Want to Strengthen Our Economy?

EXPAND ACCESS TO CAPITAL FOR SMALL BUSINESSES

Impact of access to capital challenges felt by entrepreneurs, small businesses, economic developers, and taxpayers

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ECONOMIC IMPACT CATALYST

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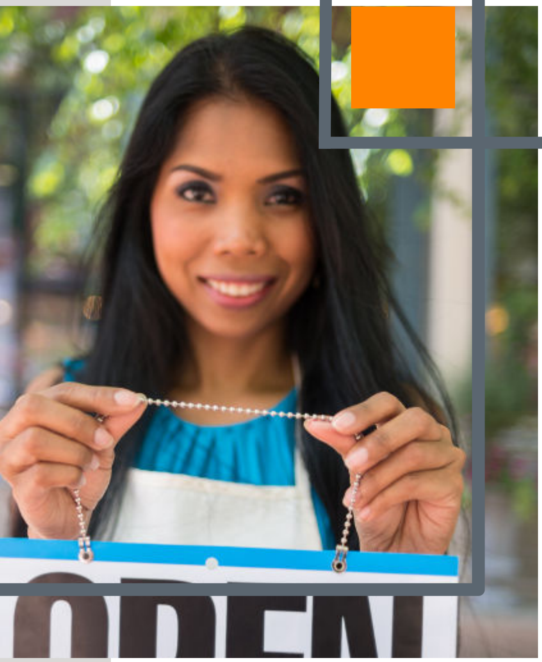


EXECUTIVE SUMMARY

As we look to invest in a more resilient future, economic development is reprioritizing the small business sector; however, the challenge for entrepreneurs to find the capital necessary to start and grow new businesses looms larger every day. The capital access problem poses substantial risks to both entrepreneurs and the economy. Some say it's even a threat to our nation. With the expansive American Rescue Plan to fuel creative solutions, now is the time for innovation.

This paper explores root causes and potential solutions to fix the capital access problem, resulting in a set of recommendations for action-oriented economic developers.

These recommendations draw on insights from EIC's work implementing technology-driven solutions for small business development in more than 100 markets since 2019, a small business survey conducted by the New Economy Initiative, and a body of research studying how America's small businesses are funded (or not), including findings from a survey with hundreds of small businesses and input from leaders working across the country to drive economic and community development through entrepreneurship.

We present key concepts for economic developers to act on closing the capital gap for small businesses in their communities. These concepts include:

- Make access to capital a policy priority, with tax incentives, state tax relief, and subsidies that encourage small business starts.
- Retool technical assistance programs to deliver individualized support focused on the financial health, skills, and position of the small business.
- Reimagine capital and how we fund small businesses to recognize the full set of benefits from the investment.

These concepts not only inform the steps to making capital more accessible, but also outline how economic developers can empower entrepreneurs in positioning their businesses for growth. The underlying principles reach beyond short-lived recovery programs to make lasting changes for small businesses to thrive.

INTRODUCTION

It took the economic collapse in the wake of COVID-19 for the small business sector to finally receive long overdue attention. As an estimated 25% of small businesses closed temporarily in 2020, "the devastation of COVID-19 … forced the country to take stock of our small-business sector," as policy experts explained, "Small businesses drive our economy, employing 47% of the U.S. workforce, generating two-thirds of new jobs, and serving as a critical path to economic self-sufficiency."[1]

We likely all agree small business is vital to America's economy and pivotal in the times of downturn. Yet the crisis of 2020-2021 and the inequitable implementation of the American Relief Program Act (ARPA) that ensued revealed severe vulnerabilities in how we fund and support small businesses.

This problem is particularly acute for small business owners from historically excluded communities, including women and Black, Indigenous, Latinx and other racial groups. In the initial rollout of the Payroll Protection Program (PPP), The New York Times reported only 12% of Latinx and Black applicants were approved for funding.[2] Myriad reports cited evidence attributing the disproportionate impact of the pandemic on minority-owned businesses to long-standing racial disparities in access to capital, mentorship, and technical training.

Of course, the small business capital problem is nothing new. Entrepreneurs know how difficult it is to find capital that's accessible, affordable, and fair.

