

Access to Capital for Small Business

Capital is the Lifeblood of Small Business

Small business is the lifeblood of our economy and capital is the lifeblood of small business.

For the American economy to thrive, small business must thrive – and small business cannot thrive without capital. Particularly at those moments when a small business is poised to make its greatest contribution to the U.S. economy through job creation – at the start-up or expansion of a business – small business relies on affordable access to capital. Wise stewardship of the economy demands strategic efforts aimed at making capital accessible to small businesses.

From seeding a new idea to securing intellectual property rights, from purchasing materials to making payroll, entrepreneurs cannot start, maintain or grow their small businesses without capital. Yet, despite being an essential ingredient for a healthy small business sector, small businesses continue struggling when it comes to accessing capital. Entrepreneurs have limited options when searching for capital: hard-to-find equity investment in the form of venture capital, or risky debt in the form of carried personal credit card balances, bank loans or personal loans.

Instead of lavishing federal dollars on large multinational corporations, we must steer those millions of federal dollars to boost small and medium-sized enterprises, jumpstarting the U.S. economy in the process.

Small Business Majority's platform proposes the expansion of small business' access to capital through five initiatives:

- 1. A new public-private partnership to generate innovative small business loans.**
- 2. Targeted tax incentives to encourage private sector investment in small business.**
- 3. Revitalized SBA and other successful capital assistance programs.**
- 4. Reform of troubled small business disaster assistance programs and implementation of the lessons of Hurricane Katrina.**
- 5. Increased small business prime participation in government contracts.**

An SBM Proposal: The Small Business Capital Corporation (SBCC)

Putting U.S. Credit to Work

The United States has the highest rate of homeownership in the world because our mortgage finance system harnesses one of our nation's underutilized resources: its creditworthiness. Uncle Sam is a reliable borrower. Home buyers benefit from this fact through two programs: the mortgage insurance programs sponsored by the Federal Housing Administration and Veterans Administration and the secondary mortgage market created by Fannie Mae and Freddie Mac, two government-sponsored enterprises. Both programs channel private capital to borrowers by placing government guarantees on loans. In the current business environment, this budget-friendly approach should be a model.

Although credit is readily available to any qualified American who wants to buy a home, the same is not true for small business owners. Access to capital remains one of the biggest

challenges for owners of small and medium-sized enterprises.¹ To finance start-ups and expansion, small business owners must take out second mortgages on their homes, max out expensive credit card debt and press relatives for loans. By applying lessons from the federal housing success story, we can do better.

To address this shortcoming, SBM calls for the creation of a new government corporation within the Small Business Administration (SBA): the Small Business Capital Corporation.²

The SBCC's Two Core Programs

The SBCC's core objective is to increase the availability of capital for small businesses and medium-sized enterprises. The SBCC cannot accomplish this objective by simply replicating housing programs. Business and mortgage lending are quite different. Unlike home loans, small business loans often must be made without underlying collateral and clear income expectations, making design of viable loan products more difficult.

To meet the demand for additional capital, the SBCC will have two core programs:

- **Expansion of secondary markets for small business loans**

There is virtually no market for small business loans not guaranteed by the SBA. The SBCC would change that.

Beginning with a pilot program, the SBCC will develop standards for loans valued at less than \$250,000 that can be made using credit scoring methods. Loans conforming to these underwriting standards set by the SBCC will be made by SBA-approved lenders. They will be eligible for purchase by the SBCC so that they can be pooled to back pass-through securities with zero credit risk to investors. This replicates one of the primary efficiencies brought to the mortgage market by Fannie Mae and Freddie Mac. The SBCC will do the same for small business loans thus making them less expensive to borrowers and more profitable for lenders.

The SBCC may also purchase the unguaranteed portion of 7(a) and 504 loans to help expand those programs as well. The SBCC will not offer products that compete directly with those currently offered by SBA-approved pool assemblers. Additionally, the innovative loan products developed through the guarantee program (see below) may be incorporated into the secondary market program.

