers and practitioners, there is a concerted effort to raise awareness of the global importance of effective public and corporate ethics systems in instilling the market confidence necessary to encourage and sustain capital investment and business development.[1]

In tribal jurisdictions, as elsewhere, public servants continually face situations that raise ethical dilemmas. For example, should they give preference in hiring or contracting to relatives? Deny business-related land lease applications submitted by political opponents? Or misuse or misappropriate monies or property in tough financial times? Many tribes have adopted ethics codes or rules of conduct pertaining to these and other matters, but they vary in how detailed they are, whether they are rules or guidelines, whom the standards apply to, what entities have oversight, what the penalties for violations are, and how the penalties are determined and enforced. While some tribal ethics systems are well developed and well managed, others are quite limited. Some interesting models have emerged in Indian Country, however, for developing effective and culturally appropriate ethics management systems.

Ethics as a building block of economic growth:

Global insights and Indian Country models

Ethics as a work in progress

Building an effective ethics management system is an ongoing effort, not a one-time project. Even in countries with well-developed economies and government institutions, ethics management systems undergo frequent revisions. For example, ethics reform is a continuous process at the federal, state, and local government levels in the United States. The current generation of federal ethics measures includes the Ethics Reform Act of 1989; the Honest and Open Government Act of 2007; various presidential memoranda on pay freezes, transparency, and open government; and a recent Executive Order on Presidential Records. In addition, all states have ethics commissions or oversight agencies and have laws requiring local governments to enforce ethics laws and regulations. In the business sector, the widespread impact of corruption and unethical practices in recent years has led to the enactment of far-reaching federal laws to curb such abuses. One prominent example is the Sarbanes-Oxley Act of 2002, enacted in response to several major accounting scandals involving Enron, Tyco International, Adelphia, Peregrine Systems, and WorldCom.

Commissions, councils, and constitutional reforms

The Navajo Nation, which straddles the borders of Arizona, Utah, and New Mexico and is the largest tribal jurisdiction in both population and land area, has developed an extensive ethics management infrastructure. The tribe's Ethics and Rules Office and Committee implement the tribe's Ethics in Government law and are entrusted with assuring accountability among elected officials and tribal employees. The Committee and Office have a dedicated web site that posts press releases, advisory opinions, official rulings, instructions for filing complaints, and explanations of how the investigative and hearings processes work. In April 2009, the Office hosted its second three-day ethics conference, which attracted more than 200 attendees. Topics included ethics law, regulations and standards of conduct for elected officials and staff, and information for filing complaints. The event featured presenters from several of the tribe's divisions, which include a white collar crime unit, an Auditor General, and offices dedicated to resource enforcement, government development, personnel management, labor relations, retirement services, finance, elections administration, and business regulation. In addition, the Navajo Nation has a separate judicial conduct commission to enhance public confidence in its courts by providing fair, impartial, and expeditious forums for grievances against tribal judges.[2]

Other tribes have established similar offices or commissions. Many have been or are in the context of constitutional reform. For example, the Blackfeet Nation in Montana has undertaken a significant constitutional reform initiative. In one recent development, the reform committee reached a consensus to recommend adoption of a four-branch form of government. This would include a cultural branch made up of an ethics committee that will oversee all tribal government systems in order to maintain ethical standards, ensure due process, and assure that unethical behavior by tribal employees is appropriately addressed.[3]

One model tribal initiative demonstrates that ethics management is not just for adults. In 2002, the Honoring Nations program of The Harvard Project on American Indian Economic Development presented an award to the Akimel O'odham/Pee-Posh Youth Council of the Gila River Indian Community in Arizona. The Youth Council, among its many recognized accomplishments, had established a Code of Ethics that strictly forbids alcohol and drug use, gang participation, and inappropriate behavior. Although violations are reported to be rare, members who fail to comply face swift and stern sanctions from their peers. The code establishes a high bar, and by it the Youth Council shows that its members can live exemplary lives. The adult community took notice, and moved to replicate the code within the tribal government.[4]

Working in tandem

These are but a few of the many good examples of ethics systems in Indian Country. Increasingly, effective tribal ethics management is being addressed at conferences, in workshops, and as part of tribal college curricula. Leaders are recognizing that reputation and trust are critical underpinnings of good governance. A depoliticized ethics management regime that helps answer the complex ethical questions arising in the day-to-day realities of the workplace will foster an environment that is trusted and conducive to economic development.