Research by the Kauffman Foundation indicates 83% of entrepreneurs overall do not access primary forms of capital including bank loans and venture capital.[3] The Minority Business Development Agency (MBDA) says, "Capital access remains the most important factor limiting the establishment, expansion and growth of minority-owned businesses."[4] U.S. Small Business Administration (SBA) research concludes, "Nationally representative data on the financing of minority firms indicates large disparities in access to financial capital," finding minority-owned businesses pay higher interest rates on credit, and "are less likely to apply for loans because they fear their applications will be denied."[5]

The capital problem reaches far beyond the small business owner's purview— it is a major threat to our economy.

The SBA says small business financing patterns are "one of the biggest policy issues in the United States today" because the ability to secure adequate financial resources determines whether small businesses continue to "drive innovation, growth, and job creation for the U.S. economy."[6]

Expanding business ownership, particularly within historically excluded communities, is a key component of a comprehensive community development strategy alongside building vibrant public spaces, strong public education, and basic infrastructure. The COVID-19 pandemic laid bare our need for a thriving small business sector; it also demonstrated our existing models for funding America's small businesses are paralyzed by apathy, misunderstandings, and lack of imagination.

If small businesses are anchors for the community, fixing the capital access problem must be a priority.To miss the mark of this moment would be to put our $50M of American Rescue Plan investments on the line.

Here, we offer three ideas for economic developers to help fix the capital access problem.

Make access to capital a policy priority

Retool technical assistance

Reimagine capital for small businesses

#1 POLICY

MAKE ACCESS TO CAPITAL A POLICY PRIORITY

Starting a small business is the American dream. Yet when it comes to policymaking, entrepreneurship has been more of an afterthought.

Policymaking neglects small business except in times of crisis, leaving the sector employing nearly half of all Americans over-exposed during economic downturns and undercapitalized during periods of expansion.

Federal programs are often uneven or unfair, and business owners from underserved and historically excluded communities are hit especially hard by policy failure.

Take federal contracts for example. The federal government is the largest purchaser of goods and services in the world, and yet the White House reported in 2021, "less than 10 percent of federal agencies' total eligible contracting dollars typically go to small disadvantaged businesses" (a category under federal law for Black-owned, Latino-owned, and other minority-owned businesses), and "less than 5 percent of federal contracting dollars go to women-owned small businesses."[7] The disparities come at a monumental cost to the American economy. Studies based on U.S. Census data estimate 9.5 million more jobs would have been created if minority business owners were able to grow their businesses at rates comparable to the White population.[8]

Philanthropy has stepped in to promote entrepreneurship as a pathway to poverty alleviation and community development by funding both programs and loan funds for new businesses to get started. An article in The Foundation Review examined the role of philanthropic foundations in economic development stating, "In response to diminished state and federal leadership and funding, communities and their regions must consider how best to connect their existing assets to real market opportunities, and to do so in ways that decrease their dependence and increase their resilience."[9]

But philanthropy alone is not the solution. Scholar Rob Reich (2017) writes, "Charity represents the effort to try and provide direct services to people... it provides people things that they might deserve or need. But it doesn't get at the root source of the problem." He says, "Our public policies need to change."[10]

The Kauffman Foundation spends roughly $100 million a year on entrepreneurship development programs and argues policy is the answer: "To build an economy that works for everyone and enables more entrepreneurship, policies must break down historic and systemic barriers so that all Americans, regardless of race, gender, and geography, can

> *Policy must be combined with technical assistance programs and creative incentives that enable small businesses to start.*

achieve economic stability, mobility, and prosperity."[11]

At the state and local levels, policy must be combined with technical assistance programs and creative incentives that enable small businesses to start and create the sustainable jobs necessary to see our country through the next (inevitable) crisis. Tax incentives, state tax relief, and subsidies can encourage the development of microbusinesses* and small businesses and can be used deliberately to advance business ownership representative of the racial, geographic, and socioeconomic makeup of America.

RESOURCES FOR POLICYMAKING

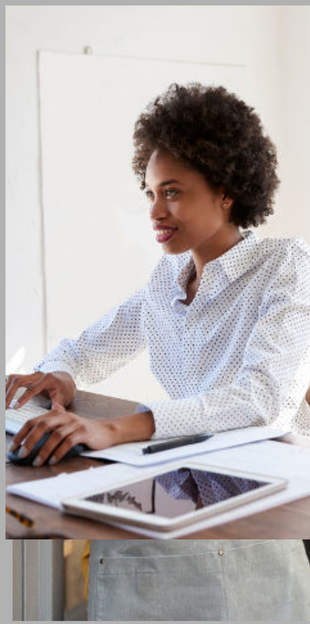
Field Guide for Policymakers
www.righttostart.org

A Roadmap to Inclusive Entrepreneurship
www.nlc.org

*Microbusinesses are defined as employers with fewer than 10 employees.