- **Encouraging the ongoing creation of innovative small business loan products**

The SBCC will use its creditworthiness to support those lenders meeting the capital needs of small businesses with innovative loan options. The SBCC will guarantee these new loans, provided that they conform to established underwriting guidelines and that the institution originating the loan shares a portion of the risk. For example, non-profit lending institutions, particularly those with a track record of successful micro-lending, should be invited to participate in this program as loan originators. By developing a variety of new products -- from small loans (less than \$30,000) to loans that do not require substantial repayment for six months to one year -- SBCC will be able to assist different segments of the market.

Micro-loans introduced under SBCC could feature:

- *Alternative payment schedules* – balloon payments or deferrals that would place less strain on small business cash-flow during critical start-up and expansion periods.
- *Alternative sources of collateral* – inventory, accounts receivable, expected revenue and tax write-offs.
- *Alternative financial instruments* – convertible debt and equity, pooled to attract investors.

First Steps

- The SBCC will initially be a government corporation within the Small Business Administration.
- The SBCC will be designed to convert from a government corporation into one or more government-sponsored enterprises (GSEs), with full privatization envisioned within 15 years (similar to the recent full privatization of Sallie Mae).
- The initial appropriation request will be \$50 million over two years. The largest portion of this capital will take the form of stock sold to the SBA. At the time of conversion to GSE, sale of this stock will provide an infusion of funds into the SBA to finance existing programs. Within 10 years, the SBCC will generate sufficient revenue to cover costs making conversion to GSE possible.

As a government corporation, the SBCC will issue securities with government status, providing a source of relatively inexpensive financing. Savings will be passed on to entrepreneurs. Conversion to a GSE will later provide the SBCC with an infusion of equity financing. The appeal of this approach is that the SBCC can leverage a fairly modest total appropriation into a significant increase in the amount of credit available to small business. The initial appropriation would cover start-up and operating expenses as well as a reserve against losses on a total loan volume that would be a significant multiple of that amount. For example, Ginnie Mae, a government corporation within the Department of Housing and Urban Development, guaranteed issuance of \$175 billion in mortgage-backed securities in 2002 and had a net positive income of \$790 million. It will be some years before the SBCC matches that level of activity.

Careful Management and Rigorous Standards

The SBCC must be managed with uncompromising dedication to fiscal soundness. With strict oversight from inception, the SBCC will provide a model for federal use of hybrid organizations including planned privatization from the outset. An independent office of the Treasury Department will be created with responsibility for oversight of the SBCC. This entity will ensure that the SBCC will retain sufficient capital to cover its liabilities and that operations are carried out in a safe and sound manner. At all times, the Administrator of the SBA will retain oversight authority to ensure that the SBCC's primary objective – maximization of credit availability for small business – never takes a back seat to pursuit of profits.

Tax Incentives to Encourage Investment in Small Business

Economic growth is the result of the push-pull of positive effects created by tax incentives offset by the negative effect of the deficit (particularly interest rates).³ What this means for the small

business sector is that in order for it to do what it does best – invigorate the economy through job growth and innovation – the federal government must provide tax incentives that encourage private investment and development of capital. Elimination of taxes on capital gains earned through long-term investment in a small business will make great strides in increasing access to capital for small business (and all the macro-economic benefits that come with it).

Unfortunately, in a time of urgent need for capital formation, the current administration uses tax policy to discourage small business investment in favor of an ideology of corporate favoritism. Ten Nobel economists came together in agreement (a rare enough event⁴) in joint opposition to the 2003 tax policy changes, and named the dividend income tax break as egregiously misguided and ineffective in stimulating investment at a time of recession.⁵ In December 2005, the House supported this folly by extending the tax break. Meanwhile, the Federal Reserve has found that these tax breaks have had almost no effect on the value of the stock market or benefit to shareholders.⁶ Instead of luring investment away from small business, a competitive tax policy must encourage capital formation and access for small business.

Reviving the Small Business Administration and Other Valuable Small Business Programs

The Small Business Administration (SBA) has helped hundreds of thousands of entrepreneurs start and expand their businesses by guaranteeing loans obtained through private lenders. Examples of past SBA success stories include Intel, Ben & Jerry's, the GAP and Callaway Golf. SBM is highly supportive of the SBA's goals as an institution, but current funding levels are grossly inadequate -- and getting worse.

