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Crowdfunding, Cryptocurrency, and Capital: Alternative Sources of Business Capital for Black Entrepreneurs

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OVERVIEW

Having access to capital is essential to the success of every business, and its ability to keep pace with its competitors. Historically, banks have featured prominently as the primary lender to businesses. Bank investors provide new businesses with startup capital, and support established businesses with capital to grow and expand their companies[2].

According to a study by the U.S. Department of Commerce Minority Business Development Agency,[3] black owned businesses continue to encounter barriers when it comes to accessing capital. Internal and external factors have been cited, but three causes have been highlighted as the key obstacles: 1) the credit worthiness of black-owned business owners; 2) institutional racism and discrimination; and 3) the lack of social capital and relational networks.[4]

Despite these impediments, technological innovation now offers black entrepreneurs more opportunities than ever before to attract investors. Crowdfunding and crowdsourcing platforms, such as Kickstarter, Fundable, GoFundMe, Indiegogo and AngelList are now viable alternatives for black owned businesses to pursue in order to raise startup funds. Similarly, cryptocurrency, such as Bitcoin, has expanded investment opportunities for African American entrepreneurs by allowing international entities to invest in U.S. based companies.

This policy brief examines the traditional barriers that African American businesses encounter when seeking access to business capital, and how black entrepreneurs can use innovations in technology to overcome these barriers, and start and grow their businesses.

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[2] Robb, Alicia and David Robinson.2012. "The Capital Structure Decisions of New Firms." *Review Of Financial Studies, Vol 1, No 1, 2012.*

[3] Fairlie, R. W., Robb, A. M., & Hinson, D. 2010. Disparities in capital access between minority and non-minority-owned businesses. ***Commerce.gov*** [online]. Retrieved from: http://edit2.my.commerce.gov/sites/default/files/documents/2012/january/hinson092210_disparitiesincapitalaccessreport1.pdf

[4] Congressional Black Caucus Foundation. *Minority Access to Capital and Employment Fact Sheet*. Retrieved from: https://www.cbcfinc.org/wp-content/uploads/2016/01/CBCF_MinorityAccessCapital_FactSheet_final.pdf

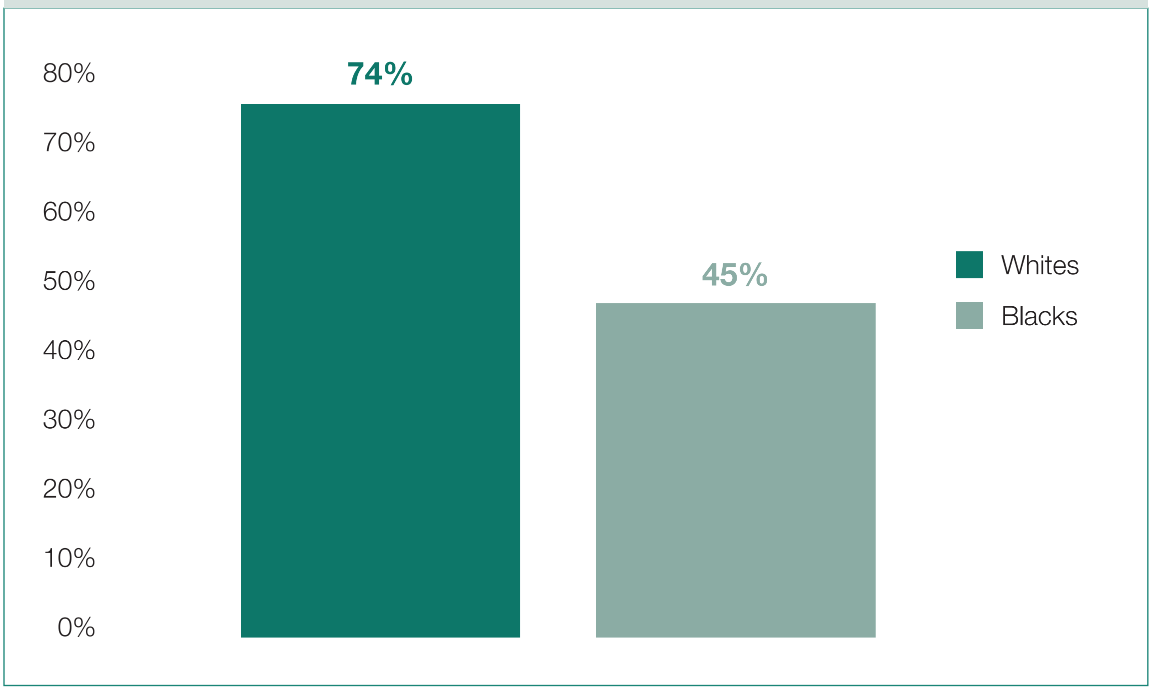
Barriers to Capital for Black Entrepreneurs

