RESEARCH REPORT

Federal Small Business Supports

A Review of Federal Programs and Policy

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Executive Summary

Small businesses are vital contributors to the health of the US economy, driving employment, economic prosperity, and innovation. They also contribute to our quality of life. Despite facing substantial obstacles, such as the COVID-19 pandemic and inflation, the small business sector has demonstrated remarkable resilience. Much of this resilience can be attributed to supports offered through local small business ecosystems, combined with unprecedented pandemic-era federal support. Notwithstanding this resilience, the United States is experiencing a long-term decline in small business participation in the labor force and the broader economy.

This report, the product of data analysis, interviews with more than 150 stakeholders, and a review of the literature, examines federal programs designed to support small businesses. The resulting insights highlight what is working well with these programs and identifies areas in need of improvement. Our research provides recommendations and technical insights for policymakers, industry stakeholders, advocates, and anyone seeking a deeper understanding of the small business sector's needs and how the federal government can enhance its support mechanisms.

Small businesses are vulnerable, with about half of start-ups failing within their first five years of operation. While entrepreneurial setbacks are part of a dynamic economy, market failures can impede businesses that otherwise have the potential to thrive. Federal support can help small businesses overcome these market failures, which include information asymmetries, unfair competition, and discriminatory or predatory practices in small business lending.

Despite the diverse landscape of the small business lending ecosystem, access to capital is often the most pressing concern for many entrepreneurs. This challenge disproportionately affects new businesses, businesses in rural communities, owners with lower wealth, and women and people of color.

Reviewing Federal Small Business Support Strategies

Our report provides an extensive review of federal small business support programs across several agencies. The variation among these programs is substantial, but the programs can be broadly understood as fitting into at least one of the following categories:

- Improving access to capital and reducing financing costs through mechanisms such as loan guarantees, more accessible loan terms, tax incentives for banks and funds, and grants.
- Offering and supporting business development programs (commonly referred to in the industry as "technical assistance") through direct programs and in collaboration with federally backed organizations.
- Promoting federal agencies' procurement of goods and services from small businesses through direct contracts and indirect support via subcontracting.
- Creating a tax and regulatory ecosystem that fosters an environment conducive to the growth and prosperity of all small businesses.

The sections in our report provide an in-depth analysis of these categories, and each concludes with specific recommendations for consideration. We organize them as follows.

- **Mid-market financing:** The federal government administers capital programs for small businesses that include loan guarantees, direct loans, and equity investments. Collectively, these programs have delivered or facilitated the delivery of large amounts of affordable capital to small businesses over the years. However, there are key areas for improvement, such as overcoming fragmentation, inefficiency, and dated processes. While consolidation of some programs may offer advantages, better alignment is a minimum standard. Efforts to improve programs should also prioritize widening access and enhancing flexibility and efficiency.
- **Microloan programs:** The United States has embraced microfinance since the 1970s. Federal microfinancing programs provide funds to intermediaries or offer direct financing to businesses, often with technical assistance requirements. The federal government's flagship microloan program, operated by the US Small Business Administration (SBA), is used widely throughout the country. Recommendations to improve these programs include revising grant allocations, removing grant usage restrictions, raising maximum loan sizes, and allowing intermediaries to sell loans.
- **Equity investments:** Federal support has historically favored providing small businesses with debt products rather than with stand-alone equity investments. While programs such as the Small Business Investment Company (SBIC) aim to fill this gap, products are usually equity-like investments with a debt component rather than true equity. This chapter of our report discusses the challenges with equity investments in small businesses, highlights promising efforts and models, and offers recommendations on how to improve existing programs, as well as considerations for establishing new programs.

- **CDFI Fund:** The Community Development Financial Institutions (CDFI) Fund, part of the US Department of the Treasury, seeks to boost economic revitalization and community development. Interviewees described many positive aspects about the flexible tools available to the CDFI Fund. The challenges identified include unpredictable awards, lack of a direct relationship between awards and performance, and barriers community development venture capital funds face in qualifying for awards. Recommendations include prioritizing support for small business lending, improving the fund's technology, and facilitating support for venture capital funds.
- **Business development support:** Numerous federal programs offer technical assistance to small businesses at the state and local levels, mostly through nonprofit providers. Interviewees shared that these programs can offer valuable services to businesses, especially where the objectives are clear, such as with procurement. However, we also heard many challenges and criticisms related to accessibility, public awareness, coordination with lenders and other services providers, and lack of evaluation and measurement to inform program design. Our recommendations ask policymakers to reimagine the function of local small business centers as hubs for outreach to businesses and to consolidate existing services within a national virtual resource center, allowing business to have more agency in deciding what services to access, how, and from whom.
- **Federal procurement:** The federal government wields significant purchasing power, spending approximately $414.5 billion in FY 2022, with $162.9 billion (26.5 percent) allocated to small businesses. However, there was a 4.2 percent decline in small business engagement in federal contracting in FY 2022. Recommendations to improve participation among small businesses include enforcing prompt payment requirements, streamlining processes, raising thresholds for special treatment for small businesses, incorporating small business goals into agency performance plans, expanding training, improving the 8(a) program, and bolstering data collection and reporting.