Although the SBA budget represents only .03% of the federal budget, the SBA and its programs have a tremendous return on investment.⁷ Indeed, small businesses rely on SBA-guaranteed loans for 30% of their long-term lending.⁸ Yet, under the current administration, funding for the SBA has been *halved* even as the need for SBA-guaranteed loans grows.⁹ At the same time, millions of dollars annually go to large corporations that do not have the same degree of need as small business, nor the same focus on creating jobs in the United States.¹⁰

The current administration has consistently targeted the SBA for more substantial budget reductions, in flagrant opposition to its recently articulated plan for American competitiveness. The White House has sought to cut SBA funding in consecutive budget proposals since 2001. Indeed, this year's proposed SBA budget reflects a 30 percent cut from last year's, and a 60% reduction from when President Bush took office.¹¹ Until 2000, the SBA's funding, loan guarantee authorization, and other small business programs increased steadily; but, the SBA's budget is now barely half of what it was in 2001.¹² On top of that, its lender fees have increased by 110%, its borrower fees have more than doubled, it is making steadily fewer loans over the past year, and its average loan size has declined by 30% since 2001.¹³ Moreover, the administration's proposed 2007 budget actually targets half of all small business programs for elimination.¹⁴ Three quarters of all small business programs government wide are slated for cuts – or outright elimination.¹⁵

The American small business community calls for an end to the starvation of the SBA and other successful capital assistance programs. America needs a strong commitment to small business formation and expansion if the small business sector is to lead the way for American competitiveness.

- **The 7(a) loan guarantee program must receive funding.**

Through loan guarantees, the 7(a) program provides 30% of long-term capital to small businesses. Once again, the current administration proposes abandoning program participants by eliminating funding entirely. As a result, small businesses will be left to bear the full cost of the program fees – despite the program’s label as a public-private partnership. SBM calls for a return to 2004 funding levels of \$79 million.

- **The SBA must continue to develop and promote women and minority entrepreneurship.**

Minorities make up one-third of the population while owning only 15% of the small businesses. Minorities are the key to the future economic health of the country, yet they face unusual hurdles in obtaining capital and credit. Of the projected 131 million increase in population by 2050, 90% will be “minorities.”¹⁶ Yet, according to a recent study by the Ewing Marion Kauffman Foundation, less than one percent of the \$250 billion in venture capital dollars invested annually nationwide is made available to meet the needs of the country’s 4.4 million minority business owners.¹⁷ It is in the best interest of American competitiveness for our government’s policies to reflect our new demographic realities.

In a shortsighted move, the administration has once again proposed eliminating the Microloan program, a program that proportionally serves the most African-American and women entrepreneurs. SBM calls for restoration of funding for this program. At the same time, SBM endorses the Minority-Owned Venture Empowerment (MOVE) Act of 2005, which seeks to modernize the 8(a) loan program and make it easier for minority business owners to access federal contracts.¹⁸

Women-owned businesses are growing at twice the national average – they, along with minority-owned businesses, are the real key to small business growth in the future. In this connection, we support SBA implementation of rules establishing women-owned business federal contracting minimums and those efforts that seek to keep the SBA true to its mission.¹⁹

- **Our government must support venture capital programs that serve those small businesses which need it most.**

A small business owner seeking equity investment soon learns that the private sector venture capital markets are temperamental and prejudiced in favor of a few industries and regions, making access nearly impossible for momentarily unpopular industries or regions. The New Markets Venture Capital program is one of the most efficient tools at getting development money (equity investment) to those regions and industries typically ignored by private sector investment. In this connection, SBM endorses Rep. Gwen Moore’s (D-WI) SEED Act²⁰, legislation that would restore funding to this vital program, and calls for more bipartisan efforts to nourish this program and others like it.²¹

- **The SBA must connect small businesses with existing sources of capital.**

Too often, in those instances where capital is available, small business owners do not know where to find it or how to access it. If capital is available but the labyrinth of loans, guarantees, regulations and fees make it impossible to obtain, what is the point?