1. Credit Worthiness

Credit worthiness has typically been viewed as the crucial determinant in the decision to pursue business ownership; and it encompasses a number of financial indicators that banks use to conduct a risk assessment before extending a business loan. In general, credit worthiness is a proxy measure of wealth—and for African Americans, their wealth level is 16 times lower than that of whites. Data from the U.S. Census Bureau (2011) reveal that that median household income for black families is $37,000 compared to that of whites, which is $63,000. Further, the median household net worth for black families is 14 times lower than that of whites, and only 6 percent of black households have investment holdings, such as stocks or mutual funds. Black families are also less likely to own their homes, or have extensive home equity lines of credit (Figure 1). Subsequently, what these figures translate to for black entrepreneurs is that they have a lower net worth and fewer assets than their white counterparts (Figure 2).

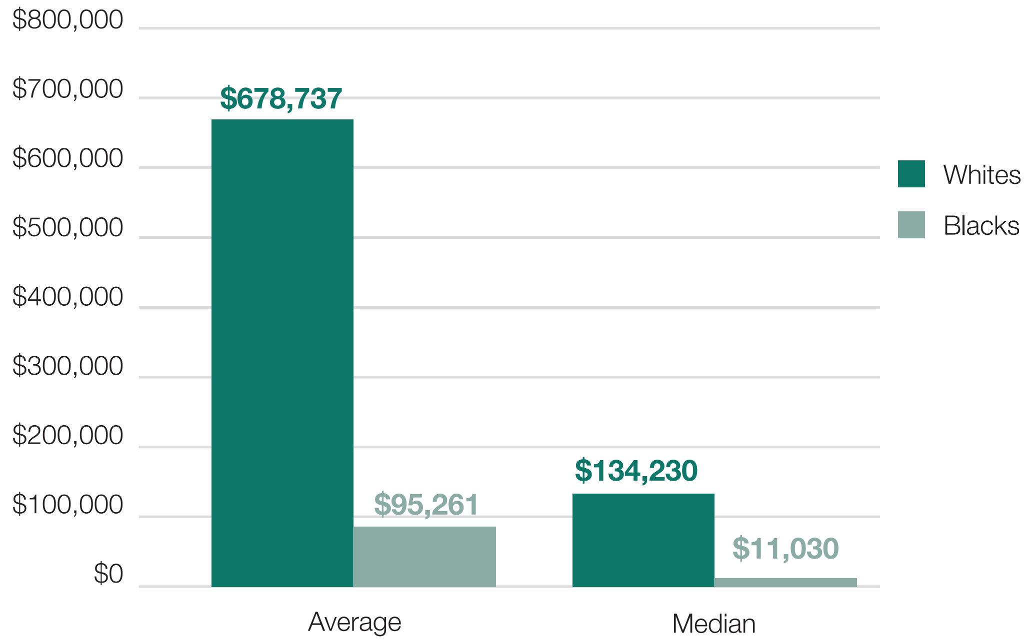
For banks, a lower net worth, and a lack of assets mean that if the borrower defaults on their loan, there are no assets, such as a home or investment holdings, that can be sold to pay off the debt. As a consequence, black businesses represent a high financial risk to bank investors, and are less

Figure 1. Home Ownership Rate for Blacks and Whites



Source: U.S. Census Bureau, 2011

Figure 2. Median and Average Wealth for Blacks and Whites



Source: Survey of Consumer Finance, Combined Extract Data, 2013

likely to receive a business loan.

