



# Small Business Development

## *An Overview*

*By Naomi Cytron*

Small business is “small” in name only. Comprising the vast majority of firms in the United States, small businesses serve as incubators for innovation, promote local and regional economic development, and provide an entry point into the economy for new and displaced workers. Small business ownership can be a means of improving a household’s ability to accumulate wealth and assets, and small business development is an important component of comprehensive strategies that aim to stabilize and revitalize distressed communities.

Definitions of what constitutes a small business vary, but the U.S. Small Business Administration (SBA) is the source of the most commonly accepted definition of the term. The SBA classifies businesses by number of employees, annual receipts, and industrial sector to help determine eligibility for governmental resources and programs, including loans and technical assistance. For research and reference purposes, though, “small business” is often simplified to refer to those firms that are independently owned and operated and employ fewer than 500 employees, even though in some sectors the threshold is lower at 100 employees or fewer. Very small businesses refer to those firms with 20 or fewer employees, and microenterprises are those businesses with five or fewer employees.

Under these definitions, the statistics are noteworthy. In 2003, small businesses comprised 99.7 percent of all firms, provided 50.6 percent of employment, and generated half the non-farm output of the U.S. economy. Very small businesses comprised nearly 90 percent of these small firms.<sup>1</sup> While the overall size of the small business sector has not markedly increased over the past decade, it has seen increased participation from women and minority entrepreneurs; between 1997 and 2002, women-owned firms increased by 20 percent to 6.5 million firms, Hispanic-owned firms increased by 31 percent to 1.6 million firms, African-American-owned firms increased by 45 percent to 1.2 million firms, and Asian-owned firms increased by 24 percent to 1.1 million firms.<sup>2</sup>

While these statistics include entrepreneurial activity in high-income, highly-educated sectors of the workforce, including lawyers and consultants, this is heartening news for women and minorities who have been historically marginalized from the mainstream economy. It also bears potential for further expansion of economic opportunity for low-income persons. A recent report by CFED examining

the role of small and medium-sized enterprises in reducing poverty points to studies which indicate that small businesses, in comparison to large firms, employ a larger share of persons on public assistance and those with lower education levels.<sup>3</sup> In addition, a study conducted by the Self Employment Learning Project of the Aspen Institute showed that small business ownership can help people move above the poverty line.<sup>4</sup> Small business development is thus an avenue for bolstering the economy and contributing to increased self-sufficiency across the socio-economic spectrum.

The great promise carried by small business development is, however, dampened by the persistence of challenges in establishing and growing small businesses in low- and moderate-income communities in both urban and rural settings. Low-income and minority entrepreneurs often face barriers in accessing capital for starting and maintaining their businesses, and typically need assistance in learning how to efficiently manage and sustain operations. Low- and moderate-income areas also often lack the infrastructure that enables small-business growth; for instance, many disinvested commercial corridors are characterized by vacant storefronts, crumbling facades and a perception of criminal activity, and do not generate the foot traffic or business networks critical for success. Those in rural areas face an additional set of barriers to small business development owing in part to the basic fact of their geographic distance from financial institutions, offices that assist with accessing governmental resources, buyer markets, and community-based organizations that provide targeted training and assistance.

### **Barriers to Accessing Capital**

Small businesses have a variety of credit and capital needs, including startup capital, equity, and working capital. Owners continue to rely on commercial banking institutions as important sources of financing; SBA data shows that small business loans, defined as loans under \$1 million, totaled \$248 billion in 2003. However, although there was growth in small business loans between 1995 and 2002, loans under \$250,000 represented a shrinking share of total bank lending. The total value of loans under \$100,000, which typically are sought by early-stage businesses, grew the least of all segments of small business lending.<sup>5</sup> Adding to this, a number of studies point to differentials in lending rates

between white and minority-owned firms, as well as between upper-income and lower-income census tracts.<sup>6</sup> These differentials are driven by a variety of factors, including:<sup>7</sup>

- Lack of performance data on loans to minority and lower-income borrowers, leading lenders to perceive them as riskier and beyond their legal risk tolerance;
- In comparison to other borrowers, a tendency of minority and lower-income borrowers to seek smaller-sized loans and require more technical assistance services leading to greater expense for lenders;
- Lack of professional and social networks linking borrowers and financial institutions;
- Limited, or lack of, credit history, collateral, and/or record-keeping required to qualify for conventional financing.

