CHAPTER 7

SUPPORTING AMERICA'S SMALL BUSINESSES

Ensuring the prosperity and growth of our Nation's small businesses and creating a climate conducive to entrepreneurship are critical to strengthening the American economy. The spirit of entrepreneurship has been intertwined with the Nation's history from the early entrepreneurs who laid the foundation for modern American commerce. Entrepreneurs built the industrial companies that helped to transform our Nation into an economic power, and today innovative startup companies proliferate across the country in a wide range of industries. Not only do small businesses now employ approximately half of the private sector workforce, nearly every American business starts small, implying that entrepreneurs play a critical role in economic growth and job creation.

Small businesses, defined by the Small Business Administration (SBA) Office of Advocacy as independent businesses having 500 or fewer employees, account for more than half of nonfarm private gross domestic product (GDP). These 27.5 million businesses, many of them family-owned companies, are a key part of the U.S. economy. The economic challenges of the past few years, however, have proved difficult for owners of small businesses. Between 2008 and 2009, the number of new businesses founded is estimated to have dropped 11.8 percent, from 626,400 to 552,600, and the number of bankruptcies rose 40 percent, from 43,546 to 60,837 (Figure 7-1).

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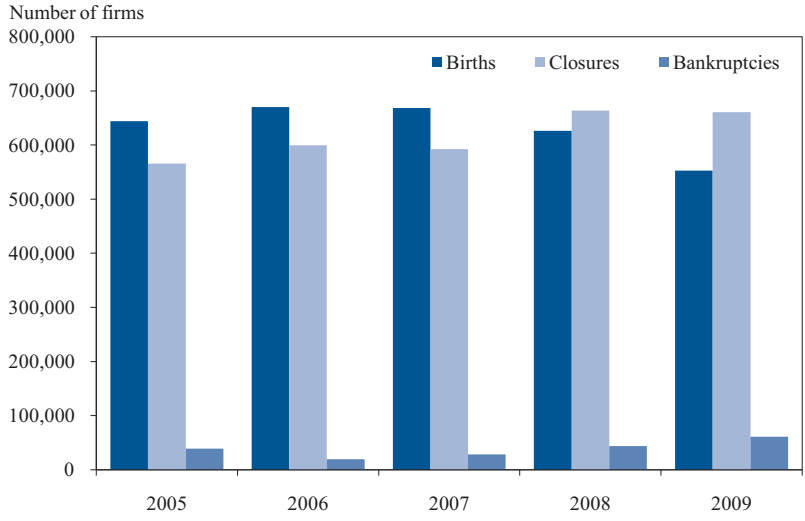
Figure 7-1
Births, Closures, and Bankruptcies of Firms



Notes: Births and closures in 2008 and 2009 are SBA estimates.
Births and closures include only employer firms. Bankruptcies include both employer and nonemployer firms. Employer firms have paid employees while nonemployer firms do not.
Sources: SBA, Office of Advocacy.

In response, the Administration has taken several actions to support small business, such as reducing taxes and improving access to capital and credit. Through the American Recovery and Reinvestment Act (Recovery Act), the Hiring Incentives to Restore Employment (HIRE) Act, the Small Business Jobs Act (SBJA), and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act, the Administration cut taxes for small businesses 17 times and improved their access to credit and capital. This chapter briefly reviews the impact of the recession on small firms and details how Administration policies have built a solid foundation for the future growth and prosperity of American small business.

Impact of the Recession on Small Businesses

Job Creation

One particularly important contribution of small firms to the Nation's well-being is the jobs they create. According to the SBA's Office of Advocacy, small firms accounted for 9.8 million of the 15 million net new private sector jobs created between 1993 and 2009—nearly two out of every three of the period's net new jobs. In normal times, new small businesses account disproportionately for employment growth. Although many new firms fail, surviving

firms create enough jobs to offset those lost to firm exits, so that most jobs created by firm births persist. A recent Kauffman Foundation study, for example, shows that startup firms created 3.1 million gross jobs in the United States in 2000. By 2005, about half of the initial firms had failed, but the survivors still employed 2.4 million people (Kane 2010).