#2 TECHNICAL ASSISTANCE

RETOOL TECHNICAL ASSISTANCE



Economic development has traditionally favored big business at the expense of small business. Will the American Rescue Plan Act (ARPA) bring lasting change?

While analysts estimate 90% of economic development incentives awarded to companies in pre-pandemic times went to large firms, small business assistance programs are underdeveloped and under-resourced.[12]

To build long-lasting local wealth, the opportunity to invest in better assistance for small businesses cannot be ignored. In 2021, one in five small businesses closed within a year, and less than half remain in business after five years.[13] For "disadvantaged small businesses," the SBA's qualification based on social and economic characteristics including race, ethnicity, and gender, lifespans are even shorter due to "liquidity constraints and unfair lending practices that result from structural inequalities or racial discrimination."[14]

Relying on federal programs to help local small businesses is not a viable option. While the SBA spent $369 million on entrepreneurial development in 2021, the Cato Institute testified to Congress, "Federal audits have found substantial weaknesses in SBA's entrepreneurial development programs."[15] A 2020 poll by the Kauffman Foundation found 69% of entrepreneurs "do not think the government cares about them," and that, "this concern is even more pronounced among female entrepreneurs (75%) compared with male entrepreneurs (65%)."

In the next section, we'll look at the results of a regional small business survey demonstrating the need to strategically develop technical assistance.

LOCAL SNAPSHOT: PRIORITIZING TECHNICAL ASSISTANCE

The problem with TA programs is playing out in local communities as the COVID-19 pandemic stresses existing faults. A 2021 survey by the New Economy Initiative, a project of the Community Foundation for Southeast Michigan, captured how the pandemic exacerbated long-standing disparities in small business assistance programs.

NEI SMALL BUSINESS SURVEY - KEY FINDINGS

760

Small Businesses Surveyed

57% BLACK-OWNED

64% WOMEN-OWNED

72% ANNUAL REVENUE LESS THAN $250K

Top 3 Small Business Needs & Challenges

Access to Capital

Finding Customers

Financial Management

The NEI survey looked at the top needs and challenges of small businesses in the Detroit region, especially those owned by persons from historically excluded/underserved communities. The top results were consistent across all races and genders.

Uneven Access Hurts Underserved Entrepreneurs Most

An analysis of survey data regarding participation in the federal Payroll Protection Program (PPP) clearly demonstrated the urgent need to retool technical assistance for the region's small businesses.

Less Likely to Apply

Black-owned businesses applied for PPP at only 60% the rate of White-owned businesses.

Female-owned businesses applied for PPP at only 65% the rate of male-owned businesses.

Less Likely to be Approved

24% fewer Black-Owned businesses were approved for PPP than White-owned businesses.

35% fewer female-owned businesses were approved for PPP than male-owned businesses.

NEI Survey, Continued

The NEI survey generated 760 responses, including 57% black-owned businesses, 64% women-owned businesses, and 72% businesses with annual revenue under $250,000.

Respondents identified their greatest needs and challenges, both prior to and during the COVID-19 pandemic, were access to capital, finding customers, and financial management. This finding was consistent across all races and genders.

The timing of the survey coincided with the COVID-19 pandemic, so naturally results indicate the pandemic negatively impacted the region's small businesses. But deeper analysis revealed the pandemic was not the cause but only a factor that had exacerbated long-standing issues in the community.

In addition to distinct racial and gender-based inequities, the survey indicated the existence of banking relationships or lending history determined PPP outcomes.

The survey did not directly explain why banks were up to 35% more likely to decline applications from Black-owned and women-owned businesses but study after study has connected the capital access problem to discrimination and exclusion from financial sectors, employment opportunity, and education systems.

The NEI survey did explain many targeted businesses in the region were left out of the initial $349M federal relief funding process because they were not able to apply. One third of small businesses did not have financial statements ready to apply for PPP; of businesses with 2 or fewer employees, more than half did not have financial statements at all.