The SBA’s Business Information Centers and Small Business Development Centers have been very successful in helping small business owners by aggressively identifying

potential borrowers and enlisting private lending institutions to locate and educate good customers. SBA funding must be restored to these programs.

- **The Office of Advocacy must be empowered to function independently.**

SBM strongly supports the Office of Advocacy and its role in the battle for regulatory parity. Within the SBA, the Office of Advocacy has been touted as the independent representative of all small businesses – it identifies itself as “the independent voice for small business within the federal government”. That said, the purse strings of the Office of Advocacy are controlled by the SBA Administrator, a political appointment. For the Office of Advocacy to flourish in its independent representation of America’s small business, Congress must grant the Office of Advocacy its own line item within the federal budget.

The Lessons of Hurricane Katrina - Timely Small Business Disaster Relief from the SBA and Others

Small businesses are particularly vulnerable to the impact of disasters. In light of small business’ centrality to our economy, it seems obvious: when a region suffers a disaster, the way to jump start the local economy is to provide meaningful assistance to local small business. The economies of entire regions are often left decimated, and the ripple effects are felt across industries and businesses of all sizes. SBM endorses reform in favor of immediate legislative response in the face of such disasters and prompt mitigation of the devastating impact on small businesses.

The current administration has struggled to provide efficient emergency response since America faced the losses of September 11, 2001. While Congress brokered comprehensive and promising bipartisan small business relief efforts²², the administration stopped these efforts at every turn. Years later, Congress is still holding hearings on the propriety of SBA relief packages that went to small business neither needing nor seeking relief.²³ In July 2005, the administration amended its original 2006 budget package – to *take funding from* the SBA’s disaster loan program. A month later, Hurricane Katrina reminded us of the importance of disaster relief preparedness.

Hurricane Katrina left thousands of small businesses in desperate need of immediate funding that never came. It is well documented that, despite immediate government attention to the needs of large businesses that were affected by the calamity, both the SBA’s disaster loan program and the “GO-Zone” mechanism failed spectacularly when it came to meeting the needs of impacted small businesses.²⁴ The SBA turned down some 88% of disaster loans, and the program seemed to have been administered without any sense of urgency – by the time the SBA had received 352,000 applications for the disaster loan program, *only 38,000* had even been processed.²⁵ By January 20, 2007, only 24% of Hurricane Katrina small business loans had been approved – of those few approved, more than 75% were yet to be actually dispersed. The “GO-Zones,” announced months after Hurricane Katrina, had made only 10 loans by the end of 2005.²⁶ Disconcertingly, the current administration seems intent on disregarding the lessons of Hurricane Katrina: in formulating its 2007 budget proposal, the current administration seeks to eliminate some 50 disaster response staff members while raising the cost of disaster assistance loans to small businesses.²⁷

Meaningful assistance for immediate recovery is the solution. To this end, bridge loans are essential to the recovery of businesses devastated by natural disaster. Bridge loans provide small businesses with the immediate assistance they need to manage clean-up, restart and subsequent energy costs. As noted in the Washington Post, this “may well represent the first time a government agency as resisted a congressional attempt to give it more money.”²⁸ SBM calls for a

return of bridge loan funding to the otherwise comprehensive Small Business Hurricane Relief and Recovery Act of 2005,²⁹ and will support those recovery initiatives that assist the desperate small business owners devastated by natural disaster.

Government Procurement

Fair competition for government contracts is of paramount concern to small business. The federal government is the largest purchaser of goods and services in the country, yet small businesses receive only 20% of all federal prime contract dollars.³⁰

In order to address agency bias toward contracting with big business³¹, SBM calls for a reduction in the “bundling” of federal contracts. In “bundling”, several smaller federal contracts are bundled into one large package that is then awarded to only one vendor. Bundled contracts are typically awarded to big business; small businesses are relegated to the role of subcontractor, missing out on the ability to make connections with contracting agencies or negotiate the terms of their engagement. For every \$100 bundled, small businesses lose \$33 in federal contract awards.³² By taking away from small business specialists who can execute faster and better, taxpayers lose both quality and value per tax dollar spent.