During the recession, small businesses hired fewer workers than usual. According to Business Employment Dynamics statistics, between 2001 and 2007, businesses with fewer than 250 employees hired an average of 18.2 million workers a year, but those numbers fell to 16.5 million and 15.1 million in 2008 and 2009. Furthermore, some evidence suggests that small businesses have found it harder to recover from this recession than from past downturns. According to a Bureau of Labor Statistics report released in November 2010, new firms created a seasonally adjusted 1.1 million jobs during the three quarters before March 2010, or 31 percent fewer than during the comparable period after the 2001 recession.

Financing Small Business

Access to credit and capital enables owners of small businesses to start, support, and expand their companies. During the recession, both credit and capital availability for small businesses declined sharply, hampering entrepreneurs' efforts to finance operations and start new businesses. Although larger businesses typically rely on banks for only 30 percent of their financing, small firms receive 90 percent of their financing from banks (SBA 2009). Importantly, community banks—those with less than $1 billion in risk-weighted assets—provide 38 percent of small business and farm loans (COP 2010).

The capital structure of small business is typically roughly half equity and half debt, and the equity comes mainly from friends, family, or the founder themself. Unlike larger public companies, which routinely submit extensive financial documentation to the Securities and Exchange Commission, small firms cannot easily provide verified data to potential investors. These information asymmetries and other market frictions tend to slow the flow of credit and capital to promising small businesses. Many researchers have found evidence of these "liquidity constraints," which limit the funding that small business owners can raise from the market.[1]

Over the years, various institutions have arisen to help surmount this challenge in small business finance. One key to overcoming information issues is long-term relationships between small firms and commercial banks, whose officers not only can observe whether each small business is servicing

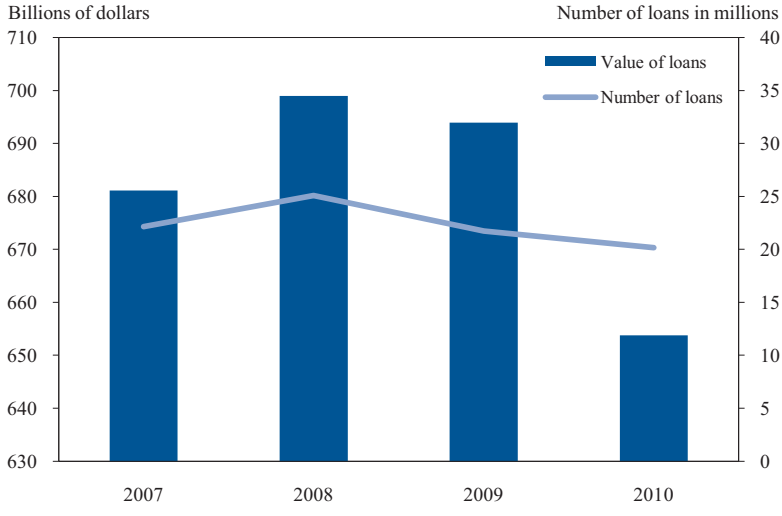
[1] This discussion draws from Berger and Udell, 2002; Peterson and Rajan, 1994; Evans and Jovanovic, 1989; and Holtz-Eakin, Joulfaian, and Rosen, 1994.

its loans, but also can collect additional information about its creditworthiness. To that end, one major aim of the SBA credit and capital programs is to overcome the market failures involved in financing small firms. The purpose of SBA loan programs, for example, is to support commercial loans to firms that would be considered good credit risks were it not for these information asymmetries. And the goal of SBA investment programs, such as the Small Business Investment Company program, is to overcome frictions in capital markets by encouraging the flow of venture and growth capital to small businesses.

Changes in Availability of Credit and Capital for Small Business

The recession complicated the already challenging financing landscape for small business in credit and capital markets. Commercial banks reduced their outstanding small loans (which are generally assumed to go disproportionately to small businesses) by more than $14 billion, or almost 2 percent, between June 30, 2008, and June 30, 2009, and the number of new loans to small business declined sharply (Duke 2010) (Figure 7-2).