A formalized ethics regime ensures that all stakeholders know and understand the rules and expectations. In addition to containing written rules that reflect important cultural values, good ethics systems typically include well-publicized and trusted reporting mechanisms, incentives for compliance, protections against retaliation and false or frivolous claims, independent or otherwise trusted investigation processes, impartially applied sanctions, consistent enforcement, and stakeholder training and awareness. Each is crucial; together, they promote an environment of transparency, predictability, and accountability that, in tandem with other efforts to develop sound governing institutions, will enhance and encourage investment and growth. cd

[1] See, for example, *Proceedings of the OECD* [Organisation for Economic Co-operation and Development] *Symposium on Ethics in the Public Sector: Challenges and Opportunities for OECD Countries,* November 3–4, 1997. Available at www.oecd.org.

[2] For more on the Ethics and Rules Office and Committee, see www.nnethicsrules.navajo.org.

[3] For more on this development, see the March 22, 2010, press release on the Blog Page at www.blackfeetvoice.org.

[4] To read more, search under "Gila River Indian Community" at http://hpaied.org/honoring-nations/awardees.

A note on corruption

There is a distinction drawn between ethics breaches and corruption. While all acts of corruption are unethical, not all unethical acts are considered corruption. *Corruption* refers to ethics breaches that, due to their context and severity, warrant intervention of the criminal justice system. While anticorruption measures are outside the scope of this article, studies of the effects of corruption and other unethical practices inform the discussion it contains. For example, according to a 2008 United Nations Development Programme report titled *Mainstreaming Anti-Corruption in Development: Anti-Corruption Practice Note,* evidence from across the globe shows that corruption hurts the poor disproportionately; hinders economic development; reduces social services; diverts investment in infrastructure; and fosters uncertainty, unpredictability, and disrespect for governing institutions and authority.

Starting up when the economy's down: A snapshot of Minnesota's new entrepreneurs

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The entrepreneurs then completed a questionnaire about their new business enterprises and in some cases were interviewed by a Community Affairs representative. We gathered the information from January 9 to February 5, 2010. In the end, we surveyed about 20 entrepreneurs.

Although our survey was too small in scale to be considered a scientific sampling, it provides a useful snapshot of the challenges that newly minted entrepreneurs face in a difficult economic climate. What follows is a discussion of our survey group's experiences. In addition to information obtained during our conversations and other information gathering, the article relies on recent research and data on new business development and entrepreneurship.

QUESTION 1:
What do the new businesses in our survey look like?

Our survey reveals a number of similarities among the entrepreneurs and their businesses. Most of the entrepreneurs told us that they had thought about their business ideas for a long time. Only two indicated that they created their businesses on the fly. Also, the majority of the entrepreneurs have worked previously in the industry in which they started their business and have spent much of their lives in the towns where the businesses are located.

The main industry sectors represented by our survey respondents are finance and insurance, manufacturing, and real estate. Most of the entrepreneurs in our group are equipped with college degrees, which enable a select few to continue working at a job other than the new business in order to generate additional income or purchase adequate medical coverage.

The businesses in our survey are small, employing one to four people including the founder. Their size means they fit the commonly used definition of a *microenterprise*: a small business that employs five people or fewer. (For more on the definition of microenterprises, see the sidebar below.) In terms of their size, these new businesses are typical of start-ups in Minnesota. Of the 8,623 new employer firms started in an average year in Minnesota between 1977 and 2005,[2] only 15.5 percent were able to hire more than four employees. Similarly, total employment by new firms that were started in an average year during the same period was only 2.78 percent of total employment by all firms.[3] Various data sources also suggest that new businesses are small when measured by revenues.