A recent Inspector General report noted that some \$384 million in government contracts was lost to big businesses because of insufficient staffing at the SBA. As a result, some 87% of bundled government contracts were never even reviewed by the SBA for possible small business contracting.³³

SBM supports a reversal of these disturbing trends and the re-establishment of a level playing field for small businesses in government contracting opportunities.

Resources

Putting the Spotlight on Small Business

Center for American Progress, John Alexander Burton, July 5, 2005,

Available online at <http://www.americanprogress.org/site/pp.asp?c=biJRJ8OVF&b=874471>

Impact of FY 2006 Budget on Small Business

Report prepared by House Small Business Committee Democratic Staff, February 16, 2005.

Available online at: <http://price.house.gov/UploadedFiles/Budget%20Report%20FY06Final.pdf>.

For a discussion of the FY07 proposed budget, see

<http://www.house.gov/smbiz/democrats/Reports/fy07budgetreport.pdf>

Carving New Channels of Capital

Milken Institute Center for Emerging Domestic Markets

Available online at: http://www.milkeninstitute.org/pdf/cedm_overview.pdf, or

<http://www.milkeninstitute.org>, for a general discussion of the issues.

Contract Bundling: A Strategy for Increasing Federal Contracting Opportunity for Small Business

A Report by the Executive Office of the President, October 2002.

Available online at: <http://www.acqnet.gov/Notes/contractbundlingreport.pdf>.

¹ National Small Business Association, on the World Wide Web at <http://www.nsba.biz/content/775.shtml>

² The SBCC was originally proposed in 2003 by Howard Dean during his presidential campaign. It was developed by Jonathan Koppell, Associate Professor of Politics and Management at the Yale School of Management. SBM is grateful to Professor Koppell for developing this innovative idea, allowing SBM to propose it, and providing assistance to SBM in putting it forth.

³ Testimony submitted to the United States Committee on Finance, February 12, 2003, by William G. Gale of the Brookings Institution Tax Policy Center.

⁴ An observation made by Joseph Stieglitz, Nobel Prize winner in economics in a discussion with other Nobel laureates and experts at the Economic Policy Institute, March 2003. <http://www.epi.org>.

⁵ To read the 2003 statement online, go to http://www.epinet.org/stmt/2003/statement_signed.pdf

⁶ “House Passes Investment Tax Breaks”, *CNNmoney.com*, December 5, 2006. Available online at: http://money.cnn.com/2005/12/08/pf/taxes/house_tax_reconcil/index.htm.

⁷ See quote by Sen. Olympia Snowe (R-ME) in “Senators Slam SBA Budget for 2007,” *HispanicBusiness.com*, February 8, 2006. Available online at: <http://www.hispanicbusiness.com/news/newsbyid.asp?id=27957>

⁸ House Committee on Small Business, Democratic Staff, “Small Businesses Receiving Smaller Loans and Less Capital through Popular lending Program,” January 9, 2006. Available online at: <http://www.house.gov/smbiz/democrats/PressReleases/2006/pr010906.htm>.

⁹ Senate Committee on Small Business & Entrepreneurship, Democratic Staff, “John Kerry Calls on President to Support Small Business Owners,” January 31, 2006. Available online at: <http://sbc.senate.gov/democrat/record.cfm?id=251036>.

¹⁰ In the 2006 budget, for example, the current administration allocated \$200 million to the controversial Market Access Program. Under this program, large sums of money are doled out to large American corporations to subsidize their international advertising, without any observable long term benefit to the industries it claims to support or last impact on the deficit. Meanwhile, the proposed 2007 budget would cut funding for most programs of the Small Business Administration, the sole entity dedicated to the vitally important small business sector.

¹¹ House Committee on Small Business, Democratic Staff, “Democrats Call on Chairman to Hold SBA Budget Hearing,” February 9, 2006. Available online at: <http://www.house.gov/smbiz/democrats/PressReleases/2006/pr020906.htm>.

¹² Senate Committee on Small Business & Entrepreneurship, Democratic Staff, “John Kerry Calls on President to Support Small Business Owners,” January 31, 2006. Available online at: <http://sbc.senate.gov/democrat/record.cfm?id=251036>.