Figure 7-2
Bank Lending to Small Business

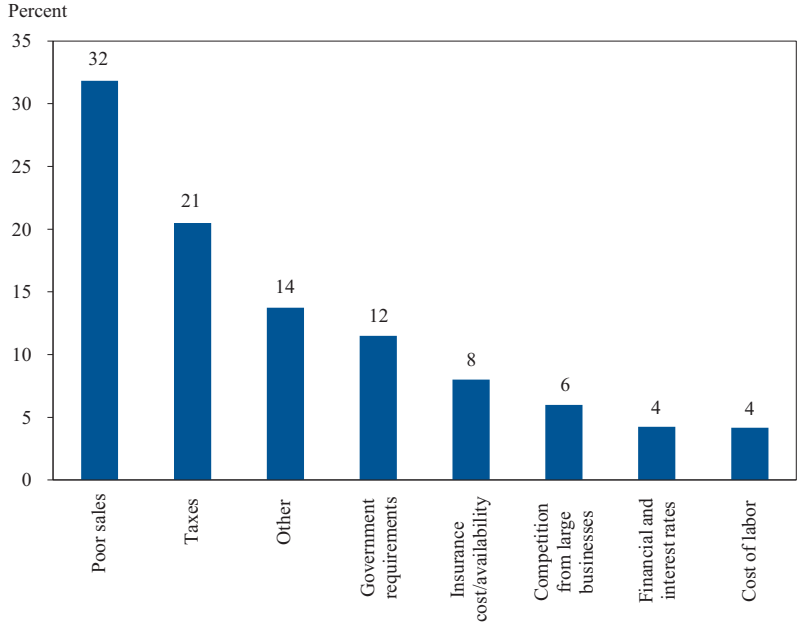


Source: FFIEC (2010).

Commercial and industrial loans, including loans to small businesses, fell an estimated 24 percent during the same period. This precipitous decline can be explained by changes in both demand and supply. First, the recession caused a drop in aggregate demand, reducing the ability of and incentives for small businesses to invest in new capital equipment or hire new employees.

As a result, the drop in demand for new loans contributed in part to the decline in lending to small business. Indeed, an additional 63.5 percent of bank senior loan officers reported lower demand in the second quarter of 2009 than reported higher or no change in demand, with smaller net differences throughout the rest of 2009 and early 2010. Furthermore, surveys from the National Federation of Independent Business indicated that in 2009 small business owners were far more concerned about poor sales than about tight credit (Figure 7-3).

Figure 7-3
Most Important Problem Facing Small Businesses in 2009



Notes: "Other" includes issues such as inflation and quality of labor. Data are an average of monthly National Federation of Independent Business surveys from 2009.
Sources: Dunkelberg and Wade (2010); CEA calculations.

But, falling demand was not the only problem. Firms that wanted to borrow and invest faced an especially grave situation during the recession. Specifically, the declining quality of existing loan portfolios for commercial banks led them to reduce or eliminate lines of credit and curtail new loans to small businesses. According to the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices, standards for lending to small businesses tightened, and interest rate spreads—the difference between rates charged to small businesses and a bank's prime customers—on loans

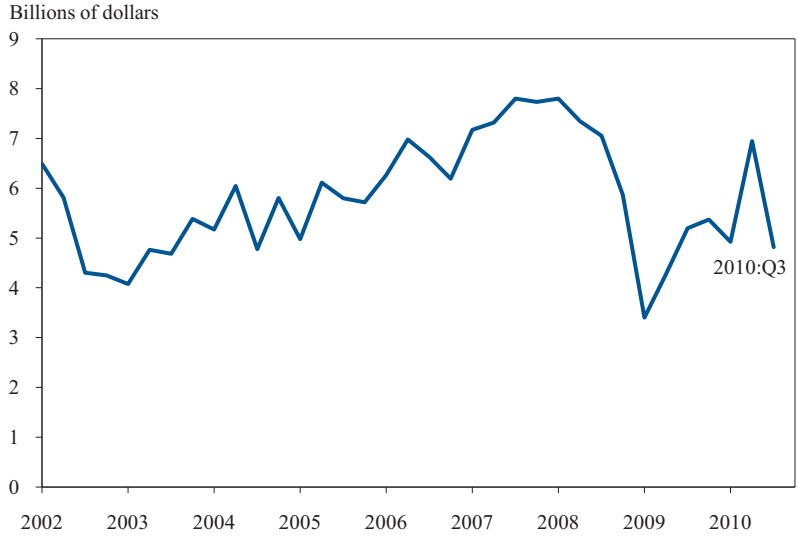
between $100,000 and $1 million increased by 1 percentage point to its highest level in more than 10 years.