More than half of the businesses in our survey needed $50,000 or less to begin operations. For most of the entrepreneurs, revenues had not exceeded expenses for more than 6 of the 12 months preceding our survey. Such was the case for Marilyn Schroeder, a licensed hearing instrument distributor and certified occupational hearing conservationist who founded Maris Hearing Center in Ivanhoe, Minn., in March 2009. At the time of our survey, Schroeder was relying on her husband's income to cover personal bills and household expenses while her business got off the ground. "I cannot take any draws from the business yet," she reported.

"Small" vs. "Micro"

Although they both refer to not-so-big business entities, the terms *small business* and *microenterprise* are not interchangeable. The U.S. Small Business Administration defines small businesses as firms with 500 or fewer employees and does not make further distinctions regarding the smallest businesses within that category. However, there is a nationwide industry of nonprofit small business lenders and development organizations that recognizes the smallest small businesses as a distinct category called *microenterprises*. The Association for Enterprise Opportunity, the national trade organization for microenterprise development groups, defines microenterprises as small businesses that have five or fewer employees. As noted in our article, all of the businesses that participated in our survey fit this definition.

PHOTOGRAPH BY MARC NORBERG

Entrepreneur Brad Peterson founded Channel Partners LLC in 2009 after losing his job at a Twin Cities-based employer. Peterson's company helps businesses connect with agencies that provide short-term working capital and cash advances.

QUESTION 2:
How were the new businesses financed?

According to a 2010 Federal Reserve survey of senior loan officers, commercial banks generally ceased tightening their credit standards on many loan types in the fourth quarter of 2009 but have yet to reverse the considerable tightening that occurred over the preceding two years.[4] In a tight credit environment such as this, requests from new businesses might not be appealing to some credit providers. As an alternative, many new businesses turn to community banks, credit unions, and CDFIs, which all rely partly on personal relationships and knowledge of the local market to assess credit risks. Also, internal finance—that is, financing from the personal resources of business owners and their family members, friends, and business associates—can help compensate for a lack of access to capital and is crucial to both new and established small enterprises.[5]

In fact, several studies show that the most common source of start-up capital for new businesses is the founders' personal savings. This was true in our survey group as well. Our small business owners indicated that their main source of start-up financing was their own savings. They did receive funding from sources such as community banks, credit unions, government agencies, CDFIs, family members, and friends, but only after using their personal savings to provide an initial equity injection.

Our new business owners also used personal credit to provide start-up funding. They used personal credit cards, relied on their personal credit histories to take out loans or lines of credit from banks and nonprofit lenders, and borrowed from friends and family members. Since the majority of the respondents are sole owners of their businesses, this indicates that they may have pledged personal assets to secure the financing. In other words, they were willing to provide personal guarantees for the debt of the new business.

QUESTION 3:
Why start a new business in an economic downturn?

On the surface, an economic downturn looks like an unwise time to launch a new business. But during periods of economic crisis, opportunities often emerge for prospective entrepreneurs. For example, when times are tough, customers will look for more cost-effective ways to get the products and services they need; they may be less likely to remain loyal even to long-time suppliers. By seizing opportunities like these, new firms can turn downturns to their advantage.

Financial difficulties resulting from job losses are another reason why people start new businesses in a tough economic environment. As people are pushed out of the job market by corporate downsizing and the outsourcing of jobs, they look for other ways to generate income. For example, Brad Peterson, one of our survey group members, started Channel Partners LLC in 2009 after losing his job at a Twin Cities-based employer. His start-up company helps advise and link businesses with financing agencies throughout the country that provide short-term working capital and cash advances.

