Small Business Access to Capital: Critical for Economic Recovery

U.S. Chamber of Commerce

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The U.S. Chamber of Commerce is the world's largest business federation representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.

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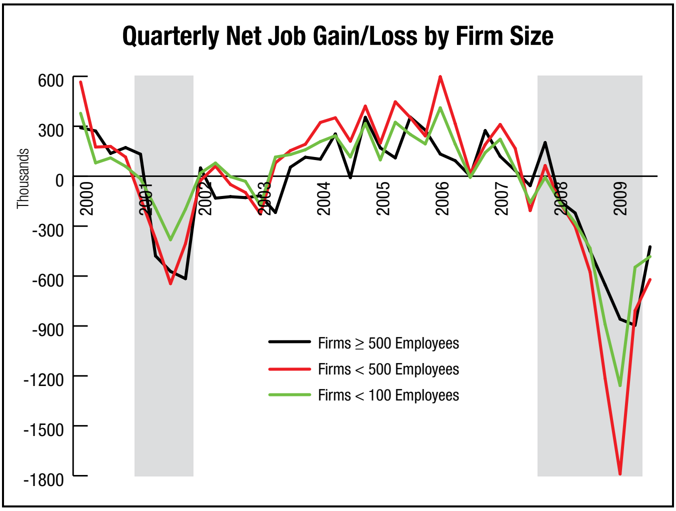
As the nation slowly emerges from trying economic times, it is difficult to overemphasize the contributions that entrepreneurs will play in creating jobs and expanding the economy. According to the Small Business Administration (SBA), small firms represent 99.7% of all employer firms, employ just over half of all private sector employees, pay 44% of total U.S. private payroll, and have generated 64% of net new jobs over the past 15 years. Clearly, any strategy to jump-start the economy must have a robust small business component that allows entrepreneurs to access capital and retain existing cash flow from operations in order to start, grow and expand their enterprises.

To that end, healthy credit markets are essential in creating an environment that enables capital to be properly allocated and risk to be priced accordingly. Well functioning credit markets provide entrepreneurs with the financing they need to commercialize innovation, seize marketplace opportunities, and compete internationally resulting in hiring and economic expansion. Conversely, when credit markets are in turmoil, paralyzed by uncertainty, or overburdened by the heavy hand of government, financial institutions are unable or unwilling to extend credit. This sidelines entrepreneurs from moving forward with opportunities that may generate jobs necessary to grow the economy and for economic prosperity.

With the unwinding of the housing market, a severe liquidity crisis, and the general deleveraging of the financial markets, the 2007–2009 economic downturn for small business owners and their employees was severe and widespread. To survive the sharp decline in the economy, Main Street businesses had to dramatically slash payrolls and reduce inventories. Frozen credit markets, in turn, accelerated the downward spiral of reduced consumer spending and weakened demand for goods and services, which resulted in additional layoffs and a prolonged and deep recession.

As seen in chart 1 on page 2, job destruction during the 2007–2009 recession was more pronounced by smaller firms than by larger ones. In contrast, the 2001 recession was mild. Net job loss by smaller firms tracked better than those of larger companies. Subsequently, smaller firms were quick to rebound from this downturn and once again, on net, create more jobs than their larger counterparts.

Chart 1



Source: Bureau of Labor Statistics Business Employment Dynamics

Not surprisingly, even though there are signs of a broad-based economic recovery, many small businesses that weathered the recent storm are still trying to survive, making defensive operational decisions in an attempt to protect assets in hopes of sure signs of stable increased economic activity. Most of these businesses were not highly leveraged at the time of the downturn and had sufficient capital on hand to help maintain operations. Many of the true risk takers were wiped out or had their resources greatly diminished.

Although some recent monthly data show incipient signs of improvement, in order to move Main Street from a posture of self-preservation to its traditional job-creating role, more customers are needed with the will and the means to spend. Main Street will be reluctant to create jobs and hire until it is clear that the economy is on a sustainable upward glide path. These business owners will have little appetite to participate in the recovery by taking on risk and beginning to aggressively hire ahead of consistently solid signs of a long-term return on the human capital investment, which can only be realized through sustained improvement in our economic outlook.