The sharp drop in both residential and commercial real estate prices also likely contributed to the deteriorating lending environment for many small businesses. The value of real estate assets is important to small businesses. According to the Federal Reserve's 2007 Survey of Consumer Finances, nearly 11 percent of all households owned and managed a small business, and 18 percent of these households used personal assets, such as their home, as collateral for loans.

Despite signs of overall economic recovery, the lending environment for small business may take some time to recover completely. Following the 1990 and 2001 recessions, for example, commercial lending continued to decline—falling 13.3 percent between 1990 and 1994, and 20.4 percent between 2001 and 2004 (COP 2010). Support for the small business lending market may thus continue to be necessary even as economic growth resumes.

The recession generated problems not only in the small business credit market but also in the angel and venture capital markets that allocate funds to promising new small businesses with high growth potential. Angel investors are wealthy individuals or small groups who invest in entrepreneurial ventures, often in the early stages of development. In 2009, these angel investors provided $17.6 billion (down 8.3 percent from 2008) in funding to 57,225 entrepreneurial ventures (Sohl 2010).

Figure 7-4
Venture Capital Investment

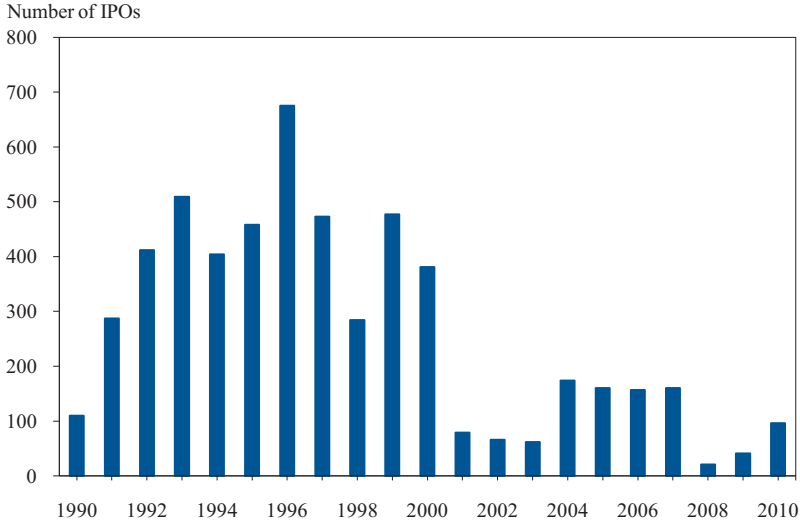


Source: PricewaterhouseCoopers and National Venture Capital Association (2010).

Venture capital firms raise funds from institutional investors and other limited partners to invest in privately held companies. Although venture capital firms fund less than 1 percent of new startups, firms that have received venture capital investments provide disproportionate growth, accounting for more than 12 million jobs and approximately $3 trillion in revenue in 2008. Venture capital has been especially important in spawning industries such as biotechnology, which has produced life-saving medicines and tens of thousands of American jobs (BIO 2008).

The venture capital market grew tremendously during the late 1990s, but fundraising has declined in recent years, and fewer venture capital firms are focusing on early-stage firms (Figure 7-4). Venture capital investment has never completely regained its strength since the end of the dot-com boom in the early 2000s, for at least three interrelated reasons: a decrease in such capital invested in early-stage startups; difficult economic conditions, including a weak initial public offering market (Figure 7-5); and asset reallocation away from venture capital funds by institutional investors. On average, $6.2 billion of venture capital was invested per quarter between 2001 and 2009. In the third quarter of 2010, however, venture capital investments fell 31 percent to $4.8 billion, according to a recent report from the National Venture Capital Association. The decline in access to capital for new firms exacerbated the more general financing challenges facing small firms.

Figure 7-5
U.S. Initial Public Offerings



Source: Ritter (2010).