2. Institutional Racism and Discrimination

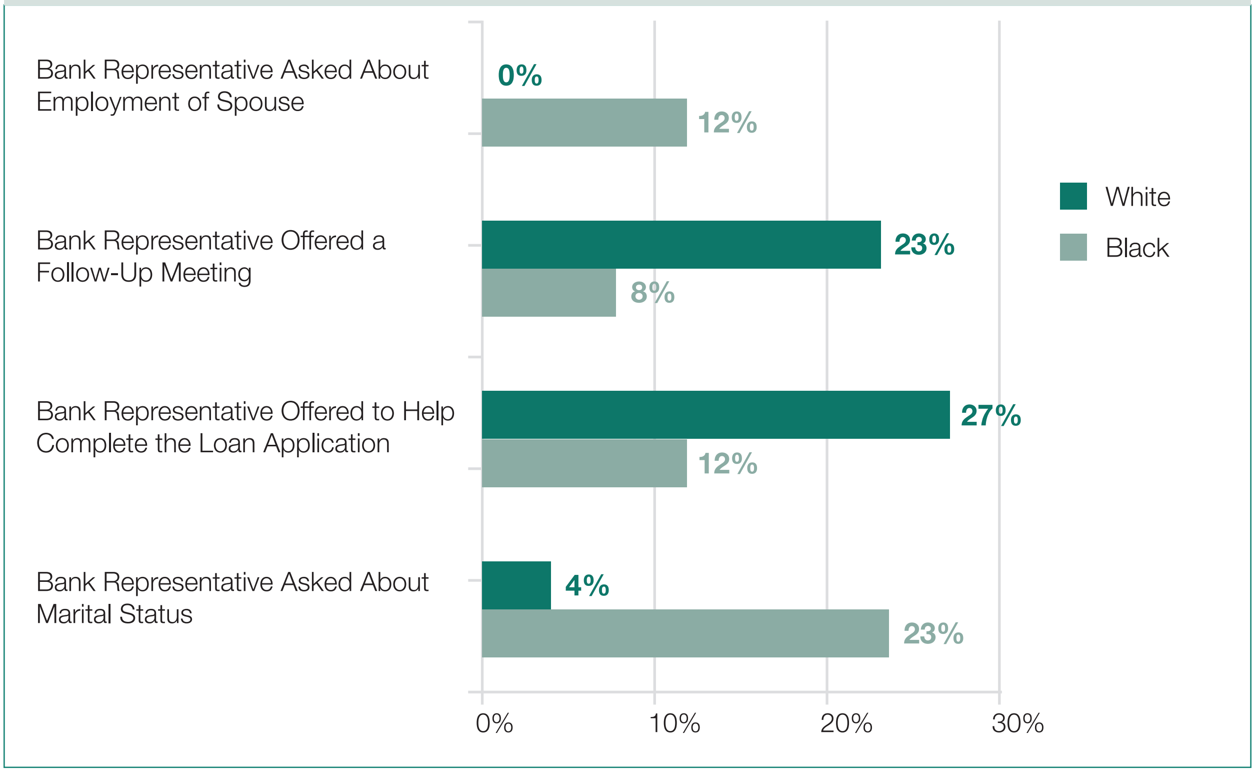
Structural and institutional racism allude to the systematic biases that are embedded within the institutions and structures that exist within a given society. Several studies have documented that racial discrimination is a significant impediment for black owned businesses.[5] For example, in a recent report conducted by a team of researchers from the National Community Reinvestment Coalition, Utah State University, Brigham Young University, Rutgers University and Lubin Research, they found that banks were three times more likely to request follow-up appointments with white business owners than better-qualified black business owners, and the black business owners were subjected to far greater personal and financial scrutiny compared to their equal or less creditworthy white counterparts (Figure 3).[6] The study concluded that it was access, and not just assets, that serve as an obstacle for black owned businesses to acquire the capital and credit necessary to start and grow a business.

[5] Congressional Black Caucus Foundation. *Minority Business Development and Entrepreneurship Fact Sheet.* Retrieved from: https://www.cbcfinc.org/wp-content/uploads/2016/01/CBC101215-Factsheet-MinorityBisDev-final.pdf

[6] Bone, Sterling and Christensen, Glenn and Williams, Jerome and Adams, Stella and Lederer, Anneliese and Lubin, Paul, Shaping Small Business Lending Policy Through Matched-Paired Mystery Shopping (September 12, 2017). Available at SSRN: https://ssrn.com/abstract=3035972 or http://dx.doi.org/10.2139/ssrn.3035972

The findings of this report illustrate the need for greater legislative and regulatory oversight. And while laws prohibiting loan discrimination, on the basis of race, have been enacted, there is an obvious need for regulatory agencies to provide greater enforcement of existing legislation that protects black owned businesses from discrimination.

Figure 3. Personal and Financial Scrutiny of Black Entrepreneurs and White Entrepreneurs



Source: Bone et al., 2017; Compiled by author.