Recent trends within the banking industry, including consolidation, changing patterns of bank branch locations, and increased use of credit scoring in making underwriting decisions are also thought to impact lending patterns. While research is somewhat mixed in determining the exact outcome of these trends—and in particular the impact of increased use of credit scoring, which in some cases has been shown to increase lending activity<sup>8</sup>—they certainly have implications for would-be borrowers' ability to build banking relationships, which is a factor shown by a number of studies to increase availability of credit or lower collateral requirements.<sup>9</sup> And for those with limited or no credit history, a prevalent scenario in immigrant and lower-income communities, the increased use of credit scoring can raise the hurdles for accessing financing.

## SBA Programs

Box 1.1

The SBA's largest program is the 7(a) loan program, which provides a guarantee of up to 85 percent of the loan amount, depending on the size of the loan. In fiscal year 2005, the SBA provided nearly \$14 billion in guarantees to banks and other loan providers through the 7(a) program, serving over 80,000 small businesses. A number of targeted programs fall within the 7(a) program, including the CommunityExpress program, which pairs 7(a) loans with technical assistance to borrowers in lower-income areas. Started as a pilot program in 1999 in partnership with the National Community Reinvestment Coalition, the majority of the loans made possible through the CommunityExpress program have benefited women and minority entrepreneurs.

The agency's second largest program is its 504 program, which offers long-term financing for fixed-assets such as buildings or equipment. A typical loan package features 40 percent financing through the SBA, 50 percent financing through a private lender, and an investment of 10 percent from the small business itself—though for start-ups a higher equity investment is often required. Most businesses receiving loans through the 504 program must create or retain a job for every \$50,000 borrowed. Nearly \$5 billion in loans were delivered in FY 2005 through Certified Development Companies, which are nonprofits established to administer 504 loans. Many Certified Development Companies offer and implement other economic development programs in their surrounding communities and regions.

Smaller SBA programs include the Small Business Investment Company (SBIC) program and the MicroLoan program. SBICs are private equity funds that invest in those businesses that meet SBA size and eligibility requirements. Of the nearly 2,300 businesses that received equity investments through SBICs in FY 2005, 23 percent were located in low- and moderate-income areas. The Microloan program is the smallest of the SBA's programs, and has for the past three years been threatened with elimination. The program provides loans of up to \$35,000 to eligible start-up businesses through participating Microloan Intermediaries, and integrates technical assistance provision through its PRIME (Program for Investments in Microentrepreneurs) program, which provides grants to community-based organizations to provide training to low-income entrepreneurs.

Through its business "matchmaking" events and HUBZone (Historically Underutilized Business Zone) program, the SBA also helps small businesses owners tap into the contract procurement marketplace, which has historically been difficult for new or emerging businesses to access. Matchmaking events bring together small business owners and procurement representatives from private corporations and federal, state and local governments, and the HUBZone program provides federal contracting preferences to small businesses operating in qualified distressed areas, including Native American reservations. The agency's 8(a) program operates similarly, but targets businesses owned by disadvantaged minorities regardless of geography.

Despite recent criticism about inefficiencies—largely related to disaster relief efforts—within the SBA, the agency has been critical in increasing access to capital by decreasing risk to banks and lowering costs to borrowers. In 2005 alone, 105,000 small businesses received \$27 billion in 7(a) and 504 loans, creating or retaining an estimated 605,000 jobs. While there are improvements that can be made to both increase the availability of capital to minorities and women and streamline lending procedures, the SBA has been an important partner in fostering the growth of small businesses in underserved communities.