Administration Policies to Support Small Business

To address the challenges for small businesses and entrepreneurs arising from the recession, the Administration has taken measures that can be grouped under two broad headings: reducing the tax burden for small business and improving access to credit and capital. Both sets of policies are designed to increase the funds available to small business owners to hire workers, invest in new equipment, expand operations, or attract new customers. It should also be noted that the stimulus provided by the Recovery Act increased aggregate demand, a key concern mentioned in surveys of small business owners. The Financial Stability Plan, administered by the Department of Treasury, was designed to restore stability and confidence in the financial market. Both of these policies addressed the macroeconomic conditions affecting small businesses.

In addition, to further spur demand for the products and services provided by small business, the President issued a memorandum on April 26, 2010, calling for an Interagency Task Force on Federal Contracting Opportunities for Small Business. The task force released 13 specific recommendations in September 2010 aimed at increasing contracting opportunities for small business. Those recommendations are now being implemented by the Office of Management and Budget, the SBA, and other Federal agencies.

Tax Cuts for Small Business

Since taking office in January 2009, President Obama has signed into law 17 tax cuts targeted to small business. Each has given relief to business owners who struggled to stay afloat during the financial crisis and subsequent recession.

As noted, hiring by small businesses slowed during 2008 and 2009. In response, the HIRE Act was enacted in the spring of 2010, to spur job creation across the economy, including in small businesses. The law provided a two tiered tax incentive to employers who hire and retain jobless workers. The first part of the incentive exempted employers from paying their share of Social Security taxes (6.2 percent of the first $106,800 of wages) on qualified employees. The second part was a general business tax credit of up to $1,000 for each new employee retained for more than one year. Both of these targeted tax cuts provided an incentive for small businesses to hire new workers and retain them, helping to revive an important engine of job growth in the American economy.

In addition, the Affordable Care Act responded to small business owners' concerns about high health care costs by giving eligible employers a tax credit of up to 35 percent of health insurance premium costs, increasing to 50 percent for any two years starting in 2014. Moreover, would-be entrepreneurs are sometimes discouraged from starting new firms for fear of losing health insurance coverage provided by their employer. In response, the SBJA allows 2 million self-employed individuals to deduct the cost of health insurance in 2010 for themselves and their family from their self-employment taxes, saving these workers an estimated $1.9 billion.

Administration policy also aimed to increase incentives for small business investment. These incentives included a Recovery Act provision, which was extended in the later SBJA, that allowed 50 percent bonus depreciation for new investments. The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act expanded this same incentive through a provision allowing businesses to expense 100 percent of their investments from September 2010 through the end of 2011. It is estimated that this provision will benefit up to 2 million businesses. The Administration also doubled, from $125,000 to $250,000, the capital investment and new equipment purchases that small businesses could write off in 2009 and increased that limit to $500,000 in 2010 and 2011. It is estimated that 4.5 million small businesses qualify for this provision. Taken together, these measures reduce the cost of capital for small business, providing significant incentives to invest in new machinery and equipment.

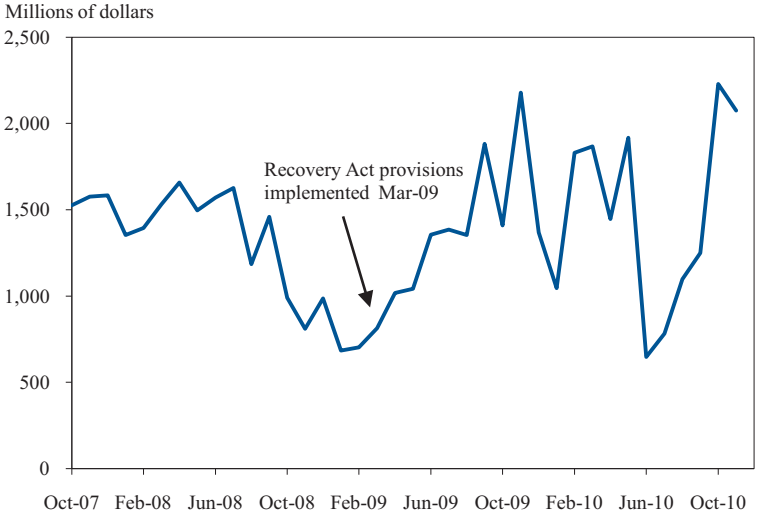
Finally, the Administration has taken key steps to facilitate the startup of new businesses and encourage equity investments in existing small businesses. The Recovery Act permitted 75 percent of capital gains on qualified small business investments to be excluded from taxation. The SBJA temporarily raised that exclusion to 100 percent for key small business investments held for at least five years, a benefit that is estimated to go to 1 million firms—and which the Administration has proposed to make permanent.

