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Entrepreneurship in Emerging Domestic Markets

Barriers and Innovation

Foreword by Robert E. Litan

Springer

Editors
Glenn Yago
Milken Institute, Santa Monica,
CA 90401.

James R. Barth
Milken Institute, Santa Monica,
CA 90401.

Betsy Zeidman
Milken Institute Santa Monica,
CA 90401.

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Guided by market-based approaches, we work to improve economic conditions and the quality of life for people in the United States and around the world. Our approach is straightforward: we put research to work, pursuing viable solutions to the gaps in access to capital markets, education and job opportunities.

Our work is rooted in the long-term trend toward three revolutions of access – the worldwide democratization of capital, health and knowledge. By improving global access in these areas to all citizens, states and nations, the Institute hopes to spur economic development and improve standards of living.

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Note from the Editors

This volume examines the crucial role entrepreneurship plays in fostering job creation and promoting economic growth, particularly in traditionally overlooked communities in the United States. Individuals with new ideas, new approaches to organizing businesses, and new products for the market are vital to generating economic development and creating wealth. Greater recognition of this fact has led to increased interest in better understanding the determinants of entrepreneurship, as well as the potential barriers limiting its ability to flourish.

The latest research in these topics is particularly important for low- and moderate-income communities, and those with high ethnic and immigrant concentrations. Entrepreneurship offers individuals in such areas the opportunity to improve their standards of living through their own efforts. In the process of improving their own lives, moreover, these entrepreneurs contribute to the overall economy. With the U.S. population undergoing rapid diversification, enabling the economic potential of these emerging domestic markets is critical to enabling the national growth.

The Federal Reserve Bank of Kansas City and the Ewing Marion Kauffman Foundation sponsored a conference November 3–4, 2005, in an effort to further our knowledge about the importance of entrepreneurship to low- and moderate-income communities. A group of experts on entrepreneurship from around the country participated in the conference, which involved the presentation and discussion of several policy-oriented papers. Most of the papers are included here and provide an up-to-date and first-rate assessment of policy actions that can alleviate the gap between those with an entrepreneurial potential and the resources necessary to make it a reality. It is hoped that the information provided here will help guide policy makers when focusing on ways to improve conditions in our emerging domestic markets. The production of this volume would not have been possible without the support of our colleagues at the Milken Institute. The Co-Editors wish to specifically acknowledge the valuable contributions of Alethea Abuyuan, Dinah McNichols, Caitlin MacLean, and Karen Giles.

James R. Barth and Glenn Yago
Milken Institute Series on Financial
Innovation and Economic Growth

Foreword

Slowly but surely, entrepreneurship is getting its proper due as a source of economic growth for the economy as a whole, and as a pathway to economic and personal independence for many individuals in our society. This book makes an important contribution to the literature by documenting the significance of entrepreneurship in low- and moderate-income communities.

The studies in this volume, by eminent experts in the field, document how entrepreneurial activity provides income to the entrepreneurs themselves (who need not be residents of these communities), and to the people they employ. But starting and growing a business is risky. Many firms fail, and individuals of low- and moderate-income face higher hurdles than others, because many lack the requisite skills, education, financial capital, and social contacts that increase a business's likelihood of success. Many of the papers in this volume provide guidance to policy makers on how to bridge these gaps so that individuals of all means have an equal shot at success in their entrepreneurial endeavors.

The Kauffman Foundation is devoted to helping the public and policy makers to appreciate and understand the contribution of entrepreneurs to the U.S. economy. The Foundation is grateful for the opportunity it had, together with the Federal Reserve Bank of Kansas City, to help sponsor the conference at which most of the papers in this volume were presented. We hope that the findings will be useful to citizens, professional researchers, and policy makers in United States and throughout the world.