Transforming Federal Small Business Support

Despite demonstrated success in supporting many enterprises, the small business support system has shortcomings, especially when it comes to assisting emerging entrepreneurs who require more substantial initial capital and business guidance.

The system's complexity, overlapping programs, and limited federal subsidies hinder its effectiveness in adapting to the changing small business landscape—and there has been considerable change in recent years. Urgent reform is required to align the federal small business support system with the evolving needs of today's entrepreneurs.

Based on our analysis, we make the following high-level recommendations.

- **Balance government expenditures and risk-taking.** Policymakers must balance the desire to limit government expenditures and the need for more risk-taking to better meet the needs of small businesses. Additional subsidies are needed, especially for the smallest and most disadvantaged businesses, as is a meaningful evaluation of whether government expenditures align with the Small Business Act's goals.
- **Address the (financial) equity capital gap.** Access to equity investment and financing is relatively siloed to high-growth start-ups and entrepreneurs, such as technology start-ups, while others have little to no access to equity financing. Similarly, the federal government's true equity support programs (Small Business Innovation Research and Small Business Technology Transfer) also prioritize technology firms. Other federal programs aimed at making equity financing more accessible primarily offer products that function more like debt than equity, limiting their utility to start-ups and companies with the opportunity to grow quickly.
- **Modernize the business development and advice system.** The current small business advice system is highly complex, with multiple programs run by various agencies. This leads to difficulties for small businesses, especially those that are located in remote areas, led by non-English speakers, or have specialized or technical support needs. Modern technology offers opportunities for improvement, including online and in-person channels for specialized advice and instruction. Coordination and integration with successful models from the private and nonprofit sectors are essential.
- **Expand protections for small business owners, especially regarding financing terms and conditions.** Key actions include requiring transparency in price disclosure, addressing prepayment penalties and hidden fees, ensuring fair debt collection, and prohibiting abusive collections practices.
- **Prioritize access to credit for entrepreneurs from low-wealth backgrounds.** Entrepreneurs who are from low-wealth backgrounds, do not have access to capital from friends and family, or have otherwise limited networks to draw from are at a severe disadvantage in starting and growing a business. This group tends to overrepresent women and entrepreneurs of color.

> While multiple credit programs are designed with these business owners in mind, these programs are neither large enough nor sufficiently targeted to meet the demand. The terms of credit should facilitate both the success of the business and the successful repayment of credit extended.

There is an evident, significant need for reform and advancement of federal small business supports. While the forces of inertia are strong, we hope this report will spark action toward aligning the federal small business support system with the needs of small businesses and the economy of the 21st century.

Federal Small Business Supports

The importance of small businesses to the economic and cultural fabric of American life is hard to overstate. The vast bulk of US businesses are classified as small businesses and, collectively, they employ nearly half (47 percent) of American workers.[1] Small businesses are critical to the overall health of the US economy as important sources of jobs, wealth for owners and communities, and innovation. Small businesses are also important contributors to community connection and belonging (Schnake-Mahl et al. 2018) and civic participation (Blanchard and Matthews 2006).

The small business sector has surprised many with its resilience following the COVID-19 pandemic and subsequent inflationary period. Revenues dropped, particularly in restaurants, accommodations, and personnel services, and many small businesses in these sectors closed; however, delinquencies and defaults did not increase substantially.[2] Unprecedented federal support helped businesses weather the pandemic, including through the Paycheck Protection Program; debt relief assistance for loans through the US Small Business Administration (SBA) Section 7(a), Section 504, and microloan programs; expanded Economic Injury Disaster Loans; Shuttered Venue Operators Grants; the Restaurant Revitalization Fund; the Employee Retention Credit; and others. The sector's resilience is perhaps most strongly indicated by a recent surge in business starts, suggesting that the shift toward remote work, tightening of labor markets, and other forces such as liquidity and credit availability have generated new opportunities (Haltiwanger 2021). Firm deaths, which spiked during the peak and immediate aftermath of the pandemic, have also normalized.[3]