As economic activity gains momentum and provides more widespread confidence for small businesses to assume additional risk, credit markets will need to respond by providing robust avenues of capital for Main Street to replenish inventories, purchase equipment, and invest in new opportunities. Financial institutions, while maintaining appropriately prudent standards, must be positioned to ensure that creditworthy borrowers with solid business plans have the access to credit to move forward in an expeditiously.

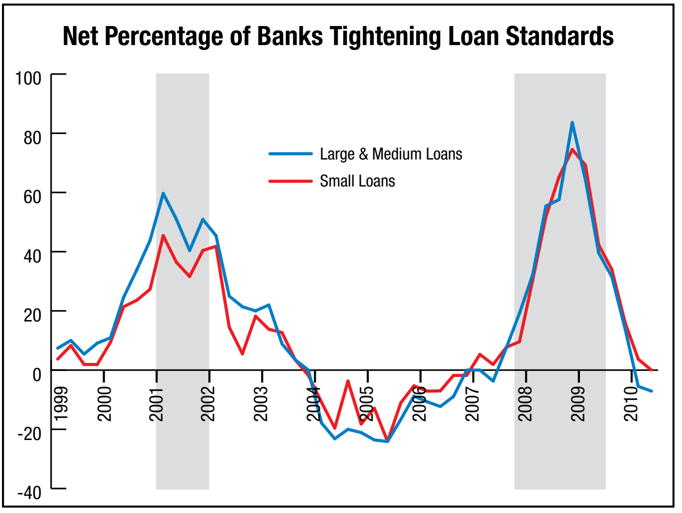
The current status of small business access to capital depends on whom you ask. From a small business perspective, it may appear as though financial institutions are not lending. When a small business owner is turned down for a loan due to increased lending standards by the bank, he may perceive this as part of an effort to withhold capital from small business. From the banks perspective, they may perceive the issue as a lack of qualified borrowers. Regardless of perspective, the net result is the same – no loan was made, and therefore economic activity is stifled.

This is also reflected in the Federal Reserve call reports which show that outstanding loans to small businesses dropped from almost $700 billion in the second quarter of 2008 to approximately $660 billion in the first quarter of 2010. This can be attributed to a variety of factors. Indeed, some of the reduction has occurred due to weakened demand. Another factor is a deleveraging of debt by all enterprises that took place in order to survive the reduced cash flow from depressed revenues during the downturn. Still, other small businesses that were not able to survive the downturn defaulted, and the banks wrote the loans off.

Examination of the Federal Reserve's Senior Loan Officer Opinion Survey (SLOS) on Bank Lending Practices provides a clear picture as it relates to lending standards for small business. A record 74.5% of banks reported tightening lending standards in the fourth quarter of 2008 (see chart 2), with a record 92.7% (see chart 3) reporting increased spreads on those loans. As we work to move out of recession and into recovery, banks, for the most part, report that they are not raising standards or spreads. However, they do not feel comfortable yet in lowering them either. The trend, though, shows a bottoming out of tighter standards and given continued positive economic news and more competition to lend, there is reason to be optimistic that banks will start to reasonably loosen standards and spreads.

While the standards and spreads for large loans closely track that of smaller loans, it must be remembered that larger firms may not be as dependent on bank lending as small businesses to raise capital. Corporate bonds, commercial paper and the sale of stock can provide alternative means for short- and long-term capital infusions for larger enterprises. Smaller firms are much more dependent on bank lending and are currently at the mercy of these extraordinary market conditions, whereby the cost of capital and the standards imposed by banks to qualify for loans limit the number of small businesses that can take advantage of legitimate opportunities in the marketplace.

Chart 2



Source: Federal Reserve Senior Loan Officer Opinion Survey

At this point in the recovery, it is imperative for lawmakers to concentrate on policies in established programs with a proven record of success that help provide financial institutions with added incentives for providing capital to small businesses. Polices that reduce the cost of capital to small businesses while mitigating risk for the lending institutions will help small businesses more easily obtain and afford needed capital to invest in opportunities that will once again spark the job-creating energies of our nation's entrepreneurs. Available capital that is reasonably priced can also be a factor in shifting small business owners from a survival frame of mind to that of proactive competitors pursing new ideas, markets, and opportunities, producing the economic activity that leads to new jobs.