Robert E. Litan
Research and Policy
The Kauffman Foundation
rlitan@kauffman.org

June 2007

Author Bios

Zoltan Acs

Zoltan J. Acs is University Professor and Director of the Center for Entrepreneurship and Public Policy at the School of Public Policy, George Mason University. He is also a Research Scholar at the Max Planck Institute for Economics in Jena, Germany, and Scholar-in-Residence at the Kauffman Foundation. He is coeditor of Small Business Economics. Zoltan Acs has served as the Chief Economic Advisor at the U.S. Small Business Administration. He is a leading advocate of the importance of entrepreneurship for economic development. Zoltan Acs has published more than 100 articles and 20 books, including articles in the American Economic Review, Review of Economics and Statistics, Journal of Urban Economics, Economica, Research Policy and Science Policy. He is currently completing a research project on Knowledge, Geography and American Economic Growth, funded by the National Science Foundation, The American Statistical Association and the U. S. Small Business Administration.

James Barth (Series/Volume editor; author)

James R. Barth is the Lowder Eminent Scholar in Finance at Auburn University and a Senior Finance Fellow at the Milken Institute. His research has focused on financial institutions and capital markets, both domestic and global, with special emphasis on regulatory issues. Most recently, he served as leader of an international team advising the People's Bank of China on banking reform.

Barth was an appointee of Presidents Ronald Reagan and George H.W. Bush as chief economist of the Office of Thrift Supervision until November 1989 and has previously served as the chief economist of the Federal Home Loan Bank Board. He has also held the positions of professor of economics at George Washington University, associate director of the economics program at the National Science Foundation, and Shaw Foundation Professor of Banking and Finance at Nanyang Technological University. He has been a visiting scholar at the U.S. Congressional Budget Office, Federal Reserve Bank of Atlanta, Office of the Comptroller of the Currency, and the World Bank. He is a member of the Advisory Council of George Washington University's Financial Services Research Program.

Barth's expertise in financial institution and capital market issues has led him to testify before the U.S. House and Senate Banking Committees on several occasions. He has authored more than 200 articles in professional journals and has written and edited several books, including The Great Savings and Loan Debacle and The Reform of Federal Deposit Insurance. His most recent books are Rethinking Bank Regulation: Till Angels Govern, with Jerry Caprio and Ross Levine, Cambridge University Press, 2006, and Financial Restructuring and Reform in Post-WTO China, with Zhongfei Zhou, Douglas Arner, Berry Hsu, and Wei Wang, Kluwer Law International, 2007. He is also the overseas associate editor of The Chinese Banker. Barth has been quoted in publications ranging from the New York Times and Wall Street Journal to Time and Newsweek, and appeared on broadcast programs including "The McNeil/Lehrer Newshour," "Good Morning America," "Moneyline," and National Public Radio.

Barth serves on the editorial boards of the Journal of Financial Services Research, Review of Pacific Basin Financial Markets and Policies, Journal of Economics and Finance, and Financial Services Review. He is also included in Who's Who in Economics: A Biographical Dictionary of Major Economists, 1700 to 1995.

Barth received his Ph.D. in Economics from Ohio State University

Timothy Bates
Timothy Bates is Professor of Labor and Urban Affairs and Economics at Wayne State University. Research reported in this study was conducted, in part, at the U.S. Bureau of the Census Center for Economic Studies. Findings expressed are those of the author and do not necessarily reflect views of the U.S. Bureau of the Census. Financial assistance from the Woodrow Wilson Center International Center for Scholars supported this study.

Ben Craig
Ben Craig is an economic advisor in the Research Department of the Federal Reserve Bank of Cleveland, where he specializes in the economics of banking and international finance.

Before joining the Bank in 1994, Dr. Craig was an assistant professor of economics at Indiana University. He has also taught at Washington State University, Stanford University, and the University of Konstanz, Germany. He was a visiting scholar at the Bundesbank in Germany in 2001.

Dr. Craig earned a bachelor's degree with honors from Harvard University in 1976 and received a doctorate in economics from Stanford in 1986. He is married and the father of three children.