Despite the resilience and integral role of small businesses in the US labor force and overall economy, all is not well. Most notably, the small business shares of both gross domestic product and total employment have been declining for many years. According to one estimate, small businesses as a share of US GDP fell from 48.0 percent to 43.5 percent between 1998 and 2014 (Kobe and Schwinn 2018). The share of employment of businesses with fewer than 500 employees reached more than 54 percent in the late 1980s before gradually declining to its present level of less than 47 percent.[4] And in its most recent survey of employer small businesses, the Federal Reserve found that small businesses have recovered since the early pandemic, though largely not to prepandemic levels (Wiersch et al. 2022).

Revisiting the Federal Government's Role

Why should the federal government support small businesses? Proponents argue that small businesses are more entrepreneurial, foster more competition in markets, create more jobs, and produce more vibrant local economies than do larger businesses. Although these reasons remain valid, the context within which small businesses operate is very different than it was when the Small Business Act was enacted in 1953. Yet federal programs and policies have remained surprisingly static in the face of exceptional technological, economic, financial, business, and demographic changes.

We embarked on this extensive research project to answer fundamental questions about federal support for small businesses: How well are current federal government supports meeting the objectives of the Small Business Act? Are the supports sufficiently robust and well targeted? Are they effective and cost effective? Have they adequately accounted for and accommodated technological change? Is there adequate awareness of them among small businesses? Are they well-coordinated or duplicative?

We analyzed program and contextual data and interviewed more than 150 small business owners, policymakers in Congress and the executive branch who have served in different Congresses and administrations over the past several years, technical assistance providers, mission and market lenders, investors, philanthropies, advocates, and relevant associations of these sectors. The interviews, data analysis, and other supporting work we have done for this paper lead us to conclude that federal support for small businesses is not adequately meeting the aims of such support. We identify significant gaps in the federal government's menu of supports and find that many of the existing supports are complex, difficult to navigate, and insufficiently subsidized. The largest gaps in support are in true equity investments, the integration of technical assistance and lending programs, and assistance for development of new businesses. Subsequent sections of this report provide an in-depth look into the range of programs targeting small businesses and offer insight into areas of success and opportunities for improvement.

As we explored the multitude of federal programs, their intended objectives were not always clear. For example, does the United States want to expand domestic production of exports through small businesses or ensure low-cost products for consumers and other businesses? Does the federal government want to develop a diversity of suppliers for its contracting, or does it want the lowest-cost solutions? Does the government want to focus on supporting existing businesses or enabling entrepreneurs to build start-ups? Does it want to invest in firms with high growth potential or firms that are more community embedded and community serving? While there are not strict dichotomies between these options, there are trade-offs. Answering these questions will inform the government's policy goals. Then, we can focus on how best to accomplish these objectives, whether through expanding or modifying existing programs, creating new programs, or otherwise shifting policies and programs to meet broad policy objectives.

The remainder of the introduction covers the key challenges that small businesses face, the characteristics of small business ownership, the difficulties of financing small businesses, and a brief overview of the history of federal small business supports. The report then covers, in turn, existing forms of support: small business debt financing, microlending, equity investment, the CDFI Fund, business development support, procurement, and other factors such as tax policy.

Key Challenges for Small Businesses

Small businesses are vulnerable and fail often. While some grow tremendously—tech giants being the latest examples—most remain small, if they stay in business at all. About half of start-ups do not survive beyond five years.[5] To an extent, this is desirable. Failure is a necessary component of a dynamic, competitive economy, where entrepreneurs can take risks, innovate, serve new markets, and improve products and processes. However, market failures can stymie businesses that otherwise might have been successful, and market failures come in many forms. For instance, some firms use market power to unfairly exclude small businesses from competing, businesses in rural areas may struggle to access capital and business development supports, and racial and gender discrimination continue in small business lending (Lederer and Oros 2020, 2023; Bellucci, Borisov, and Zazzaro 2010).

To mitigate these challenges, public, philanthropic, and private supports for small businesses have grown substantially over the past several decades. These resources help expand access to capital, support business coaching and technical assistance, and create a more level playing field for small businesses in procurement and regulation. Nevertheless, challenges confronting small businesses persist and merit further attention.