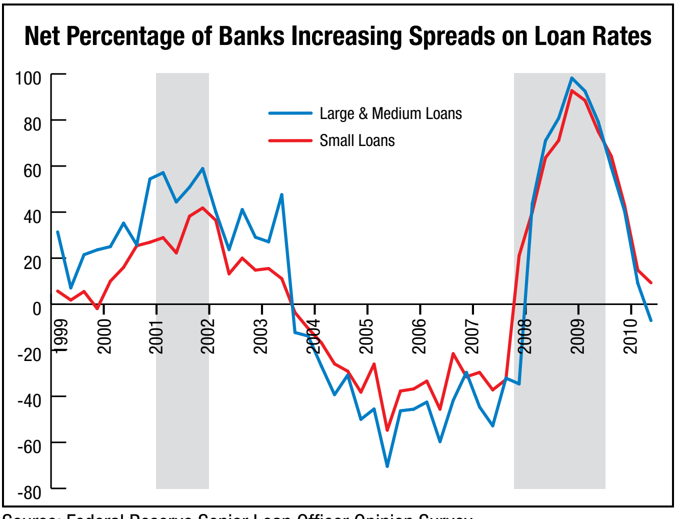
Beyond policies geared toward addressing financing acquired from financial institutions, lawmakers must also embrace polices that empower small businesses to fuel growth by retaining more of the cash they generate internally through their operations. Conversely this means rejecting provisions that hinder small businesses from building capital internally. Imposing costly mandates and labor intensive regulatory requirements on a business during these fragile economic times will divert limited and expensive cash resources toward questionable compliance efforts, rather than economic expansion.

The importance of internal financing for small businesses is buttressed in a July 2009 publication entitled Small Business in Focus: Finance, a compendium of research by the SBA's Office of Advocacy. A study included in this research finds "… a strong, positive relation between the level of internal funds and the likelihood of employment growth across small firms."

Underscoring the significance of internal funding, the report states, "For the practitioner working with small businesses, this study suggests that while outside capital is often needed, internal capital is critically important for the growth of small businesses. In addition, we find that the relationship between internal funds and employment growth is especially important for very small and women-owned firms."

It is paramount that lawmakers and bureaucrats weighing legislation and regulations that will impact, directly or indirectly, the availability and level of internal financial resources understand how and to what extent their actions will hamper the operations and growth potential for small businesses. Legislation and regulations that deplete a small business' internal cash resources should be modified to mitigate the drain or rebuffed when the benefit anticipated from the action is negligible, unproven or superfluous.

Chart 3



Source: Federal Reserve Senior Loan Officer Opinion Survey

Fiscal policy decisions by Congress can also play a significant role in determining available cash flow and capital for entrepreneurs. Lower marginal income tax rates, generous depreciation allowances, certainty in the estate tax rates, and permanency in the R&E tax credit are just a few examples of how lawmakers can augment current cash flow and enable companies to invest in new machinery and equipment, increasing their productivity and providing a further boost to the economic sectors that produce and service those items.

Another area of concern to the Chamber is the broad impact, both directly or indirectly, that the Dodd-Frank Wall Street Reform and Consumer Protection Act would have on the flow of capital to small and midsize enterprises. At this time of writing, the bill is pending. While it is not the intent to minimize the significant impact this legislation would have if it becomes law, it is beyond the scope of this paper to analyze its provisions and is left to future studies to scrutinize its effects on the regulatory structure and availability of credit.

The following are some policy initiatives that the U.S. Chamber of Commerce believes are clearly warranted to help small businesses access capital and retain internally generated cash flow for growing and creating new jobs as the economy rebounds:

Federal Individual Income Tax Rates

Many small businesses are organized as Subchapter S Corporations, Limited Liability Partnerships, and Limited Liability Corporations for federal income tax purposes. This means that the profits are not taxed at the corporate level but, instead, are passed through to shareholders who must then report the income or loss on their own individual income tax returns. While small business owners pay personal income taxes on the profits, the reality is that only a portion of the income generated by their businesses makes its way back to their personal bank accounts. Much of the income that small business owners are being taxed on is actually reinvested in their companies in the form of expansion and new equipment.