Although it is impossible to determine how many new businesses have been founded by the newly unemployed, it is interesting to note that during our current economic downturn, an unusually high unemployment rate in Minnesota has coincided with an unusually high rate of new business filings. The preliminary statewide unemployment rate in Minnesota was 7.4 percent as of December 2009, compared to 4.9 percent two years earlier. According to the latest data available from the Minnesota Secretary of State's Office at the time of this writing, Minnesota was on pace to set a state record of more than 63,000 new business filings for the 2009 calendar year. That total represents a 15 percent increase over 2008 filings.

However, a historical analysis of the relationship between recessions and job creation reveals a mixed picture. Data from the U.S. Census Bureau Business Dynamics Statistics database show that the rate of new firms formed per 1,000 people fell during the 1980 and 1981–1982 recessions (see Figure 1). The rate stabilized during the 1990–1991 recession and increased during the 2001 recession. Consequently, it is difficult to prove a direct link between periods of economic contraction and upsurges in entrepreneurial activity.

Being self-employed can bring substantial financial rewards. When a business survives the first few years, it tends to improve the income of the founder's household. One study shows that business-owning households make almost three times as much income, on average, as households without any business ownership.[6] The average net worth of a successful entrepreneur is much higher than the average net worth of a nonentrepreneur. And calculations based on census data indicate that the total personal income for self-employed people (including owners of incorporated and nonincorporated firms) averages $55,248, while the total personal income for people working for other private companies averages $40,518.[7] However, there are drawbacks to self-employment. Entrepreneurs tend to have much more variation in their income from month to month and year to year than persons who work for others,[8] and they fall in a higher income tax bracket than people who are not self-employed.

QUESTION 4:

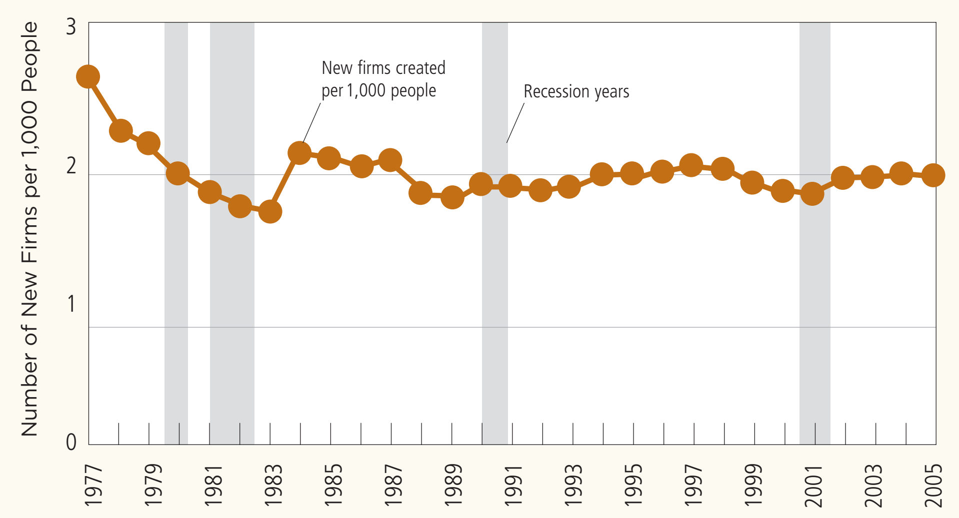
How do new businesses fare in a down economy?

Generally speaking, new businesses struggle, whether they are started during a recession or an economic boom. In fact, most studies agree that the majority of new businesses fail. When we look at five-year survival rates for the new firms started in Minnesota in any given year during the period from 1982 through 2005, the pattern for each year's batch of new firms is the same: the survival rate drops sharply in years one and two and flattens in years three to five. For any given year, an average of 45.1 percent of new firms survives to age five. It is important to note that there are no significant differences between the survival rates of businesses started in recession years and businesses started in nonrecession years. In other words, companies founded during recessions are no more likely to fail than any other new company. (For a visual representation of the consistency among survival rates from year to year, see Figure 2.)