In comparison to more overt forms of discrimination, institutional and structural racism have not been as deeply examined. For example, another significant factor in the approval rating of business loans to African American entrepreneurs is the location of the business. A substantial proportion of black owned businesses are located in neighborhoods and geographic areas that serve the needs of African Americans. However, these areas are generally characterized as low-income, urban communities. These communities exhibit low rates of home ownership, property and real estate values are depressed, and revenue from property taxes is marginal. Consequently, while these low-income, urban communities depend upon small businesses to support their economies, there is no economic incentive for banks to invest in these communities, because the return on their investment is not substantial.

This dynamic underscores how normalized institutional racism has become to the lending process. Since the 1930s, because of white discrimination, most black owned businesses have been forced to locate and remain in black communities, despite research that finds when market conditions permit ethnic businesses to provide goods and services to non-ethnics, opportunities for mobility increase significantly.[7] This relegation of black owned businesses to ethnic enclaves is indicative of historical patterns of structural racism and neighborhood exclusion that continue to negatively affect opportunities for black entrepreneurs today.

3. Lack of Social Capital

Between 2007 and 2017, minority-owned businesses grew by approximately 79%, which was ten times faster than the overall growth rate for U.S. small businesses during the same time period.[8] Hispanic-owned businesses experienced the largest growth, with the number of companies increasing by 46%, while the number of African American businesses increased by 34%, and Asian owned businesses increased by 22%. Minority owned businesses are not only experiencing growth in terms of sheer numbers, but also revenue. Since 2014, approximately 40% of minority owned businesses have experienced sales growth of 11% or greater. Asian owned businesses have witnessed the greatest increase. Between 2012 and 2017, the revenue of Asian owned businesses increased by 38% to $965 billion; while Hispanic owned business revenue increased 35% to $640 billion, and African American owned business revenue increased by 10% to $165 billion.[9]

As evidenced by the growing number of black owned firms, the business ownership gap is narrowing between African Americans, and whites and other minorities. However, just as black companies report substantially lower revenue figures than other businesses, black owned businesses also continue to lag behind that of whites, and other minorities in terms of market share. In 2014, African Americans owned 2% of U.S. based companies. In 2017, this figure increased by 1.5%, and African Americans now own 3.5% of all U.S. businesses. However, white owned business account for 81% of all U.S. companies, with Asian and Hispanic-owned firms comprising 9.7% and 5.8% of the market share, respectively.

Despite the positive trends for black businesses, it is important to understand why African American entrepreneurs are not experiencing the level of growth and revenue returns comparable

[7] Feagin, Joe E. and Imani, Nikitah, "Racial Barriers to African American Entrepreneurship: An Exploratory Study" (1994). Black Studies Faculty Publications. 6.
[8] Jeffrey, Jeff. "Minority Owned Businesses Driving Growth, Survey Says." (2017). The Business Journals. Sept. 28. https://
[9] Ibid

to that of Asian and Hispanic business owners. One explanation has emphasized the centrality of social capital to minority owned business success.

Social capital is a broad term that captures the networks and relationships that individuals form in a given society. It is the foundation of any community and the basis for creating a civil society. Social capital represents a critical component of opportunity access that supports business growth and its ability to thrive. Research indicates that in comparison to whites, African Americans have comparable, and oftentimes a greater number of "affective interactions with close family members and friends".[10] However, the types of social capital that are developed through professional networks, is less accessible to African Americans. This social capital disadvantage is not just unique to African Americans. Across other minority groups, including non-white immigrants, these groups also have less access to professional social networks than whites. Despite this however, non-white immigrants are able to leverage their affective relational networks and utilize them as social capital. That is because affective relational networks, which are integral to social capital building, are also salient to U.S. immigration, especially family-based immigration to the United States.

The diffusion of information across immigrant networks has been shown to reduce the costs associated with migrating and resettling in a foreign country. As a result, the elements of social capital that are important to business ownership, such as relational networks, monetary assistance, and economically self-sufficient ethnic enclaves, are embedded within immigrant communities. In a comparative study of African American and immigrant self-employment, the findings support this observation. Drawing upon ninety years of U.S. Census Data (1900-1990), the authors determined that "many immigrants have [tangible and intangible] resources (not available to native non-whites) that facilitate entrepreneurship."[11]

Additionally, immigrant owned businesses account for 20% of all U.S. firms (1 out of every 5 businesses). While the data for minority owned businesses does not include distinctions within subgroups, there is the inherent assumption that foreign-born entrepreneurs comprise a significant number of all minority owned businesses in the U.S.