Kelly Edmiston
Kelly D. Edmiston is a Senior Economist in the Community Affairs Department of the Federal Reserve Bank of Kansas City. His primary research interests are regional economic growth and development and state and local public policy. His research has been published in several leading economics and policy

journals, and he has presented his research findings at numerous national conferences and professional meetings. He has also provided policy advice and technical assistance to several state and local governments, as well as overseas, and has provided expert commentary in national media outlets. Prior to joining the Federal Reserve Bank of Kansas City, Kelly was Assistant Professor of Economics at the Andrew Young School of Policy Studies at Georgia State University and served as a consultant for the World Bank. He holds BA and PhD degrees from the University of Tennessee.

William E. Jackson III

William Jackson is a financial economist and associate policy adviser with the financial group of the research department of the Federal Reserve Bank of Atlanta. Dr. Jackson concentrates his research on the role financial markets and financial institutions play in making the modern economy more efficient and productive.

Before joining the Atlanta Fed, Dr. Jackson was an associate professor of finance at the Kenan-Flagler Business School of the University of North Carolina at Chapel Hill. He also taught at the Kellogg Graduate School of Management at Northwestern University and at Boston University.

He has published in the Journal of Money Credit and Banking, the Review of Industrial Organization, the Journal of Banking and Finance, Management Science, and the Review of Economics and Statistics. Dr. Jackson is currently on the editorial advisory board of the Journal of Small Business Management. In July 2004, Dr. Jackson provided expert testimony before the U.S. House of Representatives on the deregulation of credit unions. In 2005, he served as editor of a special issue of the Journal of Small Business Management on "Small Firm Finance, Governance, and Imperfect Capital Markets" and also in 2005 was selected to serve a three-year term as a Filene Research Fellow.

Dr. Jackson earned his bachelor's degree in economics and applied mathematics at Centre College. He earned an MBA in finance at Stanford University and his master's degree and doctorate in economics at the University of Chicago.

Kadri Kallas

Kadri Kallas is a Ph.D student at the School of Public Policy, George Mason University. She received her MA in Public Administration and Social Policy at the University of Tartu, Estonia. She has been involved in European Union Research Programs and studied the organization and processes of Estonia's accession of European Union. Her current research areas include innovation systems, technology transfer, and entrepreneurship.

Robert Litan

Robert Litan is vice president of Research and Policy at the Kauffman Foundation.

Litan has been affiliated with The Brookings Institution for nearly 20 years, first as a Senior Fellow and since 1996 as director of Economic Studies and holder of Cabot Family Chair in Economics. At Brookings, he led a team of economists monitoring the global economy and seeking answers to economic policy issues in the U.S. and around the world. The group's rigorous, independent research was designed to increase the public's understanding of how the economy works and how to make it better. During his time with Brookings, Litan authored or co-authored more than 25 books and 200 articles for professional journals and magazines. He co-founded and serves as the Director of the AEI-Brookings Joint Center on Regulatory Studies.

Litan has had a distinguished career in public service. He served on the staff of the Council of Economic Advisers (1977–79), as Deputy Assistant Attorney General in the Antitrust Division of the Justice Department (1993–95), and Associate Director of the Office and Management and Budget (1995–96). He also has been a consultant to the Treasury Department on financial policy issues.

Litan received his B.S. degree in Economics, graduating summa cum laude, from the Wharton School Department of Finance at the University of Pennsylvania; his J.D. from Yale Law School; and both a Master of Philosophy and Ph.D. in Economics from Yale University.

David Mushinski

David Mushinski is an Associate Professor in the Department of Economics, Colorate State University. He has a Ph.D. in Economics from the University of Wisconsin-Madison, a J.D. from the University of Virginia School of Law, and B.A. in Economics from the College of William and Mary. His research has focused on micro-enterprise and small business access to credit in developing areas, American Indian economic development, and regional economics. His current research interests include the relationship between entrepreneurship and health insurance, and the Morris Plan of lending.