There is ample research to confirm this trend. For example, according to a study conducted by the Ewing Marion Kauffman Foundation, recessions do not appear to have a significantly negative impact on the formation and survival of new businesses.[9] In fact, many successful, well-known companies got their start during a recession. Examples include General Electric and AT&T. More than half of the companies on the 2009 *Fortune* 500 list (57 percent) and just under half of the 2008 *Inc.* list (48 percent) began during a recession. Also, the 2009 *Inc.* list of the fastest-growing companies includes 17 companies in Minnesota that were started during a recession. And of the 32 Minnesota-based companies included on the *Fortune* 1,000 list, well over half were started during tough economic times. Additional findings from the Kauffman Foundation study indicate that job creation from start-ups is much less volatile and sensitive to downturns than job creation in the economy as a whole.[10]

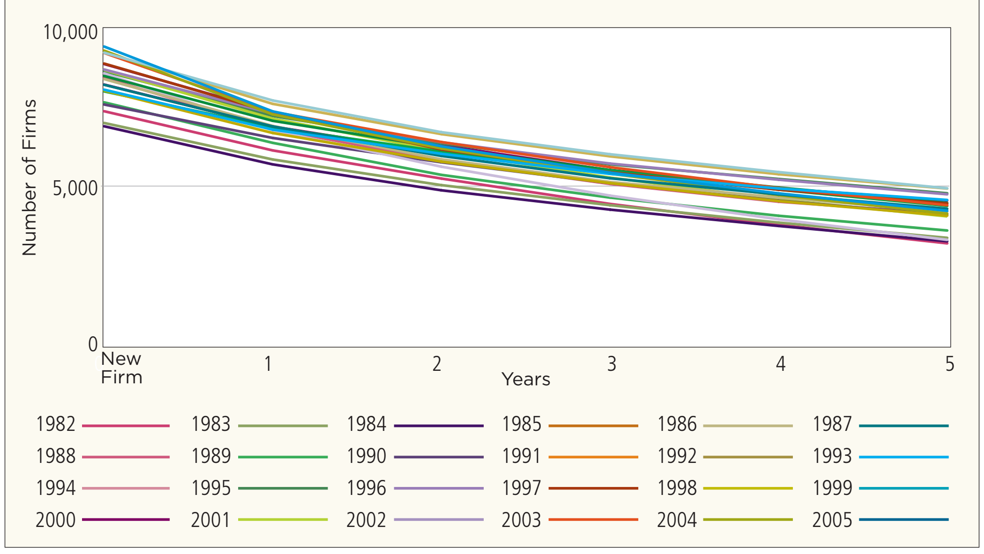
For a start-up business to survive, it must find ways to innovate and overcome the challenges it encounters. One major challenge for new firms is establishing a competitive advantage. Generally speaking, if a new business has a patented technology, high-quality customer service, the ability to achieve economies of scale, and attractive financing terms, it can out-compete existing firms in the same industry. In a tumultuous time, the most successful companies never stop funding their critical competencies and maintaining their advantage. Unfortunately, some surveys indicate that many new businesses lack a competitive advantage. Preliminary data from a Kauffman Foundation survey reveal that more than one-third of new entrepreneurs believe that their companies do not have a competitive advantage.[11] Among the entrepreneurs we surveyed, almost half indicated

Figure 1 Rates of New Business Formation in Minnesota, 1977–2005



Source: U.S. Census Bureau Business Dynamics Statistics and author's calculations.

Figure 2 Five-year Survival Rates of New Firms in Minnesota 1982–2005



Source: U.S. Census Bureau Business Dynamics Statistics and author's calculations.

that the products they offer are no different from those of their competitors.

Managing growth is another major challenge for business start-ups. Since many new businesses are one- or two-person operations, it can be hard for them to keep up if the demand for their services increases.