[10] Smith, Danielle T. (2013). "African Americans and Network Disadvantage: Enhancing Social Capital through Participation on Social Networking Sites." *Future Internet*, 5, 56-66; doi:10.3390/fi5010056. P. 58
[11] Bogan, Vicki & William Darity. (2008). Culture and entrepreneurship? African American and immigrant self-employment in the United States. *Journal of Socio-Economics*, 37(5), 1999-2019, p. 20.

Driven by foreign-born entrepreneurship, other minority businesses owners appear to start their businesses with more resources and foundational elements in place, such as economically viable relational networks and a pattern of monetary assistance from remittances[12]. Migration based relational networks and remittances are not a component of the African American experience in contemporary America; therefore, these resources are not available to African Americans, which helps explain why black-owned businesses are growing at such a slower rate, especially in comparison to other minority-owned businesses.

Social capital, undoubtedly, plays a significant role in the entrepreneurial process. And when compared to whites, African Americans and other minorities have less access to professional social capital networks that are the foundation for business development and expansion. At the same time, immigrants of color are able to effectively translate the networks and resources that are established as a component of the immigration process, into social capital. Thus, it is believed that one of the main reasons why the businesses of other minority groups are growing at a faster rate than black businesses is due to the social capital benefits inherent to the immigration process. With that said, an avenue for future research that we are committed to pursuing is an analysis of the business outcomes for African American entrepreneurs, in comparison to African and Afro-Caribbean immigrant business owners, to determine just how impactful social capital is to immigrant business owners, when controlling for race. The aforementioned comparative analyses will better position researchers and policymakers to extend working models of social capital utilized in other minority and immigrant communities to better understand best practices and strategies for enhancing the value of social capital for African Americans.

Despite the social capital disadvantages for African American entrepreneurs, emerging research once again suggests that technology is helping black business owners overcome some of these obstacles. A recent study finds that African Americans are far more likely than whites to use social networking platforms and sites to engage in professional activities that enhance their social capital, which includes, establishing new professional and business contacts, promoting themselves, and advertising their work.[13] Thus, it is important to continue this vein of research and explores the ways in which social networking sites have aided black entrepreneurs beyond that of social capital building, but in other business areas, such as marketing, recruitment, and with generating investment capital.

[12] Ibid
[13] Smith, Danielle T. (2013). "African Americans and Network Disadvantage: Enhancing Social Capital through Participation on Social Networking Sites." *Future Internet*, 5, 56-66; doi:10.3390/fi5010056.

Alternative Sources of Business Capital for Black Entrepreneurs

1. Equity Crowdfunding

Although similar, there are important distinctions between crowdfunding and crowdsourcing. Crowdsourcing is the process of obtaining money, services, content, ideas, or information from a crowd (i.e. a group of people). Although businesses can, and sometimes do, pitch their ideas on crowdsourcing sites, and investors have the opportunity to contribute, crowdsourcing is not specifically dedicated to the generation of business capital, and investors do not receive any return on their investment in the business.[14] That is why crowdsourcing is considered less efficient for business startups, and is more often used by existing business owners for a specific project or initiative, and to assist them in expanding an aspect of their business.

Crowdfunding is an internet-based method that is specifically used for raising business capital. It allows inventors and burgeoning business owners to connect directly with investors, and attract loyal consumers. In turn, crowdfunding allows investors to contribute funds directly to a business in exchange for a tangible return on their investment, which is typically in the form of the finished product.[15]

There are many benefits to African American entrepreneurs who elect to use equity crowdfunding to start their businesses:

1. *Accessibility of Capital*—The factors that marginalize black entrepreneurs from traditional sources of funding are not salient. Crowdfunding allows entrepreneurs to connect directly with the public, and interested investors. It also allows entrepreneurs to spread the financial risk across several people, so they do not bear the risk alone.
2. *Test Product/Idea Marketability*—Crowdfunding is designed to attract a large number of individuals who consider the product/idea valuable, and are interested in investing in it. When a funding opportunity is announced, a funding goal is set, that is accompanied by a deadline. At the end of the funding time period, some businesses achieve their goal and even exceed it, while other businesses do not. This mechanism allows

[14] GoFundMe and Wikipedia represent crowdsourcing platforms.
[15] Kickstarter is an example of a crowdfunding platform.

entrepreneurs to gauge their startup's potential for market success.

3. *Entrepreneurs Retain Exclusive Control*—With venture capitalists and angel investors, the investors exercise significant decision-making control over the business. That is because the partnership is heavily dependent upon the financial support of VCs and angel investors. However, with crowdfunding, the entrepreneur retains exclusive control over the company and the product.