Ronnie J. Phillips

Ronnie J. Phillips received and his B.A. in Urban Studies from the University of Oklahoma in 1973 and his Ph.D. in Economics from The University of Texas at Austin in 1980. He is a Senior Fellow at Networks Financial Institute in Indianapolis, Indiana and Professor of Economics at Colorado State University where he has taught since 1983. From 2001–2006, he was Chairman of the Economics Department. He was the recipient of the Oliver Pennock Distinguished Service Award from CSU in 2000. A past president of the Association for Evolutionary Economics, he has been a Scholar in Residence at the Ewing Marion Kauffman Foundation in Kansas City, Missouri; a Visiting Research Fellow at the American Institute for Economic Research in Great Barrington, Massachusetts; a Visiting Scholar in the Division of Insurance at the Federal Deposit Insurance Corporation in Washington, D.C.; a Visiting Scholar in the Bank Research Division at the Office of the Comptroller of the Currency, Department of the Treasury, in Washington, D.C.; and a Resident Scholar at the Jerome Levy Economics Institute of Bard College in Annandale-on-Hudson, New York. Before coming to CSU he taught at Texas A&M University in College Station, Texas. He has published widely on banking issues, entrepreneurship, and public policy in books, academic journals, newspapers, magazines, and public policy briefs. His current research interests are payday lending and entrepreneurship in the music industry.

James Thomson

James Thomson is vice president and economist in the Research Department of the Federal Reserve Bank of Cleveland. His research interests focus on financial markets and institutions, historical banking, and government-sponsored enterprises.

Prior to joining the Bank in 1986, Dr. Thomson worked as a financial economist at the U.S. General Accounting Office. He is currently a member of the American Finance Association as well as the Financial Management Association. He has published numerous papers on federal deposit insurance, bank structure, and bank capital regulation, including articles in the Journal of Finance, Journal of Money, Credit, and Banking, and Journal of Small Business Management.

Dr. Thomson received a bachelor's degree in economics from Georgia Institute of Technology and a master's and Ph.D. in economics from The Ohio State University. He is married and has three children.

Glenn Yago (Series/Volume editor; author)

Glenn Yago is Director of Capital Studies at the Milken Institute. He specializes in financial innovations, financial institutions and capital markets, and has extensively analyzed public policy relating to job creation and capital formation.

Before coming to the Institute, Yago was Director of the Center for Capital Studies in New York, which he founded in 1992 to develop insight into the process of capital access and ownership change. He was a faculty member of the City University of New York Graduate Center Ph.D. Program in Economics, and a Senior Research Associate at the Center for the Study of Business Government at Baruch College—City University of New York.

He has held the positions of Faculty Fellow at the Rockefeller Institute of Government, Director of the Economic Research Bureau at the State University of New York at Stony Brook and Associate Professor of Management at Stony Brook's Harriman School for Management and Policy. He has also served as Chairman of the New York State Network for Economic Research and consulted for corporations and governments on economic policy and strategy. Yago received his Ph.D. from the University of Wisconsin, Madison.

Betsy Zeidman (Volume editor; author)

Betsy Zeidman is Director of the Center for Emerging Domestic Markets (CEDM) and a Research Fellow at the Milken Institute. CEDM aims to increase the flow of capital to America's emerging entrepreneurs and communities through its research and information network, educational center and financial innovations laboratory. She also manages the Center's activity in such areas as strategic philanthropy, mission-related investing, corporate governance, environmental finance and international microfinance. In this position, Zeidman works with foundations, governments, institutional and individual investors, entrepreneurs and policy makers. She authors articles and research reports, and speaks frequently at conferences and to the media. Zeidman also provides strategic advisory services, with a specialty in corporate responsibility and financial performance. Prior to joining the Institute, she served as senior management at several entertainment companies and public affairs firms, and staffed national and state political campaigns. She received her B.A and M.B.A. degrees from Yale University.