Raising or lowering the individual federal income tax rates directly impacts the cost of capital for small and midsize businesses formed as pass-through entities. If Congress raises the individual income tax rates, capital will cost more and small business owners will have less money to invest in their companies. In contrast, by keeping taxes low, small and midsize businesses can invest and grow and create jobs and help expand the economy.

As lawmakers look to address tax rates in the 111th Congress, the Chamber recommends that Congress lower all marginal tax rates or, at the very least, maintain those rates at present levels. By lowering or keeping rates at present levels, Congress would enable small business owners to invest more in their companies. Allowing these rates to rise would increase the cost of capital, diminish investment opportunities, and ultimately make small businesses less competitive, thus hampering job creation and leaving our nation less prosperous.

Federal Income Tax Depreciation

It is sound economic policy and in the best interests of our country that small businesses be encouraged to grow and nurture their businesses through cash flow from operations. This can be manifested, in part, by reform of the federal tax code's small business capital expensing provisions.

In general, businesses investing more than the annual expensing allowance must recover the cost of their expenditures over several years through the depreciation system. This injustice would best be remedied through the full expensing of business equipment. At the very least, amending Section 179 to permanently allow progressively greater expensing amounts and enhanced phase outs would be warranted. Such measures would spur additional investment in business assets and lead to increased productivity, creation of more jobs, and economic growth. Moreover, it would be a component of good, long-term public policy.

Changes to the Tax Treatment of Small Business Pass-Through Entities

Subchapter S Corporations, LLCs, and partnerships have provided business owners with important and unique vehicles by which to do business and

distinguish between time-investment return and capital-investment return. Long-standing principles of tax policy regarding the use of these tax structures have been embodied in our tax code and shaped by the courts.

Lawmakers have recently proposed broad and significant changes to current tax law as it relates to pass-through entities under the premises that compliance problems and inequities exist in the current system for distributing profits to employee-owners. Many of these proposals try to add self-employment taxes to distributions which, if enacted, would threaten to increase the cost of capital investment and business expansion through the use of these entities.

Further, increased taxes on income generated by pass-through entities, coupled with increases in all or some of the marginal income tax rates, could provide a significant barrier for the growth and expansion of businesses through internal cash flow. In addition, these provisions would add to the code's complexity by creating new categories of business activity that will have to be defined and litigated. That these and other proposals to increase the tax burden on small businesses are being "floated" in Washington, D.C., only adds to an aura of uncertainly for small business owners who are not clear as to what their tax liability will be in the next year and beyond. Such uncertainly has a chilling effect on business investment and job creation.

Access to Capital Lending Provisions

Access to capital through financial institutions is critical for small enterprises if they are to fully unleash the job-creating engines that are vital in igniting an economic turnaround for the country. One source of funding, the SBA 7(a) and 504 government guaranteed loan programs, plays an essential role in providing an alternative means of obtaining capital for many small business owners where funding has not been available through conventional lending methods. Although the volume of lending through SBA lending programs has dramatically rebounded over the past year due to incentives contained in prior legislation that was supported by the U.S. Chamber, loan volume is still at depressed levels, compared to pre-recessionary times.

In order to have capital available for small businesses so that they can create jobs and help revive the economy, the Chamber supports the following legislative efforts:

- **Temporarily extend and fund through the current calendar year the reduced borrower and lender fees for the SBA 7(a) and 504 loan programs.** Significant fee reductions will continue to incentivize the existing financial institutions to lend and will make funds more affordable for small businesses to borrow. Many small business owners cannot wait for new untested programs to be developed, no matter how well intentioned, that are currently being discussed as part of House and Senate jobs-related packages, in order to access funds to run their businesses. Also, new short-term programs may have the unintended consequence of further disrupting traditional channels of distribution.

- **Extend and fund through the calendar year the 90% government guaranteed percentage of SBA 7(a) loans.** Appropriate increases in the federal government guaranteed portion of the loan reduce risk to financial institutions and provide additional incentives for the industry to underwrite small business lending during a time when increased business default risk exists.