With every potential opportunity, specifically those that are relatively new, there are inherent risks, challenges and weaknesses. Black entrepreneurs who are attracted to crowdsourcing, should also consider the potential drawbacks:

1. *Vulnerability of Intellectual Property*—Prior to launching a crowdfunding campaign, it is crucial that entrepreneurs protect their business idea with a patent or a copyright. In the absence of these protections, one's idea is vulnerable to being copied and stolen. Also, it is important to be aware that even with patents and/or copyrights in place, better funded investors and/or larger companies can still replicate and steal the idea, thereby requiring litigation that is costly and time consuming.
2. *Lack of Advice and Mentorship*—The use of crowdfunding for new businesses in the U.S. is still relatively new, and crowdfunding involves unique accounting and administrative challenges. Entrepreneurs, who follow more traditional business models, have the benefit of direct investor support and advice, as well as mentorship from more experienced business owners. Crowdfunded business owners do not have access to a deep well of business networks and mentors. Also, Crowdfunding is based on investors receiving rewards, and the task of recording contributions and distributing rewards in a timely manner is time consuming. Further, when a significant number of investors transition to shareholders, businesses will confront even greater administrative and accounting challenges that they are ill prepared for.

2. Cryptocurrency

Cryptocurrency is essentially digital money in that it represents a digital asset and functions as a medium of exchange. Cryptocurrency uses cryptography to secure, moderate and verify all financial transactions. Bitcoin emerged in 2009 as the first cryptocurrency, but since then several thousand cryptocurrencies have been developed. The primary advantage of cryptocurrency is that there is decentralized control. For example, with banking systems, control is centralized, in that an institution has the sole authority to issue currencies and print money. However, "cryptocurrency uses cryptography to gather all the information and data, and it [then] passes through blockchains, which represent the distributed ledger."[16] This allows cryptocurrency to be easily used in international financial transactions.

The benefit of cryptocurrency to African American entrepreneurs is that it can be used in conjunction with crowdfunding and crowdsourcing platforms to attract international investors. Beyond crowdfunding and crowdsourcing, there are also now a number of new companies that are making it even easier for startups to fundraise using cryptocurrency. Businesses, such as Dropdeck, Ambisafe, and DealBox, function as virtual brokers between businesses and investors. These companies provide a financing platform for startup businesses with a token-incentivized mechanism for investors to evaluate and fund businesses worldwide.

Despite the benefits of using cryptocurrency to generate capital, black entrepreneurs also should recognize that using cryptocurrencies involves heightened risks.

1. *Lack of Regulation*—Given the absence of a centralized authority, cryptocurrency also lacks sufficient regulation. For every financial industry in the U.S., there is some form of government regulation (i.e. U.S. Treasury, SEC) that protects the consumer and attempts to minimize business predation. Without sufficient regulation, cryptocurrency is vulnerable to fraud, and price manipulation. Thus, business owners should not rely heavily on capital investments using cryptocurrency.
2. *Price Volatility*—With any investment, whether it's gold, stocks, or real estate, there are market swings and volatility. And in the case of cryptocurrency, both the capital investor and the business owner, face risks similar to that of all other investments. However, cryptocurrencies are notably more volatile than more traditional investments. On average, Bitcoin experiences daily swings of 10-15%, compared to the NASDAQ, with daily changes of less than one percent.

[16] Milutinović, Monia. (2018). Cyptocurrency. *Ekonomika*, 64(1), 105-122. See p. 107 doi:http://dx.doi.org/10.5937/ekonomika1801105M

Key Findings and Recommendations

1. Black owned business owners continue to face barriers to access business capital. These barriers included credit worthiness, institutional racism and discrimination, and the lack of social capital.

2. The barriers for black owned businesses have resulted in significantly lower revenues in comparison to other minority owned businesses.

3. Despite these barriers, black owned businesses continue to grow in number, and their revenues have increased within the last four years.

4. Technological innovations offer black entrepreneurs more alternatives than ever before to overcome these existing barriers, and gain access to startup and growth capital. Technology has also provided greater opportunities for black entrepreneurs to access professional social capital through social networking platforms.

5. Crowdfunding, Crowdsourcing, and Cryptocurrency are viable alternatives to traditional funding sources that allow African American entrepreneurs and business owners to access startup and growth capital that is vital to achieving entrepreneurial success.

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