This situation to one described in a 2017 report by the Woodstock Institute in which businesses in majority-minority census tracts in the Detroit region represented 10.1% of all businesses but received only 6.2% of Community Reinvestment Act loans under $100,000—a discrepancy of 8,800 loans worth more than $114 million.[16]

From the 2021 NEI Small Business Survey, we see capital is critical but not always the first tool small businesses need. Of NEI's survey respondents, 75% expressed an interest in one-on-one technical assistance. Technical assistance should empower business owners to prepare and maintain accurate, timely financial information to effectively manage the business and apply for capital when needed. This is pivotal for minority-owned businesses which are more likely (15% more often than White-owned firms) to experience significant financial challenges and are less likely to have personal capital or savings to finance a business.[17]

THE TA OPPORTUNITY FOR ECONOMIC DEVELOPMENT

1). DEVELOP INDIVIDUALIZED TA PROGRAMS

Often programs available through economic development organizations, nonprofits, or community development financial institutions at the local level are ineffective due to uneven quality, generalized information, and lack capacity to meet demand. Local leaders can help to strategically develop programs delivering individualized, easily accessible technical assistance focused on actionable business plans and accurate financial information.

Economic developers can invest in developing and growing one-on-one support from knowledgeable advisors for extended periods of time to help small businesses develop flexible business plans and accurate financial statements that help them successfully manage their operations and finances.

Small businesses will further benefit from industry-specific support and credit-building or credit repair solutions. Programs must be responsive to the digital divide that may exist and offer education on tools and systems that small businesses can use to successfully manage their operations and finances.

INDIVIDUALIZED ASSISTANCE

Elevate Business HC
www.mplschamber.com/elevate-business-hc

Rising Tide Capital
www.risingtidecapital.org

ProsperUS Detroit
www.prosperusdetroit.org

2). SCALE CULTURALLY-SPECIFIC TA PROGRAMS

Most TA programs have been defined for a White male image of success. The Milken Institute advises, "TA needs to recognize how race and ethnicity shape a population's relationship to financial products and services, and build TA programs so they are responsive to these populations," noting, "Blacks and Hispanics face a legacy of poverty, inequality, and bias that negatively affects their relationship with financial products and services, including a wariness to engage with banks, other financial institutions, and potential mentors and consultants."[18] TA must adapt to better address the needs of businesses outside of the White male-ownership models to serve lifestyle businesses, cooperative and multigenerational ownership models, and social enterprises. If TA is to be useful for underserved small businesses, the rules must change to embrace the individual entrepreneur and expand the traditional definition of entrepreneurial success.

3). ESTABLISH FINANCIAL EMPOWERMENT NETWORKS

The disconnect between what TA programs provide and what capital holders require leaves many small businesses in the lurch. Though TA programs are readily available in most communities, the effectiveness of TA programs is not well documented or widely understood. Our research indicated many programs lack the capacity and capabilities to provide specific guidance on small business financing options and are not in the practice of advising business owners on specific capital products. In addition, capital providers are typically not positioned or trusted to offer this advice to small businesses. Expanding TA networks to include providers that are equipped to help business owners navigate financing options, from retained business earnings and grants, to loans and venture capital, strengthens TA outcomes. Emerging technology-enabled solutions like those from Economic Impact Catalyst can help build and grow TA networks at scale, measure outcomes, and share information in the field.

#3 CAPITAL

REIMAGINE CAPITAL FOR SMALL BUSINESS

Though half of small businesses (50.9%) start with less than $25K, the struggle to find capital is increasingly difficult and exceedingly risky for most of America's entrepreneurs.

Currently, three-fourths of small businesses are using personal or family savings to get started.[19] Innovation is needed to solve the capital access problem.

There are 32.5 million small businesses in the US, representing 99.9% of all firms (SBA, 2021) and most are financed using high-risk capital. Credit cards make up the largest source of small business financing at 59%, a trend in play for more than a decade according to the National Small Business Association. The committee overseeing the SBA's loan programs explains this trend is due to "tightened lending" that has made it even harder for entrepreneurs to acquire commercial and SBA loans in recent years.[20]

Minority-owned businesses use more and pay a higher price for capital to get started than White-owned firms and are hit disproportionately by the worsening trends in lending and contracts. Of the $36.5 billion in federal 7(a) loans made in 2021 to an estimated 50,000 small businesses, only 30% of recipients were minority-owned businesses (6% Hispanic, 3% African American, 14% women).[21]

Conventional lenders continue to make borrowing criteria more stringent. Only 19% of small businesses borrow from banks; SBA 7(a) and 504 loans make up only 5% of financing for small businesses. Community Development Financial Institutions (CDFI) facilitate investments in distressed areas and underserved communities with a majority (60%) of lending to minority-owned small businesses, but CDFIs are restrained from bold moves as they must also meet reporting and risk requirements like those of commercial lenders.