"It's a roller coaster," said Brad Peterson of Channel Partners LLC. "It's difficult focusing our efforts on originating new deals while working on the existing deals at the same time. Because of the size of our company, we don't have staff devoted solely to initiating deals. We get the deals, work on them, and then we go back and work on getting deals again." Marilyn Schroeder of Maris Hearing Center added, "I would love to hire a new staff person to help, but I can't do that yet. When I go visit neighboring communities or I'm with a patient, all I have is the answering machine. I'd like to be able to have someone here, so I could have more consistent hours for these people when they walk in the door."

Fortunately for business start-ups, overcoming challenges and surviving the first several years are not just matters of chance. Research suggests there are some factors under an entrepreneur's control that can increase the likelihood of success. One example is to choose an industry that is favorable to new companies. Another is to choose a business idea that aligns with one's prior career experience and existing business skills. As noted earlier, most of the entrepreneurs in our survey started their businesses in industries where they had previous experience. This choice not only affects the short-term survival of a new firm, but also its long-term growth and profitability.

Achieving the dream

All of our survey group members indicated that they believe the economic woes are not over yet. Still, they are optimistic about the future. In light of the sobering statistics concerning the survival rates of new businesses, such optimism might seem misplaced. However, the popular image of the successful firm that had its beginnings in

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Starting up when the economy's down

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someone's garage or basement is not merely an illusion. There is some truth to it. Even if they are founded during difficult economic times, some microenterprises can grow into small businesses, and small businesses can grow into large firms. At every stage of their development, successful businesses can provide economic independence and self-reliance for their founders, employment opportunities for the local community, and valued products and services for consumers.

The allure of creating a big success from small beginnings is what drives entrepreneurship. The individuals who participated in our small business survey are all hoping to beat the odds and achieve their entrepreneurial dreams. As we have seen, they have a number of things in common, and in some ways are typical of nascent entrepreneurs in Minnesota. Yet they also differ in some important respects, such as their industries of choice, levels of business skill, and competitive positions. Each entrepreneur brings a unique mix of traits, experiences, and circumstances that will determine whether he or she succeeds. While research can tell us much about trends, survival rates, and success factors among business start-ups, only time can tell us whether the new businesses in our survey will ultimately thrive. cd

1 CDFIs are specialized entities that provide lending, investments, and other financial services in economically distressed communities. The CDFI industry includes banks, credit unions, loan funds, venture capital funds, and microenterprise development loan funds.

2 A *firm* is the aggregation of all establishments owned by a parent company (within a geographic location and/or industry) that have some annual payroll. A firm may be located in one or more places.

3 Sources: www.ces.census.gov/index.php/bds/bds_database_list and author's calculations.

4 For more on this survey, see www.federalreserve.gov/boarddocs/snloansurvey.

5 Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, "Entrepreneurial Decisions and Liquidity Constraints," *RAND Journal of Economics,* Volume 24, Summer 1994.

6 M. Gutter and T. Saleem, "Financial Vulnerability of Small Business Owners," *Financial Services Review,* Volume 14, 2005.

7 Author's calculations based on data from the U.S. Census Bureau's Integrated Public Use Microdata Series 2006–2008 American Community Survey three-year sample.

8 W. Carrington, K. McCue, and B. Pierce, "The Role of Employer/Employee Interactions in Labor Market Cycles: Evidence from the Self-Employed," *Journal of Economics,* Volume 14, No. 4, 1996.

9 Dane Stangler, *The Economic Future Just Happened,* Ewing Marion Kauffman Foundation, June 9, 2009.

10 Ibid.

11 This survey is a national probability sample of new businesses founded in the United States in 2004.

News and Notes

Fed Governor Duke tours Minneapolis marketplaces

On April 15, the Minneapolis Fed's Community Affairs team had the honor of hosting a community development meeting and tour for Federal Reserve Governor Elizabeth Duke, who was making her first visit to the Ninth District since her appointment to the Federal Reserve Board in 2008. Following a roundtable discussion with a group of Twin Cities community bankers and small business development practitioners, Governor Duke toured Midtown Global Market and Mercado Central, two culturally diverse marketplaces that have helped revitalize the Lake Street corridor in south central Minneapolis. For more on Governor Duke's visit, see the *Community Dividend* Current Issue page on the Publications & Papers tab at www.minneapolisfed.org.