¹³ House Committee on Small Business, Democratic Staff, “Small Businesses Receiving Smaller Loans and Less Capital through Popular lending Program,” January 9, 2006. Available online at: <http://www.house.gov/smbiz/democrats/PressReleases/2006/pr010906.htm>.

¹⁴ House Small Business Committee, Democratic Staff, “The Impact of the FY 2007 Budget on Small Business,” March 2, 2006. Available online at: <http://www.house.gov/smbiz/democrats/Reports/fy07budgetreport.pdf>

¹⁵ *Ibid.*

¹⁶ “Carving New Channels of Capital,” Milken Institute Center for Emerging Domestic Markets. Available online at: http://www.milkeninstitute.org/pdf/cedm_overview.pdf

¹⁷ As cited by the Senate Committee on Small Business & Entrepreneurship, Democratic Staff, “Kerry Calls on Government to Expand Opportunities for Women, Minorities in Venture Capital Program,” February 16, 2006. Available online at: <http://sbc.senate.gov/democrat/record.cfm?id=251702>.

¹⁸ “The Minority-Owned Venture Empowerment (MOVE) Act of 2005”, 109th Congress, 1st sess. H.R. 4474.

¹⁹ Stacey Perman, “Is the SBA Hurting Small Business?” *BusinessWeek*, January 27, 2006. Available online at: http://www.businessweek.com/smallbiz/content/jan2006/sb20060126_977682.htm.

²⁰ “The Securing Equity for the Economic Development for Low-Income Areas Act (SEED Act)”, 109th Congress, 1st sess., H.R. 4303.

²¹ See, for example, the Angels Nurture Growing Entrepreneurs into Long Term Successes (ANGELS) Act, which seeks to encourage investment in minority entrepreneurs. 109th Congress, 1st sess., H.R. 4565.

²² Such efforts include “The America Small Business Emergency Relief and Recovery Act” which had 63 bipartisan cosponsors ranging the ideological spectrum. 109th Congress, 1st sess., S. 1499.

²³ Among the many articles discussing this troubling revelation, see Walter Alarkon, “9/11 Loans Ended Up in Wrong Hands”, Inc.com, December 29, 2005. Available online at: <http://www.inc.com/criticalnews/articles/200512/911loans.html>.

²⁴ John Alexander Burton “The GO Zone Won't Go: Lessons for Gulf Opportunity Zones”, November 9, 2005, Center for American Progress. Available online at: <http://www.americanprogress.org/site/pp.asp?c=biJRJ8OVF&b=1170683>

²⁵ See the January 12, 2006, statement by Sen. John Kerry, Ranking Member of the U.S. Senate Committee on Small Business and Entrepreneurship. Available online at: <http://sbc.senate.gov/democrat/record.cfm?id=250401>

²⁶ See the December 12, 2005, statement by Sen. John Kerry, Ranking Member of the U.S. Senate Committee on Small Business and Entrepreneurship. Available online at: <http://sbc.senate.gov/democrat/record.cfm?id=249629>.

²⁷ See footnote 24.

²⁸ “Slow Business Administration,” *Washington Post*, December 9, 2005.

²⁹ “The Small Business Hurricane Relief and Recovery Act of 2005”, 109th Congress, 1st sess., S. 1807.

³⁰ The Executive Office of the President, *Contract Bundling: A Strategy for Increasing Federal Contracting Opportunity for Small Business*, October 2002.

³¹ In 2002, nearly \$2 billion in government contracts reserved for small businesses went to 39 big businesses. The Small Business Administration, Office of Advocacy, “Analysis of Type of Business Coding for the Top 1,000 Contractors Receiving Small Business Awards in FY 2002” December 2004.

³² The U.S. Small Business Administration, Office of Advocacy, *The Impact of Contract Bundling on Small Business, FY 1992 – FY 2001*, September 2000.

³³ “President’s Budget Doesn’t Meet Needs of Small Businesses”, February 6, 2006, statement by Sen. John Kerry, Ranking Member on the Senate Committee on Small Business and Entrepreneurship.