## Expanding the Reach of Capital

A number of governmental channels and specialized financial and community-based organizations aim to expand the reach of commercial banking institutions and serve under-bankable small businesses in alternate ways. For one, the SBA provides an important set of products and programs that have been effective in assisting eligible small businesses obtain the financing that they would otherwise not be able to access (See Box 1.1 “SBA Programs”). SBA lending has also been shown to correlate with increases in local employment levels in low-income areas.<sup>10</sup> However, the agency has faced a perennially shrinking budget, and the lion’s share of SBA programs is geared toward “larger” small businesses. Its programs designed to assist the smallest of businesses are limited relative to demand and in recent years have been threatened with elimination.

A range of other specialized providers of financing and technical assistance supplement SBA offerings, including the USDA, local governments, microenterprise development organizations (See article “Microbusiness, Macro-impact: Capitalizing on Potential”) and Community Development Financial Institutions (CDFIs). Many areas are also served by Community Development Venture Capital funds, which are important providers of equity financing for businesses with high growth-potential in low-income areas (See “Delivering Financial Return and Community Results”). All of these niched organizations provide critical support in building the capacity of small businesses in hard-to-reach communities.

Cascadia Revolving Fund, for example, a nonprofit CDFI based in Seattle, serves entrepreneurs and nonprofits in distressed urban and rural communities in Washington and Oregon. Cascadia makes its small business loans, which range from as little as \$1,000 up to \$1.3 million, through its revolving loan pool, which is capitalized by financial institutions, individuals, foundations and churches. Over a third of Cascadia’s capitalization specifically comes from equity-equivalent investments (EQ2s) made by banks. These are typically large, below-market rate, very long-term investments that allow Cascadia to make larger and longer-term loans—a powerful tool for deepening the impact the organization can have in its region. Cascadia’s loan pool structure enables the organization to underwrite loans with more flexible standards than those typically used by commercial banks, thereby extending the reach of capital to borrowers otherwise considered too risky.

### Access to Capital is Only Part of the Story

Despite having what is typically considered a higher-risk portfolio, Cascadia’s 20-year cumulative loan-loss rate as of 2005 in its core loan portfolio was just 2.5 percent. In part, this is because small business owners who receive loans through Cascadia can receive intensive, ongoing technical support for developing and sustaining their businesses. This underscores the point that access to capital is only part of the story. Alberto Alvarado, Director of the Los Angeles

## Alternative sources of small business financing

Box 1.2

Alternative sources of credit and capital, including credit cards, trade credit, and loans from family and friends, are also used to finance small businesses. Of these, only credit card usage showed an increase between 1993 and 1998.<sup>1</sup> Survey data showed that over 50 percent of firms used personal credit cards to finance business expenses, and that business credit cards have become increasingly available, with 34 percent of firms using such cards.<sup>2</sup> However, the average monthly charges of the businesses that used credit cards (either business or personal) were \$600 and the majority reported that they paid their credit card balance in full each month, indicating that credit cards are primarily used as a convenient form of payment rather than as a substitute for more traditional credit.<sup>3</sup>

District SBA office, emphasized the critical role played by technical assistance provision, saying that, “There is a tremendous and increasing need for technical assistance and mentoring arrangements for emerging entrepreneurs. It is a real challenge to build competency levels and managerial skill sets in people who are, for the first time, thinking like an owner rather than a worker.”

Training needs include business plan development, marketing assistance, and help with basic accounting and business management procedures. The SBA offers a variety of capacity-building opportunities through the Service Corps of Retired Executives (SCORE), Women’s Business Centers and its Small Business Development Centers (SBDCs). SBDCs, which are often run in partnership with local universities and colleges, have been very effective in boosting entrepreneurial success, leading to job creation, increased sales and tax revenues, and an increased ability to leverage other resources.<sup>11</sup> SBA-sponsored services, however, are typically more able to assist owners of existing businesses who can access conventional financing services. For less sophisticated borrowers who are struggling to keep pace with the changing demands of business ownership, microenterprise programs offer a similar set of training and counseling opportunities, and typically place great emphasis on coupling financial assistance with outreach and mentoring to those small businesses with the greatest training needs (See “Microbusiness, Macro-impact: Capitalizing on Potential”).