BOX 1

Defining Small Businesses

Small business is a widely used term that encompasses most of the firms that exist in the United States and around the globe. But the precise definition and characteristics of a small business are far from universal. The size standard used has important consequences for which businesses have access to certain programs and can make comparisons between businesses difficult. Recognizing that defining a small business in absolute terms is challenging, the Small Business Act of 1953 instead laid out a set of flexible guidelines for establishing size standards. In general, the Small Business Administration (SBA) uses a standard of 500 employees when reporting aggregate statistics. However, in some cases, the SBA and other federal agencies rely on industry-specific size standards.

The SBA's size standards classify businesses by North American Industry Classification System (NAICS) code and whether their revenues or number of employees exceed a certain threshold.[6] These range from caps on revenues of $2 million to more than $100 million to caps on employees between 100 and 1,500 full-time equivalents. The SBA and other government agencies use these standards to determine eligibility in lending, technical assistance, and procurement programs, but they are not consistent for every program that targets small businesses—and these standards have evolved over time. For instance, the National Defense Authorization Act of 2013 required the SBA to establish individual standards for each NAICS code, where previously it had used a limited number of standards (Blackford and Cilluffo 2022). The SBA last comprehensively updated size standards in 2008, and over the past several years has shifted its focus between employee count, revenues, and assets. The rationale behind standards has shifted as well. Proponents of simple policy implementation argue for a small set of employment standards, while others point to the diversity of firm size distributions and market shares across industries as evidence that standards must be specifically tailored.

Other governments and NGOs internationally have established their own standards and classification systems for small businesses. For instance, the European Union designates businesses as either micro (1–9 employees), small (10–49 employees), or medium (50–249 employees) enterprises, with additional criteria for turnover and balance sheet totals.[7] Note that some small businesses are informal and not officially licensed, meaning they are less likely to be captured in data.

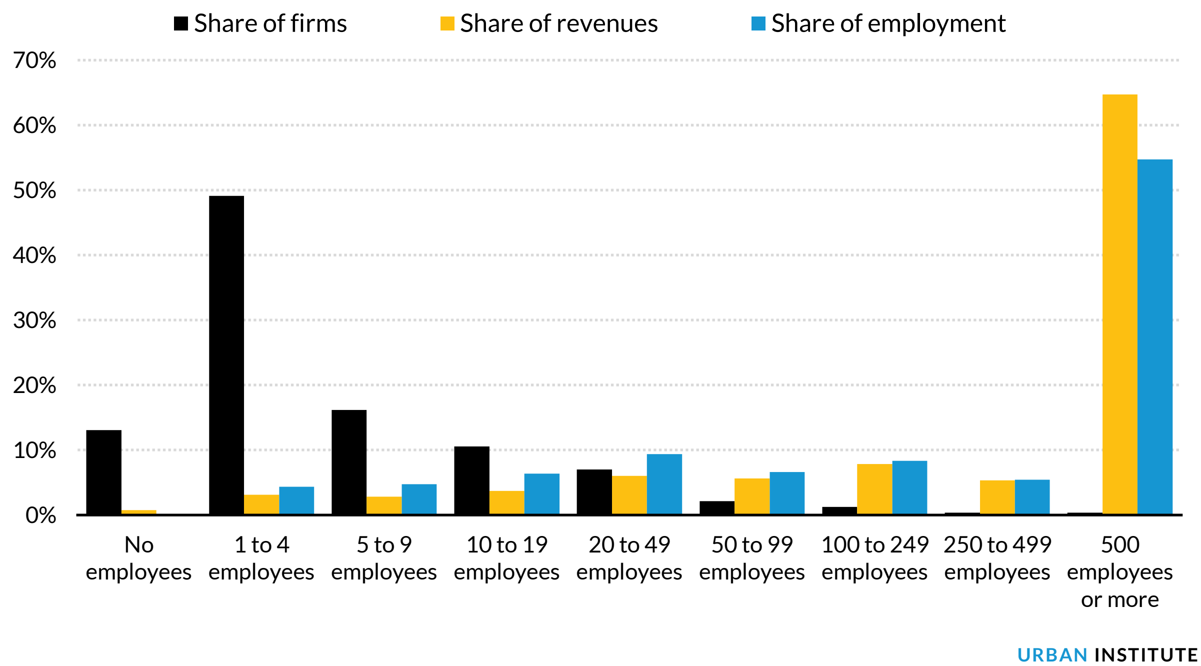
Characteristics of Small Businesses

The following figures provide an overview and background of small business ownership, employment, economic output, and investment in recent years. Collectively, they set the stage for the issues addressed in this report. The figures show the concentration of employment and revenues in larger firms (figure 1); the decline of small business shares of national employment and GDP over the past two decades (figure 2); the net loss of establishments during the past two recessions (figure 3);

race/ethnicity and gender disparities in business ownership and revenues (figures 4 and 5); differences in small business investment in rural and urban areas and by the poverty rate and predominant race/ethnicity of census tracts (figure 6); how small business investment varies across the country (figure 7); and that venture capital investment is highly concentrated in three metropolitan areas (figure 8).

