

U.S. banking deregulation and self-employment: A differential impact on those in need[☆]

Yuliya Demyanyk^{*}

*Supervisory Policy Analysis, Banking Supervision and Regulation, Federal Reserve Bank of St. Louis,
P.O. Box 442, St. Louis, MO 63166-0442, United States*

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Abstract

Starting in 1978, the U.S. banking sector was gradually deregulated in terms of restrictions on geographical expansion. This paper examines the impact of intrastate branching deregulation on self-employment income growth rates. Cross-state evidence suggests that the growth rate of self-employment income increased after reform, with the effect being more pronounced for women and non-white minorities at the low end of the income distribution. As banks are the prime source of finance for the self-employed, the results suggest that branching reform led to improved access to credit for previously underserved business owners.

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1. Introduction

This paper empirically shows that removal of bank branching restrictions had a positive impact on (state-specific) self-employment income growth rates for females and minorities at the low end of income distribution.

Since the late 1970s, the structure of the U.S. banking industry has changed considerably because of the lifting of restrictions on intrastate branching and interstate banking. As a result, competition and efficiency in the banking sector have increased. Such improvements in banking were passed on to borrowers, especially to small business owners and the self-employed, for whom bank credit is one of the main sources of business financing.

[☆] The views expressed are those of the author and do not necessarily reflect official positions of the Federal Reserve Bank of St. Louis or the Federal Reserve System.

^{*} Corresponding author. Tel.: +1 314 444 8837.

E-mail address: Yuliya.Demyanyk@stls.frb.org.

Self-employment is often an alternative to unemployment, providing a way out of poverty. Moreover, it is one of the sources of upward economic mobility. This is particularly true for minorities and women to the extent they can be subject to discrimination – taste-based or statistical – in the labor market.¹ To become self-employed, one needs to either possess large asset/wealth holdings or to borrow from a financial institution. Relatively poor individuals, and especially the women and minorities among them, usually lack both sufficient wealth and credit financing. Thereafter we will also refer to this group of individuals as a *credit-constrained* group.

There can be several reasons why credit-constrained individuals lack credit financing for their businesses. They may apply for credit less often than other types of business owners (the demand is lower) or may be denied credit more often (face a lower supply), or may not apply for a loan because they guess their applications would be denied.

Credit-constrained customers could have their loan applications rejected for several reasons. First, being relatively poor, they may not have enough assets that can serve as collateral. Second, they are on average riskier business owners. Third, prior to deregulation, banks may have just preferred not to finance certain groups (i.e., could have been employing some taste-based, non-economic discrimination practices) and could get away with it because there was limited competition in the banking industry. Whether any taste-based discrimination has a material effect on the credit market is an empirical question.

Several earlier studies have addressed the issues of discriminatory practices employed by financial institutions against minority groups. The available empirical evidence, however, is mixed. For example, Durkin and Elliehausen (1978), Peterson (1981), Elliehausen and Lawrence (1988), and Elliehausen and Durkin (1989) find that either no taste-based discrimination against women and non-white minorities is present in the credit market or that discrimination is not widespread enough to be determined empirically.

But Cavalluzzo, Cavalluzzo, and Wolken (2002), Gabriel and Rosenthal (1991) and Munnell, Browne, McEneaney, and Tootell (1996) find that, even after controlling for default risk, minorities are less likely to obtain a loan than white applicants. Jappelli (1990) identified that, among other factors, gender and race play a crucial role in determining the probability a loan application will be denied. This evidence might suggest that taste-based discrimination against women and minorities is taking place.

Taking a different approach, Ferguson and Peters (1995) show that a higher loan denial rate for minority applicants does *not* mean they are being discriminated against.² Groups of borrowers with different credit quality distributions (such as whites and non-whites, men and women) have different average credit quality, therefore both loan denial and default rates must differ under a fair, non-discriminatory, credit policy.

As discussed above, the most widely used measures of discrimination in credit markets – loan denial rates – produce mixed evidence and are being questioned for adequacy. Moreover, there are data limitations that restrict the ability to differentiate economic (statistical) discrimination from non-economic (taste-based) discrimination in the credit market. This paper, therefore, utilizes an *indirect* approach to analyze whether there was a *change* in (taste-based) discrimination in lending following banking deregulation. The intuition for this approach is discussed below.

¹ Statistical, or “economic discrimination,” is discrimination based on credit applicants’ potential risk; taste-based, or “non-economic discrimination,” is discrimination based on the preferences of a lender regarding the personal (mainly demographic) characteristics of potential borrowers.

² More precisely, Ferguson and Peters (1995) show that “. . . a higher denial rate for minority applicants is consistent with a uniform (non-discriminatory) credit policy . . . [and] equal default rates imply that minorities *are* being discriminated against.

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