Small business incubators, which generally integrate access to mentoring and assistance in obtaining financing or contracts with appropriate rental space, flexible leases, shared basic business services and equipment, and technology support services, offer another mechanism to help fledgling businesses thrive. The William M. Factory Small Business Incubator, for example, located in one of Tacoma, Washington’s poorest neighborhoods, has been successful in



helping many women, minority and low-income entrepreneurs grow businesses that, in turn, contribute to revitalizing the local economy. The incubator helps foster relationships between incubator tenants, who are mostly in construction-related industries, and public and private sector agencies, which boosts availability of training, financial support and marketing opportunities. Tenants, who sign agreements to first consider unemployed neighborhood residents for job openings, created 300 jobs in 2005. The Factory Incubator won the 2005 Incubator of the Year award from the National Business Incubator Association, and has since inception in 1986 graduated more than 200 companies, 80 percent of which have remained in business or successfully merged with other companies.

Approaches that aim to enhance neighborhood business districts are also important to enabling small business success in low- and moderate-income areas. The Local Initiatives Support Corporation (LISC) is investing resources in neighborhood-level improvements through its Commercial Corridor Revitalization initiatives in many of its program sites nationwide. Bay Area LISC, for example, is active in a number of business districts in low-income and ethnic neighborhoods in Richmond, Oakland and San Francisco, and provides grants and technical assistance for community groups and collaboratives engaging in projects such as streetscape and real estate improvements, creation of marketing materials and promotional events, and safety enhancements. Amy Cohen of Bay Area LISC noted, “The program’s strength is its multi-stakeholder involvement. The

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model engages neighborhood residents, community organizations, city agencies, and local merchants in developing plans that will strengthen neighborhood business districts without placing additional burdens on business owners.”

### **Filling Gaps and Building Bridges**

There are, then, a range of agencies and organizations whose mission is to help foster success among small business owners who have typically found themselves outside the economic mainstream. However, many programs have difficulty achieving the capacity and efficiency that would allow them to more fully serve individual and community needs.

The CDFI industry, for instance, has been able to support small businesses in a variety of ways and has both demonstrated the viability of markets once viewed as prohibitively risky and created a host of innovative products and services. However, a number of trends, including changes in the financial industry and shifts in federal budget allocations, threaten the sustainability and growth potential

of many of these organizations. As such, the industry is in transition and is seeking ways to more efficiently meet the needs of targeted communities.<sup>12</sup>

Financial institutions are vital partners in leveraging resources and filling gaps between ongoing demand and shrinking public support. One boost to the CDFI industry is a recent announcement by Bank of America of a \$10 million investment in the Opportunity Finance Network (OFN) specifically earmarked for small business and microenterprise development. OFN works to strengthen CDFIs through financing, capacity building, and policy development (See Box 1.3, “Small Business Initiatives”). Participation by financial institutions in loan pools dedicated to microenterprise development in hard-to-serve areas is also critical for maintaining flexible sources of capital for start-up and expansion of the small businesses located there (See “Building Bridges in LMI Communities” and Box 2.4, “Innovations in Oregon”).

While one side of the coin is that financial and community-based organizations struggle to fully meet the needs of emerging entrepreneurs, the flipside is that it can be difficult for business owners to take advantage of the services available to them. Cristy Johnston, a project manager with the Excelsior Neighborhood Commercial Revitalization (ENCoRe) Project in San Francisco, noted that business owners in low-income or minority communities may not know about available financial and technical assistance

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resources, may have difficulty accessing them due to cultural and language barriers, or may find it overly time-consuming to navigate through what can be a confusing array of disparate and/or distant service providers. As a community liaison, Johnston works to connect business owners with appropriate resources and bridge the cultural gaps that keep them from seeking or receiving needed technical assistance. “The overall goal [of our program] is to help the local community recover economically and begin to grow into a vibrant and thriving commercial district,” said Johnston. “ENCoRe is here to strengthen and stabilize the small business community, and ensure that small business operators and their families are able to continue to run their businesses and get the assistance they need to do so.”