FIGURE 1

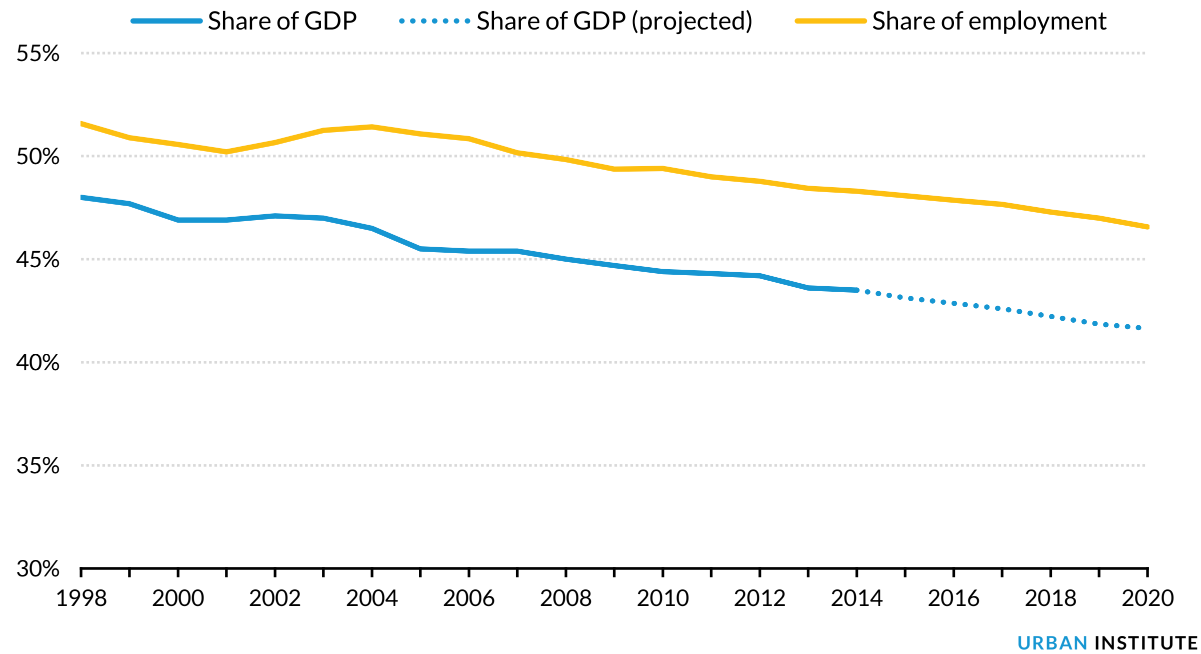
Share of US Firms, Revenues, and Employment by Firm Size



Source: "2020 Annual Business Survey," US Census Bureau, 2021.