Contributors

Zoltan J. Acs
George Mason University
zacs@gmu.edu

Michael S. Barr
University of Michigan Law School and The Brookings Institution
msbarr@umich.edu

James R. Barth
Milken Institute
jbarth@milkeninstitute.org

Timothy Bates
Wayne State University
aa4811@wayne.edu

Ben R. Craig
Federal Reserve Bank of Cleveland
ben.r.craig@clev.frb.org

William E. Jackson
Federal Reserve Bank of Atlanta and the University of Alabama
william.jackson@atl.frb.org

Kadri Kallas
George Mason University
kkallas@gmu.edu

David Mushinski
Colorado State University
david.mushinski@colostate.edu

Ronnie J. Phillips
Colorado State University
ronnie.phillips@colostate.edu

James B. Thomson
Federal Reserve Bank of Cleveland
jb.thomson@clev.frb.org

Glenn Yago
Milken Institute
gyago@milkeninstitute.org

Betsy Zeidman
Milken Institute
bzeidman@milkeninstitute.org

Entrepreneurship in Low and Moderate Income Communities

Kelly D. Edmiston[1]

Over the last several decades, numerous programs and policies have been established to assist low and moderate income families.[2] Some of these endeavors, especially those targeting the very poor, have made substantial improvements in the lives of those they have touched. Historically, however, most of these efforts to assist low and moderate income people have had little impact beyond the provision of basic needs, such as food, clothing, and shelter. Advocates have recognized this, and increasingly efforts are being made to generate more sustainable improvements in the financial well-being of low and moderate income people by assisting them in creating and maintaining wealth (Sherraden, 1991). Examples of these endeavors include home ownership programs and individual development accounts. Another important way one can create wealth is through entrepreneurship.

Although a consensus definition does not exist, most would agree that an entrepreneur is one who starts a business and accepts (most of) the risk associated with owning that business. Some believe that one must bring an innovative product or service to market to be considered an entrepreneur, but others would consider any self-employed person to be an entrepreneur.[3] In the low and moderate income context, it is probably best to use a broad definition, which would include self-employed people generally.

Evidence suggests that entrepreneurship is a viable alternative to wage and salary employment (or unemployment) for many low and moderate income

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K. Edmiston
Community Affairs Department of the Federal Reserve Bank of Kansas City.
kelly.edmiston@kc.frb.org

[1] The views expressed in this chapter are those of the author do not necessarily reflect the views of the Federal Reserve Bank of Kansas City or the Federal Reserve System.

[2] Low income refers to families earning less than 40 percent of area median income (metropolitan statistical area median income for those living in metropolitan areas and state median income for those living in nonmetropolitan areas). The earnings of moderate income families lie between 40 percent and 80 percent of area median income.

[3] See, for example, Evans and Leighton (1989) and Blanchflower and Oswald (1998).

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people. An analysis of data from the Panel Study of Entrepreneurial Dynamics (PSED) suggests that 38 percent of nascent entrepreneurs, defined as those who are actively involved in the creation of new business ventures, live in low and moderate income households.[4] Of these, about 45 percent live in low income households. Roughly eight percent of nascent entrepreneurs live in households with below poverty-level income.

Entrepreneurship may yield a double dividend in low and moderate income communities. Many of the retail and services establishments available in higher income areas, such as grocery stores, often are not available to low and moderate income people because they tend not to be located in low and moderate income places, and many low and moderate income people face transportation challenges (Cotterill and Franklin, 1995). Entrepreneurial activity not only provides income to the entrepreneurs and perhaps others in the community, but also provides needed goods and services. The entrepreneurs themselves do not need to be low and moderate income people for the community to profit from this double dividend, however. Benefits also arise from the location of entrepreneurial enterprises developed and operated by higher income people, but located in low and moderate income communities.

Additional gains may also arise from increased entrepreneurship. Self-employed people on average have higher incomes than wage and salary workers (Fronczek, 2005), and self-employment may be an important component of upward mobility. Further, many report nonpecuniary benefits: self-employed people tend to report having more control over their lives and more often report being highly satisfied with their lives than do wage and salary workers (Blanchflower, 2004).[5] And of course, self-employment may be the only reasonable option to earn income for many low and moderate income people.