Financial institutions can help here, too, in directing would-be borrowers to microlenders and technical assistance providers when they themselves cannot provide direct

## Small Business Initiatives

Box 1.3

Two significant announcements were made in the early months of 2006 regarding investments in programs geared toward enhancing small business development in low- and moderate-income communities. In February, CRAFund Advisors launched a \$50 million Small Business Initiative, and in April, Bank of America announced a \$10 million investment in the Opportunity Finance Network (OFN) to spur small business and microenterprise development.


CRAFund Advisors, a fixed-income money manager based in Florida, is developing their Small Business Initiative with the Community Reinvestment Fund, a Minnesota-based nonprofit that operates a secondary market for economic development loans. The Initiative earmarks funds that will be used to purchase SBA 7(a) loans, USDA loans, and municipal bonds for economic development and enterprise growth, all of which finance the start-up and continuation of small businesses in low- to moderate-income and minority and communities. During the press release event, Alyssa Greenspan, Director and Portfolio Manager of CRAFund Advisors, noted, “Our new Small Business Initiative will appeal to individuals, corporations, public pensions, government entities, banks and institutions that are seeking a competitively performing investment that generates the capital needed for small business development and economic growth in minority, rural, and other emerging communities.”

Bank of America's investment in the Opportunity Finance Network was made through the bank's Program Related Investments division. OFN will use the capital to provide loans and investments to CDFIs in its national network. In turn, CDFIs will lend to, and make investments in, small enterprises that are not otherwise able to access the financing necessary for growth and expansion. Distribution of financing will first be within California, and will expand later to other markets. One of the first products of this investment was a \$2.5 million loan made by OFN to Clearinghouse CDFI, based in Lake Forest, CA. Doug Bystry, Clearinghouse CDFI President and CEO, said, “This loan will make a major impact in addressing unmet credit needs throughout California. Every loan we make benefits the community in a measurable way. Opportunity Finance Network's backing will sharply accelerate our small business lending in California.”

financing (See Box 1.4, “Making Connections”). Alvarado also encouraged those financial institutions not already working with local SBA offices to establish relationships with them as a means to connect entrepreneurs to resources and build the capacity of community organizations serving marginalized communities. “This work is very much about building direct relationships,” he said, “and it is so important to really raise awareness of opportunities.”

Financial institutions can also help build entrepreneurial readiness and develop banking relationships through financial education, culturally-appropriate outreach measures and asset building strategies such as Individual Development Account (IDA) programs. IDAs, through a match incentive, help low-income people save for specific asset-building purposes such as capitalizing a small business (See Community Investments, Vol. 17, No. 2 for more information on IDAs and asset building). EARN, a San Francisco-based organization that helps low-wage workers amass savings through IDA programs, reported that as of the first quarter of 2006, a third of their savers were working towards investing in microenterprises. Success stories include savers who used IDA funds to purchase inventory and equipment for new catering, graphic design, and clothing businesses that allow their owners to support their families and reduce reliance on public support.

## Building Knowledge, Building Relationships

As is true for many strategies aimed at bolstering wealth and stabilizing low- and moderate-income communities, within the field of small business development there is a need for continued research, innovation and outreach. A number of questions remain, including how to build efficiencies without sacrificing the ground-level relationships necessary for building the capacity of small and unsophisticated businesses, how to further the recognition of the market potential of businesses in lower-income areas and thereby increase targeted investments, and how to more effectively measure the performance of programs that aim to link entrepreneurship with poverty reduction. Also at issue are ways to strengthen small business success in rural and remote areas, where economic development strategies that center on local entrepreneurship are increasingly being promoted and implemented (See “The Corner Store: Investing in a Sense of Place”). Continued partnership building and collaboration among financial institutions, government, private and nonprofit stakeholders, though, can help to improve service delivery and enhance the entrepreneurial climate. Overall, coordinating support across what is a continuum of need can strengthen the viability of small business development as a part of a comprehensive strategy to revitalize communities and build household wealth. 