FIGURE 2

Small Business Share of GDP and Employment, 1998–2020

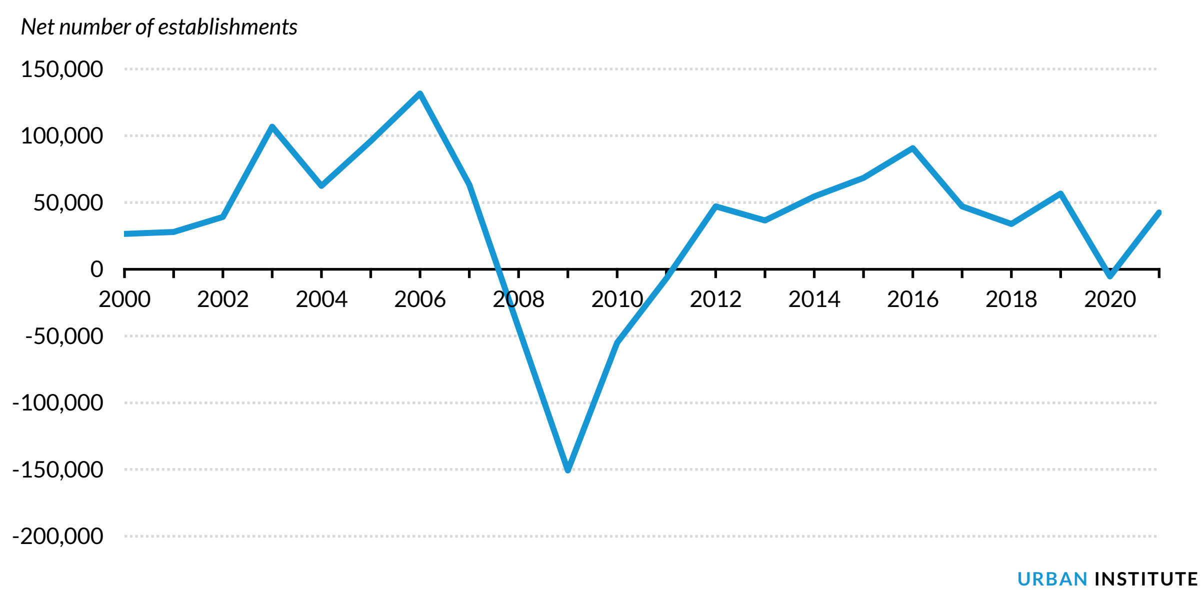


Sources: "Business Dynamics Statistics," US Census Bureau, 2020; Kobe and Schwinn (2018).

Note: Estimates for the small business share of GDP are not available past 2014 as the underlying data have changed.

FIGURE 3

Net Number of Establishments, 2000–2021



Source: "Business Dynamics Statistics," US Census Bureau, 2020.

Notes: The most recent year for which data are available is 2020. Calculated by subtracting exiting establishments from new establishments in a year.

FIGURE 4

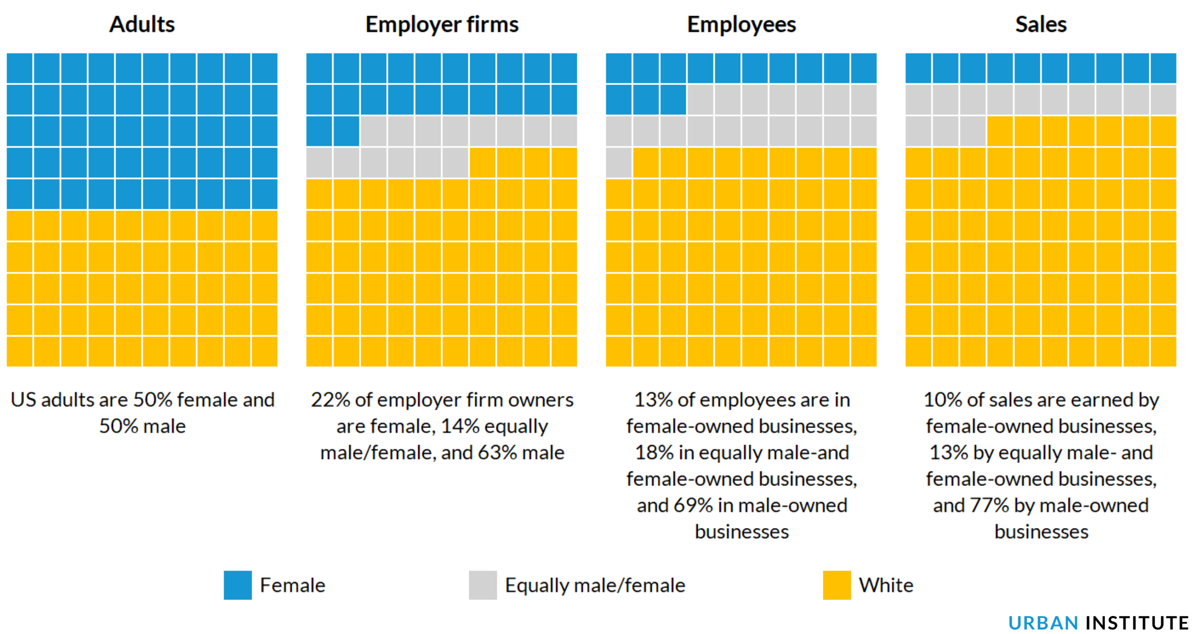
Share of US Adults, Employer Firms, Employees, and Sales by Race/Ethnicity

Sources: "2020 Annual Business Survey," US Census Bureau, 2021.