Board releases two new consumer education resources

The Board of Governors of the Federal Reserve System has released two online publications designed to help people understand important new consumer protection rules. The two publications are the latest installments in the Board's *What You Need to Know* series of online consumer education guides. The first of the new guides, *What You Need to Know: New Overdraft Rules for Debit and ATM Cards,* explains new overdraft protections that take effect July 1, 2010. The protections prohibit financial institutions from charging overdraft fees for ATM (automated teller machine) and one-time debit card transactions unless consumers have opted in to an overdraft service plan for those types of transactions. The second guide, *What You Need to Know: New Rules for Gift Cards,* explains how new rules that take effect August 22, 2010, will govern the fees, expiration dates, and disclosures applied to prepaid gift cards. Both guides are available at www.federalreserve.gov/consumerinfo.

Community Affairs publications update

The Minneapolis Fed's Community Affairs team recently made a few notable changes and enhancements to two of its previously published materials. Details follow.

Online essays expand L^3C discussion. In order to expand the discussion of a complex and compelling topic, Community Affairs has added supplemental materials to the online version of a November 2009 *Community Dividend* article about low-profit limited liability companies, or L^3Cs. The article, "The L^3C: A new business model for socially responsible investing" by Steve Davis and Sue Woodrow, generated considerable interest, both favorable and skeptical, among our readers. Accordingly, we invited some legal and development finance professionals to present their perspectives on the merits of the L^3C business model. In the essays they submitted for that purpose, Daniel S. Kleinberger of William Mitchell College of Law and J. William Callison of Faegre and Benson offer a cautionary, negative assessment of L^3Cs, while John Tyler of the Ewing Marion Kauffman Foundation and Marcus Owens of Caplin & Drysdale provide a cautious but positive perspective. To read the essays, visit the November 2009 edition of *Community Dividend* on our All Issues page, which can be reached via the Publications & Papers tab at www.minneapolisfed.org.

Report about costs of homeownership programs revised. A recently released Community Affairs report has been revised to reflect changes in the authors' methodology. When the report, "Gaining a Better Understanding of the Costs of Homeownership Programs: A Case Study and Recommendations for Minnesota's Home Ownership Center" by Leo T. Gabriel and Richard M. Todd, was released earlier this year, it triggered discussions among the authors and homeownership service providers regarding the way some components of the costs of homeownership programs had been classified. As a result, the authors decided to reclassify some of the expenses and repeat their analysis. The changes had little effect on the report's principal findings, but some results did change. For example, the average cost for foreclosure counseling at Community Action Agencies is now in line with overall foreclosure counseling costs. The new results appear in a revised version of the report, which is available at www.minneapolisfed.org/community_education/community/pubs_papers.

Calendar

2011 Fed Community Affairs Research Conference

SAVE THE DATE!

The Changing Landscape of Community Development: Linking Research with Policy and Practice in Low-Income Communities

The Federal Reserve's Seventh Biennial Community Affairs Research Conference, April 28–29, 2011, Arlington, Va.

Highlighting new research that can directly inform community development policy and practice and that points the way to a more inclusive vision of sustainable economic recovery.

Call for papers

The Community Affairs officers of the Federal Reserve System invite paper submissions for their seventh biennial research conference. They welcome research papers and studies that reflect the conference's theme of "The Changing Landscape of Community Development" and fall into one of the following five broad topic areas: Understanding Community Change, The Future of Consumer Credit, Bridging the Divide between People and Place, Measuring the Impact of Community Development, and Community Development Finance. (Papers that fit the conference theme but fall outside of these five topic areas will also be considered.) To submit a completed paper (preferred) or detailed abstract, e-mail Carolina Reid of the Federal Reserve Bank of San Francisco at carolina.reid@sf.frb.org. To read the full version of this call for papers, visit www.frbsf.org/community/2011ResearchConference.