Effectiveness of CDFI Loans to Small Businesses on Job Growth in the United States

Primary Honors Thesis Proposal

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I. Introduction

Access to capital for small businesses is an extremely salient policy issue in the United States, as the availability of capital is crucial for small business startup, survival and growth. In 2013, small businesses employed 56.8 million people, or 48.0% of the private workforce and created nearly 1.1 million jobs. Of these small businesses, 36.0% of the firms were "very small businesses," having fewer than 20 employees (Small Business Administration, 2016). Given the important role of small businesses in the U.S. economy, policymakers strive to ensure that entrepreneurs and creditworthy firms are able to secure adequate financial resources for growth and success. For decades, the conventional banking sector has failed to meet the capital needs of low-income rural and urban communities. Although the Community Reinvestment Act of 1977 was enacted to combat the practice of redlining and required banks to address the credit needs of all communities within their service area, many low- and moderate-income communities and communities of color continued to be underserved by conventional banks (Benjamin et al., 2004). Forty-one percent of small businesses cite lack of capital as hindering their ability to grow their business or expand operations, and 20 percent of small businesses have had to reduce their number of employees as a result of lack of access to capital (National Small Business Administration, 2016).

My research will focus on the effectiveness of one response to this problem: the community development financial institution (CDFI). The CDFI industry was formally established and funded under the U.S. Department of Treasury through the Community Development and Regulatory Improvement Act of 1994. The purpose of the CDFI fund is to advance "economic revitalization and community development through development in and assistance to community development financial institutions," with the mission of increasing economic opportunity in underserved and distressed communities. CDFIs provide a range of financial products and services that often are not available from traditional lending institution. CDFIs augment their lending with a range of counseling and educational services that increase their borrowers' economic capacities and potential (Benjamin et al., 2004). In fiscal year 2016, CDFI organizations reported that they provided $3.6 billion in financing to homeowners, businesses and commercial and residential real estate developments throughout the United States. CDFI organizations also financed over 13,300 businesses and provided financial literacy or other training to more than 427,000 individuals throughout the United States (CDFI Fund, 2016). In this paper, I propose a quantitative evaluation of the effect of the presence of a CDFI on job growth at the county-level in the United States.

II. Motivation

Although community development financial institutions are rapidly growing and are an increasingly important component of community economic development, they have not received proportionate attention from academic researchers. Some papers have broadly examined the history of CDFIs and their future prospects (Benjamin et al. 2004; MacInnes, 2002). Other papers have evaluated the social benefits of CDFIs on their beneficiaries by examining outcomes such as feelings of economic empowerment (Kolodinsky et al. 2006). Other papers have examined the effectiveness of CDFI loans and services in reaching and building relationships with minority entrepreneurs in both rural and urban communities (Nembhard, 2103; Patraporn, 2015). However, no paper has evaluated the effect the presence of CDFI on job creation at the county-level. Therefore, my paper would fill a gap in the existing literature about CDFIs. This is a particularly salient issue as President Trump's proposed budget includes cutting the CDFI fund's budget by $210 million, leaving it $19 million to continue the operation of its old programs but not to make any new grants (Anzilotti, 2017). Therefore, understanding the effectiveness of CDFI small business loans on key economic outcomes, such as job creation, is particularly relevant and interesting given the current political atmosphere.

III. Contribution

There has been some academic research on various aspects of community development financial institutions, but there are large gaps in the literature. MacInnes (2002) examines the economic and social conditions in the United States during the late 1900s that led to the adoption of the Community Reinvestment Act in 1977. This paper also explores the development of the legislation supporting community development financial institutions as a means of achieving the goals of the Community Reinvestment Act. Similarly, Benjamin et al. (2004) built on existing literature focusing on the lack of capital in low-income communities (Jackson, 1995; Kasarda, 1989) in order to provide an overview of the role of CDFIs in the broad context of development finance and their development throughout time. Although these papers do not contain any quantitative policy evaluation, they are important components of the literature as they provide background information on the conditions that led to the development of CDFIs and position CDFIs within the larger context of development finance.