Although the benefits from entrepreneurship in low and moderate income communities are many, numerous hurdles also exist. For example, low and moderate income people hold little of the nation's wealth. Wealth can be critical for entrepreneurial success because it may provide start-up capital, provides a financial safety net during the transition from wage and salary employment, and may serve as a positive signal to other potential investors (Kim et al., 2004). Although there is some debate, research largely suggests that the lack of financial capital is a major impediment to entrepreneurship (Kim et al., 2004; Dunn and Holtz-Eakin, 2000; Evans and Jovanovic, 1989).

Human capital also presents a problem in low and moderate income communities. Educational attainment among low and moderate income people

[4] All figures reflect calculations by the author using data from the PSED. For data and documentation, visit http://www.psed.isr.umich.edu/main.php (accessed May 17, 2006).

[5] Of course, as Blanchflower notes, self-employment people also work under a lot of pressure and report that they find their work stressful, come home from work exhausted, are constantly under strain, lose sleep over worry, and place more weight on work than they do on leisure.

is significantly lower than that of higher income households (Zhan and Schreiner, 2004). Low and moderate income people also tend to have less work experience.[6] Research suggests that human capital, in the form of both education and work experience, is positively related to the survival and performance of new ventures (Brush and Manolova, 2004; Cooper and Gimeno-Gascon, 1992).

Many other obstacles to entrepreneurship exist for low and moderate income communities as well, not the least of which is a declining economy in many urban areas. Although several promising efforts to promote entrepreneurship and support small business owners in low and moderate income communities have been implemented in the last several years, the idea of fostering entrepreneurship in low and moderate income communities has received little attention in academic circles. In an effort to stimulate research, encourage discussion, and begin to frame the issues, several leading scholars were brought together for a conference to explore the possibilities that entrepreneurship might offer for low and moderate income communities. The conference, which was held November 3–4, 2005 in Kansas City, Missouri, was jointly sponsored by the Federal Reserve Bank of Kansas City and the Ewing Marion Kauffman Foundation. This volume is a collection of original essays prepared for the conference, as well as comments from discussants and remarks from panelists.

One way to think about entrepreneurship in low and moderate income communities is to consider the role of entrepreneurship in revitalizing depressed areas, which often are heavily populated by low and moderate income people. This is the path followed by Tim Bates.

In many of the great industrial centers of the 20th century, established firms constituting the economic base of the area – firms serving national and international markets, which provide the "*raison d'etre* for the regional economy" – have lost their competitive edge, due in large part to an increasingly globalized economy and relatively cheap labor over seas. Reduced money flows from outside the area also result in dimmer fortunes for local suppliers that service the base industries and for the many, mostly smaller firms that service local needs, such as food, housing, and medical services.

As the local economy becomes depressed, "bright young people" and established professionals often depart to seek attractive opportunities in expanding regions. Physical capital often is drained from the area as well, as factories and other facilities become underutilized or closed down altogether. The flight of human capital and erosion of physical capital simply exacerbate the problem, and a downward spiral often ensues. Finally, public infrastructure tends to decay and public service delivery suffers as local governments face declining resources.

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[6] For data, see http://pubdb3.census.gov/macro/032002/perinc/new05_001.htm (accessed May 19, 2006).

Bates argues that often local government attempts to revitalize depressed areas contribute to further deterioration. There is little "hard evidence" that enterprise and empowerment zones, and to some degree tax incentives in general, achieve their stated goals – one only has to look at Detroit, which is "blanketed" by a variety of such incentives. Worker training and education make sense as a tool for easing the transition of workers into sectors where labor demand is increasing, but these are "people based" rather than "place based" policies, and the effect is to enhance the workers' mobility, which often means an escape from stagnant and declining areas to expanding areas where job opportunities are readily available.

Revitalization of a depressed area requires an entrepreneur to re-deploy its underutilized resources. This can be most directly accomplished by strengthening the region's economic base. But if the market for the base product is large and stable, and the product is highly standardized, the strategy is not going to work. Rather, what is needed are circumstances in which small, innovative, entrepreneurial firms can compete at this level. These include a small, but highly viable market for a product that is highly differentiated (as opposed to standardized) and for which the weight and bulk to value ratio is high, where speed of delivery is important and applicable supplier industries are competitive.