Initiatives to Increase Access to Credit

Aside from these important tax cuts for small business, the President also signed legislation that has helped small businesses access credit to hire employees and expand. The Recovery Act provided $730 million to the SBA to eliminate fees on SBA-backed loans and raise the guarantee to 90 percent on certain loans. Furthermore, the Administration expanded the Microloan program and the Surety Bond Guarantee program and provided funds to improve the efficiency of the SBA's lending and oversight

processes. Combined with measures taken under the Financial Stability Plan to unfreeze the secondary markets on which SBA loans are bought and sold, the Recovery Act SBA loan provisions have supported $30 billion in lending to more than 70,000 small businesses through October 2010. These measures were critical to the rebound of SBA-backed loans through 2009 and early 2010 (Figure 7-6).

Figure 7-6
SBA-Backed Loan Approvals



Source: SBA.

The SBJA went even further to increase the amount of loans to small businesses. It provided $505 million to the SBA to support up to $14 billion in new lending for small business while extending Recovery Act provisions to increase loan guarantees and reduce fees, thus ensuring continued access to more affordable credit for small business owners. From February 2009 through December 2010, the SBA has supported more than $42 billion of loans to nearly 82,000 small businesses.

The Administration also took several new steps to increase access to credit. For example, as small businesses grow, they typically need to borrow more to finance more expensive equipment, to increase their real estate holdings, and to hire more skilled workers. In addition to extending Recovery Act SBA lending initiatives, the SBJA also permanently increased the maximum size of SBA 7(a) program loans from $2 million to $5 million, raised the lending limit in the SBA 504 manufacturing-related loan program

from $4 million to $5.5 million, and temporarily increased the SBA Express program limit from $350,000 to $1 million.

Small Business Lending Fund. The Administration's efforts also focused on increasing small business lending more broadly. As noted, community banks are a critical source of credit for small businesses. These banks struggled during the financial crisis and sharply cut back their small business lending, though less dramatically than did larger institutions. To support these community banks and encourage more lending, the Administration created a Small Business Lending Fund to be administered by the Treasury Department and tailored to the specific needs of each state. Under this plan, the Federal Government is authorized to lend up to $30 billion in capital to community banks in return for preferred stock. The dividend rate that banks are required to pay back to the Treasury depends on how much they increase their loans to small business, with a dividend rate as low as 1 percent for lenders that increase loans by 10 percent or more.

State Small Business Credit Initiative. As part of the SBJA, the Administration also took action to boost small business lending by establishing a State Small Business Credit Initiative. Several states have already implemented loan programs to support small businesses, and the Administration is working with other states to create similar programs. Capital Access Programs, for example, create loan-loss reserves to which lenders and state governments contribute funds. Across a range of states, these funds have historically leveraged $10 to $30 from every $1 of public funds. The credit initiative will provide $1.5 billion to shore up state programs that faced difficulties during the economic downturn and to spur private sector lending to small businesses. This initiative will require a minimum leverage of 10 to 1—$10 for every $1 received from the Treasury Department, thus designed to support a total of $15 billion in lending across the nation.

National Export Initiative. Another important program to benefit small business is the National Export Initiative (NEI), launched through an executive order issued by the President on March 11, 2010. The NEI calls for a national outreach campaign both to identify small businesses that may be able to increase their exports and to raise awareness generally among the nation's small businesses about export opportunities. The NEI, working through a number of agencies, including the Commerce Department's International Trade Administration, will also provide training and other kinds of technical assistance to help small businesses prepare to become exporters. In addition, the NEI proposes to set up a pilot program to match small businesses with export intermediaries and outlines several measures to support small businesses with trade assistance programs once they begin

to export to new markets. In the 11 months before August 2010, the Export-Import bank increased its approvals for small business loans nearly 14 percent, from $3.6 billion to $4.1 billion.

Policies to Encourage Greater Access to Capital

In addition to providing tax cuts and increasing credit for existing small firms, the Administration also has introduced important policies to provide access to capital and to encourage the formation of new businesses. In particular, the Administration has launched several important initiatives to facilitate the flow of venture and growth capital to small businesses and create more supportive conditions for the launch of new ventures.