## Making Connections

Box 1.4

When entrepreneurs are turned down for small business loans by a mainstream financial institution, they may encounter difficulties in finding out where to turn for further assistance. The iCapital Assistance Network, launched in September 2005, is a national, web-based business loan referral network and loan packaging service designed to serve as a pipeline to refer small business loan declines to certified CDFIs and SBA Microlenders. This no-cost service, available online at [www.icanloan.com](http://www.icanloan.com), is intended to assist emerging entrepreneurs access capital and technical assistance, and to help these clients eventually become eligible for traditional bank loans and products. Participation in this network can help banks further their community development goals and is a way to help the microloan industry build scale and efficiency.

Bank of America is one of the institutions piloting the iCAN project and has incorporated standardized language about the referral network into their small business loan declination letters issued throughout their 30-state footprint. Through iCAN's website, clients can access contact information for alternate lenders in their area and use an online loan-packaging tutorial feature, which is a step-by-step guide to assembling a loan package. The service was developed by the Self-Employment Loan Fund, Inc (SELF), an SBA Microloan Intermediary and CDFI located in Phoenix, AZ. To find out more about how to become a member of iCAN's referral network, please contact Caroline Newsom, Executive Director of SELF, at (602) 340-8834 or [carolineneewsom@selfloanfund.org](mailto:carolineneewsom@selfloanfund.org).

Other directories of microlenders and technical assistance providers are available online through the Association for Enterprise Opportunity, a national member-based association dedicated to microenterprise development, and through the Microenterprise Fund for Innovation, Effectiveness, Learning and Dissemination (FIELD), a research, policy, and grant-making project of the Aspen Institute in Washington D.C.:

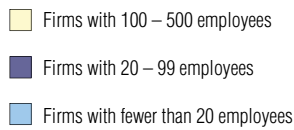
[www.microenterpriseworks.org/nearyou/bystate.asp](http://www.microenterpriseworks.org/nearyou/bystate.asp)

[www.fieldus.org/Publications/Directory.asp](http://www.fieldus.org/Publications/Directory.asp)

# Small Business in the 12th District

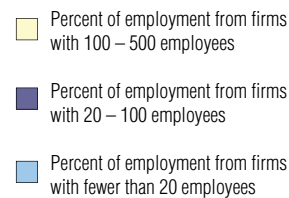
Box 1.5

## Small firms comprise majority of businesses in the 12th District (2003)



As in the U.S. as a whole, small businesses make up the majority of firms in the 12th district, and in most 12th District states, smaller firms provide significant employment.

## Small businesses provide significant employment in the 12th District (2003)



Although Nevada and Arizona lag slightly behind other 12th district states in small business measures, entrepreneurial activity that results in self-employment, captured by the Census as data on "nonemployers," is on the rise in both states. Census data showed that, nationwide, Nevada and Arizona led growth in nonemployer businesses between 2002 and 2003, with 11.4 and 9.4 percent growth, respectively. Idaho and Utah also saw higher than average self-employment activity in this period. Four of the five counties leading growth nationwide in self-employment between 2002-2003 were in the 12th district.

Source: US Census

## 12th District Counties Lead Growth in Self-Employment

	Number of Non-employer Firms: 2002	Number of Non-employer Firms: 2003	Percent Change
United States	17,646,062	18,649,114	5.7%
<i>Top five counties</i>			
1. Clark, NV	84,219	95,923	13.9%
2. Riverside, CA	97,800	109,583	12.0%
3. Gwinnett, GA	49,113	54,784	11.5%
4. Maricopa, AZ	181,059	199,254	10.0%
5. San Bernardino, CA	91,578	99,952	9.1%

# COMMUNITY INVESTMENTS

## Endnotes

### Small Business: An Overview

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### Box 1.2

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### Box 2.2

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### Delivering Financial Return and Community Results: Pacific Community Ventures

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