- **Make improvements to the SBA Express loan program.** Increase the maximum SBA Express loan value to $1 million and provide a temporary increase in the Express guarantee to 75% for two years.

- **Increase the maximum loan size and maximum guaranteed portion of SBA loans**. Lawmakers of both parties in both the House and Senate have introduced legislation that would increase the maximum size of SBA 7(a) and 504 loans from $2 million to $5 million. Their legislation would importantly also provide a commensurate increase in the statutory maximum guaranteed portion of SBA 7(a) loans. These levels are recommended by the administration and have bipartisan support.

- **Changes to the SBA 504 program to temporarily allow for commercial real estate refinancing.** Many small business owners are challenged to refinance real estate loans structured as balloon payments and collateralized by devalued assets when the loan matures. Even though the small business borrower may be current on payments, the financial institution with tightened lending standards and increased oversight by examiners may not have a choice but to either force the business into foreclosure or take a loss by writing down the loan. Lawmakers must enact legislation that would help small businesses and financial institutions overcome these hurdles by allowing borrowers to refinance eligible debt with a SBA 504 loan. This could be done with no expense to taxpayers.

- **Current data on small business lending.** The more current data we have on small business lending, the more informed lawmakers and policymakers will be in making better policy decisions. The Survey of Small Business Finances will no longer be sponsored by the Federal Reserve Board. In its place, the Federal Reserve Board will use the 2010 Survey of Consumer Finances to collect information on the finances of business-owning households. This will be a step in the wrong direction.

  Moreover, policymakers need better information on how many loans and their sizes are being made by financial institutions to small businesses, how many are being turned down, and what are the reasons that the loans are not being made.

- **More transparency.** Small businesses that need lending should have more information at their disposal in order to drive competition among the financial institutions that want to attract their business. Whether from the Export-Import Bank or the SBA, all government guaranteed business lending is public information. Information on who received these loans and the financial institutions that made them should be readily available

through a comprehensive database on a government-run website. Small businesses needing financing should be able to immediately identify and sort the information in order to drive a more competitive marketplace for acquiring a loan.

➢ **Single government source for information.** The government is involved in small business lending through a variety of entities, for example, the Department of Agriculture, the SBA, and the Export-Import Bank. There should be a one-stop shop, e.g. smallbusinesslending.gov, that would provide valuable information on how these loans are obtained and the financial intermediaries and their contact information capable of handling the transactions.

The Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR) programs

Congress established the Small Business Innovation Research program in 1982 to provide a fraction of federal agencies' research budget to small businesses in the form of grants. This program, over the years, has successfully harnessed the talents of small businesses to help meet the government's research and development needs when there was significant concern that the United States was falling behind its global competitors in developing innovative technologies. U.S. technological supremacy is again being challenged, yet SBIR and STTR currently do not enjoy a long-term reauthorization.

To ensure that small businesses are fully involved in advancing the nation's innovation and technology, the Chamber encourages the House and Senate to expeditiously negotiate a comprehensive long-term reauthorization of these two critical programs. The programs have currently been on life support with a series of short-term reauthorizations that have created an unstable environment for SBIR and STTR program managers to administer funding. This has served to undermine an important program that provides a source of capital for small businesses.

Regulation

Executive agencies issue up to 4,000 rules annually, meaning that nearly 60,000 have been issued since 1995. To say that these regulations represent a "hidden tax" on business and a drain on resources is a gross understatement. Last year, annual regulatory compliance costs were $1.187 trillion,[1] which dwarfed corporate income taxes of $147 billion. In 2009, Congress passed and the president signed into law 125 bills. When you consider that executive agencies, by contrast, issued a staggering 3,503 final rules in 2009, it becomes clear that a considerable amount of lawmaking power is delegated to unelected bureaucrats at federal agencies. The regulatory costs of $1.187 trillion absorb 8.3% of the U.S. gross domestic product (GDP), estimated at $14.253 trillion in 2009.

While many of these regulations are needed to provide clarity to laws and protect the public, many are counterproductive and provide needless paperwork and compliance burdens on the small business community. According to studies by the SBA, small firms with fewer than 20 employees annually spend 45% more per employee than larger firms to comply with federal regulations. Lawmakers and regulators must recognize the disproportional impact of regulation on small businesses and carefully examine alternative strategies or even if the regulation is needed at all.