Echoing Bates, Zoltan Acs and Kadri Kallas argue that the role of the entrepreneur is to shift resources yielding a low return into activities that yield a high return and a personal gain to the entrepreneur. In the absence of entrepreneurs, resources continue to be employed in activities yielding low returns, which leads to an "ossified economy" where resources are under-utilized. Empirical evidence supports the notion that entrepreneurship can be a critical factor in economic growth. Acs and Kallas refer to findings of a 2004 paper Acs wrote with Catherine Armington, which suggest that a one standard deviation increase in the rate of new firm formation (from 3.5 to 4.5 per thousand in the labor force) yields a one-half standard deviation increase in the employment growth rate, from 2.1 percent to 2.85 percent.

Unfortunately, while entrepreneurship can provide a substantial boost to economic growth in general, its prospects for revitalizing low and moderate income communities are not very promising. Acs and Kallas assert that a major conclusion of his literature survey is that "entrepreneurship may not play an important role in poor communities." The majority of microentrepreneurs who start off poor remain poor.

The chief problem, it seems, is that many low and moderate income people simply lack the requisite skills to be successful entrepreneurs. Many of the deficiencies that prevent entry into white-collar employment, such as language and technical skills, also hinder small business development. Of course, the lack of human capital is not the only problem impeding entrepreneurship in low and moderate income areas. These communities often also suffer from a lack of other required inputs and inadequate social capital and finance. Having said that, it is important to note that money will not overcome gaps in education and entrepreneurial skills.

Acs and Kallas argue that “each segment of the population includes some proportion of entrepreneurs.” The extent to which they will emerge depends on the support they receive. In terms of support from the public sector, he suggests that it is not so much pro-active policies that are needed, but the undoing of some destructive policies. The economic value of the inner city as a business location can be increased by, among other things, “abolishing self-inflicted regulatory costs.” There is little evidence that public financial support programs to small businesses are effective in poor communities, although there is evidence that some specific programs work well in some cases. In general, public intervention should not try to imitate market functioning mechanisms. Rather, it should focus on creating an enabling environment for entrepreneurship and applying non-market solutions to market failures, such as education and physical infrastructure.

An interesting twist in the Acs and Kallas paper is the notion that the link between entrepreneurship and low and moderate income communities may be social entrepreneurship. They argue that “social entrepreneurship is when an individual who has the prerequisite skills to pursue for-profit entrepreneurship chooses to maximize his or her utility instead of profits.” An “attractive” opportunity is one with sufficient potential for a positive impact to justify the investment. The development of social capital that social entrepreneurship often engenders can help to “empower disadvantaged people and encourage them to take greater responsibility for, and control over, their lives.”

Much of the literature Acs and Kallas review is tepid at best in its support of public financial support programs for small businesses in poor communities. But the U.S. Small Business Association’s loan guarantee programs may have something to offer low and moderate income communities, according to a paper by Will Jackson, Ben Craig, and James Thompson. Previous work by the same authors suggests that SBA guaranteed lending has a positive, albeit small effect on economic growth rates in local geographic markets, as measured by per capita income. In this paper, the authors extend the analysis to another measure of economic performance, the employment rate. Perhaps more importantly from the perspective of this volume, they investigate the possibility of a differential impact on low income communities *vis-à-vis* higher income markets.

Using a simple fixed effects model, Jackson, Craig, and Thompson find that the inflation-adjusted total dollar amount of SBA-guaranteed loans, scaled by population, has a statistically significant positive impact on employment rates in MSAs and non-MSA counties, but similar to their previous work, they find that the result is economically small. Importantly, the authors find that the effect of per capita SBA-guaranteed lending on the employment rate diminishes with greater levels of market development, as measured by per capita bank deposits. Given a positive correlation between financial market development and per capita income, the authors draw the conclusion that SBA-guaranteed lending has a larger impact in lower income areas.

Like Acs and Kallas and Bates, Barth, Yago, and Zeidman suggest that government regulations can be stumbling blocks to entrepreneurship. Results