Small Business Investment Company (SBIC) Program. SBICs are private venture and later-stage capital firms that register with the SBA and make equity investments in small companies. They raise equity capital from private sources, raise debt backed by SBA guarantees, and deploy this capital in private companies. Since 1958, SBICs have invested more than $56 billion in more than 100,000 small businesses. Today, approximately 338 SBICs manage more than $17 billion.

Just as the Administration took action to counteract the decline in small business credit availability, it worked to counter the decline in the funding of new small businesses. To reverse the precipitous fall in venture capital fundraising during 2008 and early 2009, provisions in the Recovery Act permanently increased the effectiveness of SBICs in providing capital to high-growth firms. The Recovery Act first made SBICs eligible for increased SBA guaranteed funding. It then required them to increase their investments in smaller companies.

In 2010, SBIC financing to small firms totaled $1.6 billion, an increase of 23 percent over its average for the previous four years. In addition, processing time fell from more than a year to less than six months, allowing the SBA to increase markedly the number of new SBICs that it licensed.

Promoting Entrepreneurship in Regional Clusters. The SBA also launched its Innovative Economies Initiative to spur the development of entrepreneurship in regional clusters. The SBA provided $6 million to 10 regional economies across the nation to nurture and grow small businesses in critical industry supply chains. In one instance, the SBA provided funds to its Small Business Development Centers in the Philadelphia region to link local small businesses to the Energy Regional Innovation Cluster initiative on green buildings.

Startup America. The Administration has also promoted the success of new small businesses with high growth potential. On January 31, 2011, it launched Startup America to encourage high-growth entrepreneurial ventures such as those that have revolutionized the nation's software, semiconductor, life science, and energy sectors, among others. Startup America includes both specific federal policies and a public-private partnership to promote entrepreneurship. The primary goal is to increase the number of high-growth startups that create broad-based economic growth and jobs. A second goal is to celebrate and honor entrepreneurship as a core American value and give more Americans the opportunity to start their own business.

Startup America features policy initiatives in four areas: access to capital, entrepreneurship education and mentoring, commercialization of university and federal laboratory research, and reductions of barriers to growth for new ventures. To improve access to capital, the SBA will work with the private sector, through its SBIC Impact Fund program, to guarantee investments totaling $1 billion over the next five years in high-growth small businesses in underserved regions. The SBIC Innovation Fund program will guarantee an additional $1 billion of investment over several years in early-stage innovative companies. This initiative also calls for an extension of the 100 percent exemption of capital gains from qualified investments in small businesses and expands the New Markets tax credit program from $3.5 billion to $5 billion a year.

In the area of education and mentoring, the Department of Energy, the SBA, and the Department of Veterans Affairs will provide support to expand successful business mentorship programs for veterans of the wars in Iraq and Afghanistan and for clean energy entrepreneurs around the nation. In addition, private sector partners have committed to more than $350 million in investments for entrepreneurial education and mentoring. The third set of initiatives in Startup America will invest in strategies to bring innovative ideas from federal labs and universities into the commercial marketplace, both by establishing and disseminating best practices for commercialization and by funding regional "proof of concept" centers. In the fourth set of initiatives on reducing barriers to growth, the U.S. Patent and Trademark Office has announced that it will pursue a more efficient "Three Track" patent examination process, creating benefits for entrepreneurs seeking more certainty over the timing of important intellectual property protection. Startup America will also ask Federal agencies to identify barriers to high-growth entrepreneurship and launch a listening tour for Administration officials to travel the nation and meet with entrepreneurs to solicit their recommendations for improving the environment for entrepreneurship.

Conclusion

Small businesses, the foundation of the American economy, are critical to economic growth and job creation. Entrepreneurs, in part because of their reliance on commercial banks, were especially hard hit during the financial crisis and subsequent recession. A swift and comprehensive policy response was thus essential. The Administration has advanced important initiatives to lower taxes and make health insurance more affordable for small businesses, to increase their access to credit and capital, and to provide stronger incentives for job creation and investment. Taken together, these steps have stabilized the small business economy and placed it on a stronger footing for future growth.