Notes: Each rectangle represents 1 percent. AIAN = American Indian and Alaska Native; NHPI = Native Hawaiian and other Pacific Islander.

FIGURE 5

Share of US Adults, Employer Firms, Employees, and Sales by Gender



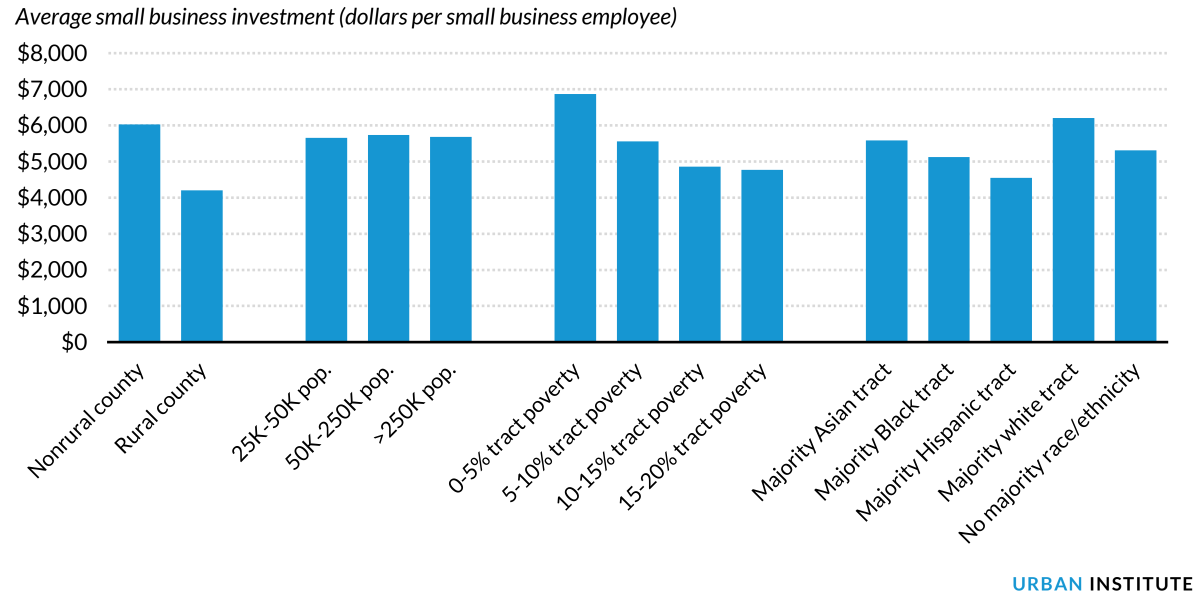
Source: "2020 Annual Business Survey," US Census Bureau, 2021.

Note: Each rectangle represents 1 percent.