The expanded information reporting mandate is just one example of an onerous regulation that will be promulgated as a result of Section 9006 of the recently passed health care legislation and was used as an unrelated

[1] Clyde Wayne Crews, *Ten Thousand Commandments: A Snapshot of the Federal Regulatory State*; April 15, 2010.

“pay for.” Businesses across the nation will soon be subjected to the folly of data collection and information filing on virtually all business-to-business transactions they make aggregating $600 or more per year at a time in which many can least afford it. As a result, lawmakers and regulators will divert precious time and resources that entrepreneurs could use to expand their businesses, collect volumes of information, and fill out mounds of new paperwork for the government.

This regulation will also have a chilling effect on new business relationships, most of which will be small businesses and startups. Many businesses in an attempt to decrease data collection and paperwork burdens will simply consolidate vendors and refuse to entertain new business dealings. This will have a disproportional impact on small businesses and entrepreneurs trying to get a foot in the door.

The ultimate irony of these new burdens is that the IRS neither has the resources nor the ability to use the new information to reconstruct an accurate picture of a company’s revenues since a large volume of business-to-consumer transactions are not reported. While the vast majority of compliant taxpayers will bear the cost of implementing this law, it will have only minimal benefit as a government tool in reducing noncompliance.

The 3% Withholding of Revenues on Government Procurement Contracts

Section 511 of P.L. 109-222, which created Section 3402(t) of the Internal Revenue Code, requires a 3% withholding on revenues from all government payments. This affects all federal, state, and local government contracts as well as other disbursements, such as Medicare payments, grants to for-profit companies, and farm payments. This requirement is set to go into effect January 1, 2012, and companies, as well as federal, state, and local governments, are already expending funds to prepare for implementation. Compliance with this law will impose significant, unnecessary financial burdens on both the public and private sectors.

The Department of Defense estimated that the costs to comply with the 3% withholding requirement will be in excess of $17 billion over the first five years, which is far more than any estimated revenue gains. While $17 billion is substantial, it is only a portion of the additional costs with which governments and the private sector will be burdened. This will remove essential working capital needed by the business community. It will require businesses to increase their financing costs, decrease their cash flow, and force needless capital expenditures to modify systems. Accordingly, the Chamber leads a coalition of more than 100 associations working to repeal the 3% tax withholding law.

Governmental Insourcing of Contracted Functions

Currently, there is a government wide initiative for federal agencies to contract out fewer functions and to insource functions that have previously been contracted out to the private sector. The Chamber has a long-standing policy that the government should not produce goods and services for itself or others if acceptable privately owned and operated services are or can be made available for such purposes. The government saves billions of dollars when it partners with and invests in private sector companies to help achieve agency missions, which, in turn, helps sustain our nation's competitive edge.

The federal government needs to continue providing opportunities for contractors to offer the most technologically advanced products and services and not arbitrarily shut off these opportunities by further growing federal government payrolls at the expense of private sector payrolls and growth. Certainly, some agency functions should not be contracted out, but the Chamber vigorously opposes quotas that mandate insourcing or prohibit the use of contractors. When the federal government grows, it grows at the expense of private sector contractors that have provided valuable products and services for decades.

Conclusion

To get the economy back on track and generating jobs, America needs a strong and vibrant small business community. Fundamental to the ability of entrepreneurs to participate in any economic recovery by seizing new opportunities, growing their businesses, and creating jobs is their ability to access capital—the life blood of their business. To that end, lawmakers must create an environment by which credit markets can readily respond to the needs of small businesses to fund their enterprises as well as enhance their capacity to finance themselves through internal cash flows. While this is not a comprehensive list, it does offer concrete priorities for lawmakers to consider, and the Chamber looks forward to continuing to work, in a bipartisan manner, with Members of Congress to support small businesses through greater availability to capital.

By Giovanni Coratolo
Vice President, Small Business Policy
Contribution by Steve Lutes
U.S. Chamber of Commerce

U.S. Chamber of Commerce
1615 H Street, NW
Washington, DC 20062
www.uschamber.com