The practice of lending based on existing relationships or the perceived risk that a borrower will not repay the loan is simply not good enough.

These practices marginalize too many entrepreneurs, penalizing them based on race, color, ethnicity, or gender, among other biases.

If the small business sector is to prop up our economic future, we need innovation in the field of small business lending.

Why should we hold financial risk in higher regard than the economic and social benefits of small businesses? Reconsidering our notion of risk and failure is not only good for small business; it's what best serves the public interest.

Small businesses, no matter how high-risk or short-lived, contribute significantly to improved standard of living, stronger social safety nets, increased gross domestic product and jobs, and innovation. Traditional capital largely ignores the many positive externalities small businesses create.

Whether a small business survives for one, five, ten years or more, new businesses grow the economy and the capital they borrow stays in the community even if the business does not.

Regardless of longevity, small business capital contributes to:

- Increased economic activity and local spending
- Sustainable local job creation
- Lower unemployment claims
- Lower crime rates
- Poverty alleviation
- Additional innovation and products/services the community needs

Taxpayers and donors readily invest in government programs and nonprofits to produce these outcomes with no possibility of financial return but see small business lending in a different light. Investments in small businesses resulting in positive economic impact should be regarded alongside subsidies and philanthropy in the economic development toolkit.

> *Lending based on existing relationships or the risk that a borrower will not repay the loan is simply not good enough.*

CREATIVE SOLUTIONS TO THE CAPITAL ACCESS PROBLEM

- **Loan loss reserves to protect lenders that accept additional risk and lend at lower interest rates.**

- **Philanthropy to establish loan guarantee funds for non-profit lenders.**

- **New and better loan products that help to build credit or unlock additional funds as part of the structure of the loan, or use revenue-based models to position the lender as a partner in the borrower's success.**

- **Risk assessment based on alternative characteristics:**

  Completion of small business training/education as a prerequisite for funding.

  Incremental lending based on achievement of milestones.

  Business advising as a term of borrowing.

  Lower cost of capital or favorable terms for businesses targeting a key industry or problem.

  Pro-bono legal and accounting services throughout early stages.

  Use of low-burden financial reporting systems as a term of lending, e.g., cloud-based accounting software.

  Restrictions on how borrowers use the funds.

  Lower risk/barrier to exit if business fails; cancellation of debt without damage to personal credit profiles.

The concept of expanding access to capital to businesses deemed high risk by traditional standards draws on principles widely accepted in the venture capital market. There, investors readily assume the risk of investing in some startups that are likely to fail as part of an overall portfolio in which the gains exceed the losses.

Taking a page from venture capital, providing capital to a small business should be seen as an investment not in a “risky business” but as part of an overall economic development strategy with outcomes greater than the sum of its parts.

Trailblazers are already laying the groundwork for economic developers to collaborate in transforming the market to include new and better forms of capital that weigh value beyond repayment in funding small businesses.

Small businesses have the power to transform our economy as they create jobs, buy locally, and drive innovation. It's time to rethink our assumptions about ROI and capital access.

Today, local coffers are flush with the funds needed to innovate but it won’t be long before the next crisis has us reeling for creative solutions once again. Now is the time.

ACCESS TO CAPITAL

INVEST ATLANTA
www.investatlanta.com/businesses

JUST (Austin)
hellojust.com

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ECONOMIC IMPACT CATALYST

Economic Impact Catalyst (EIC) creates best-in-class, technology-enabled solutions for economic development organizations to manage their small business programs. In addition to access to the Startup Space platform, we provide meaningful data and surveys to help our clients understand their impact and drive policy. We work in more than 100 markets in the United States to enable strategies to empower entrepreneurs from underrepresented communities build wealth, autonomy, and improve outcomes for their communities.

Learn more about our solutions, our mission, and our clients at www.economicimpactcatalyst.com.

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