AN ANALYSIS OF THE FORMATION AND FAILURE RATES OF MINORITY-OWNED FIRMS

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This article primarily investigates the applicability of principles of industrial organization to an understanding of the formation and failure process of minority-owned firms. Among these principles are that formation will be high (and failure low) when a firm is located in a high growth industry, a high growth geographic locale, and an industry with low capital intensity and low concentration. The article also evaluates whether some of the hypotheses from the minority literature, such as the impact of SBA loans to minorities, also contribute to an explanation of the formation and failure process.

This article investigates the determinants of business formation and failure rates by ethnic group, industry, and region. The ethnic groups are blacks, Asians, and Hispanics. The industries are all two-digit sic industries in the economy, and the regions are the nine census divisions.

The chief contribution of the study to the literature on minority-owned businesses is its test of the hypothesis that much of the variation in formation and failure rates can be explained by classic (independent of minority status) barriers to entry: low growth in an industry, high capital intensity, high concentration, and low growth in the local geographic area. A useful feature of the formation and failure data is that it is based on an economic census—that is, all minority-owned firms in the United States are included.

HYPOTHESES

There are two hypotheses advanced in this study. One is that the classic barriers to entry suggested by general propositions in industrial organiza-
tion help determine the formation and failure rates of minority-owned firms. The other hypothesis is that the barriers to entry highlighted in the minority-specific literature also matter.

General propositions in industrial organization suggest that formation rates will be high (and failure rates low) when the firm is in a high growth industry, a high growth geographic area, and in an industry with low capital intensity and low concentration. In addition, formation (but not failure) will be high in an industry in which existing firm size is small insofar as existing firm size reflects economies of scale. In contrast, failure (but not formation) will be high when firms are relatively new or when their own-size is small.

The minority-specific literature has tended to ignore the hypotheses about the causes of low formation rates and high failure rates that are suggested by the general propositions of industrial organization (an exception is the impact of small own-size on failure), but it has provided a rich array of additional factors to explain differences in formation and failure rates. A paper by the research staff at MBDA is an example of work in this area. An extensive review of minority literature by this author suggests the chief explanations of differences in formation and failure rates in the minority literature are the degree of business knowledge/experience of the owner and his access to capital, especially noninstitutional equity seed capital. Formation will be high (and failure low) when there is a knowledgeable and experienced business owner and when noninstitutional equity seed capital is available to the firm. The minority-specific literature, of course, provides many additional explanations of formation and failure rates. Two that are tested in this study are the supply of potential entrepreneurs and the role of government in the form of U.S. Small Business Administration (SBA) direct loans to minorities.

DATA

There were seven sources of data for this study, the most important being the Minority Business Development Agency (MBDA)/Census data that enabled us to calculate formation and failure rates for all minority-owned firms by ethnic group, industry, and region between 1972 and 1977. (This data source also provides information on the own-size of minority-owned firms.) A few words should be said about the calculation of formation rates (there is no problem with the calculation of failure rates). The conventional way to define formation rates is the ratio of the number of formations between 1972 and 1977 to the total number of