Nembhard (2013) reports and analyzes qualitative research on how community development credit unions, a type of CDFI, in Black communities in the U.S. provide affordable financial services and help their clients preserve assets. The paper found that all CDCUs note that they charge lower rates for their products and provide higher interest or dividends when possible, both of which enable clients to save money and build assets. It also found that CDCUs work closely with their clients to personalize services, to help them avoid loans they cannot afford and to educate their clients on making sound financial decisions. Patraporn (2015) explores the unique way that CDFIs lend to ethnic entrepreneurs by analyzing interviews with the staff of ten Los Angeles, CA area CDFIs. This paper found that CDFIs provide extensive technical assistance, utilize flexible lending criteria and build co-ethnic ties. It also found that CDFI staff members' specialized knowledge about particular ethnic groups, shared cultural background and/or language ability allow them to take on greater risk.

Kolodinsky et al. (2006) utilized qualitative and quantitative measures to evaluate if CDFIs provide a measurable level of social benefit to its clients. The paper found that CDFIs do provide social benefits to their clients by allowing clients to take control of their financial futures and build a sense of empowerment that reaches beyond the finances of an individual or family. It found that the impacts were generally greater for lower income and less educated households, households with children, and for households that indicated wealth and asset building services as important. Although there is an existing body of literature on CDFIs, my paper will fill a gap. The existing literature focuses on CDFIs in a theoretical sense or evaluates the impact of CDFIs on outcomes such as senses of economic empowerment. No paper has evaluated the quantitative impacts of the presence of a CDFI on job growth at the county-level in the United States.

There is a significant body of literature about the effectiveness of small business loans in general the United States, in contexts outside of CDFIs. Cortes (2010) analyzes the relationship between economic performance and the Small Business Administration's 504-guaranteed lending program, which provides long-term financing to small firms. This paper examined the impact of SBA 504 loans on indicators of small business activity, such as employment rate and per capita income, while controlling for other determinants of state economic growth. It found that SBA loans had a positive and significant impact on the growth of small businesses and, by consequence, the number of workers employed in small firms. Although this paper is useful in understanding the effectiveness of a similar small business loan program, there is a gap in the literature about the effectiveness of the CDFI program in particular.

IV. Data and Methodology

I plan to combine two datasets to analyze the quantitative impacts of the presence of a CDFI on job growth at the county-level in the United States. The first dataset that I plan to use is the FY2015 CIIS CDFI Institution Level Report (ILR). This dataset contains annual information collected from CDFIs by the U.S. Department of the Treasury. The dataset contains institutional level data about each CDFI in the United States, including variables such as the zip code of the CDFI, the fiscal year in which it was founded, demographic information about its staff, whether it is located in an urban or rural location, financial information, etc. This dataset contains information on 823 unique CDFIs. I will use this dataset to identify where CDFIs are around the country. I will also use variables like the number of years the CDFI has operated, the number of loans that it grants, number of employees, etc., as control variables in my analysis. These control variables will help me identify the causal effect of CDFIs on job growth in their communities. I also plan to use data from the Quarterly Census of Employment and Wages from the Bureau of Labor Statistics that contains information on unemployment at the county-level across the United States. I plan to use this dataset to evaluate changes in employment level at the county-level.

In order to evaluate the effectiveness of the presence of a CDFI on job growth, I plan to use the difference-in-difference estimator. The difference-in-difference estimator is commonly used to evaluate the impact of a policy or treatment on some outcome over a population of individuals. The difference-in-difference is a useful statistical technique that will allow my paper to evaluate the effect of CDFI small business loans on job growth in a county while accounting for any permanent differences between counties as well as biases that could result from natural variation over time. I also plan to control for various factors that change over time that could impact the effect of CDFI small business loans on job growth. These variables will include factors variables for the number of years the CDFI has been functioning (fiscalyear) and the size of the CDFI (totalassets, lendingstaff, numberIDA). These variables will act as proxies for the effectiveness of the CDFI itself. I will also include a variable for other policy shifts at the state or local level which could impact the effectiveness of the CDFI loans. By using a difference-in-difference estimator with controls, I hope to be able to isolate the effect of the presence of a CDFI on job growth in a county.

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