FIGURE 6

Small Business Investment by Rural Status, Poverty, and Ethnicity

Using tract-level investment and demographic data

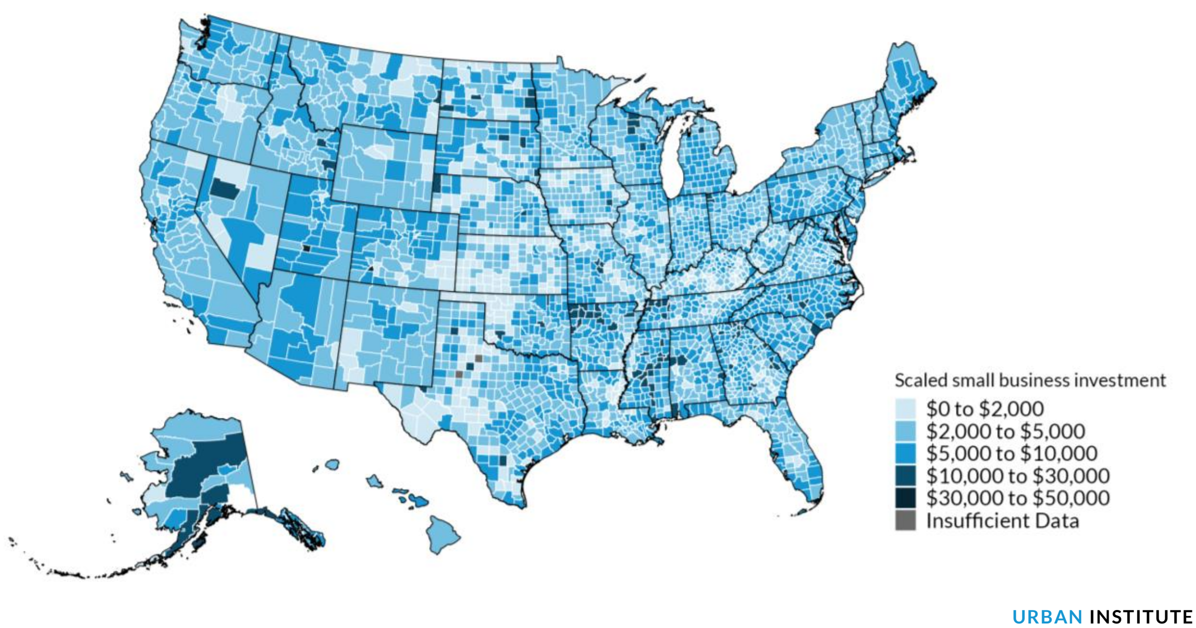


Sources: 2019 American Community Survey; US Small Business Administration data; and Community Reinvestment Act data.
Note: Investment is scaled by the number of small business employees in a county/tract.

FIGURE 7

Small Business Investment by County

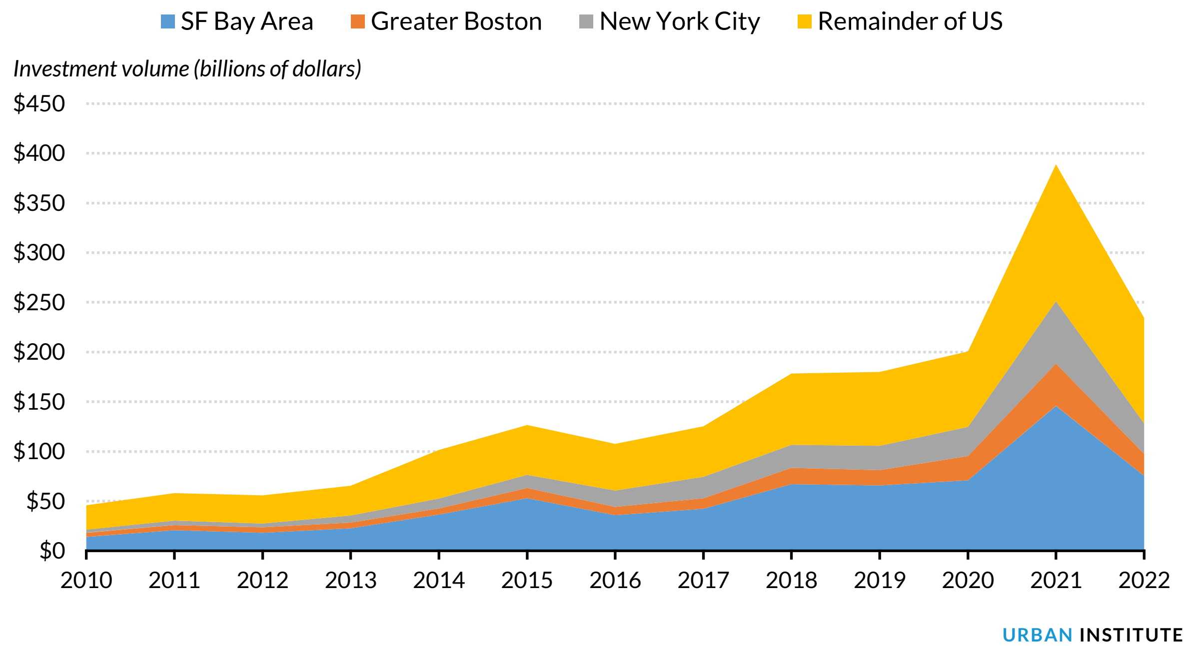
Average investment per small business employee



Sources: 2019 American Community Survey; Small Business Administration data; Community Reinvestment Act data.
Note: Investment is scaled by the number of small business employees in a county/tract.

FIGURE 8

Venture Capital Investment Volume by Region, 2010–2022



Source: "Guide: USA," Dealroom.co, 2023.

Business Ownership

Business ownership does not closely reflect the US population overall. More than half of business owners are older than 55,[8] and the average age is rising. Race and gender disparities are acute. Business ownership is disproportionately concentrated among white and Asian owners. While Latino people make up 18 percent of the adult population, only 7 percent of firms are Latino owned, and those firms represent only 2 percent of total US business revenue. Black people make up 12 percent of the adult US population, but just 2 percent of firms are Black owned, and those firms represent only 1 percent of total revenue. Additionally, there is a significant gender imbalance in business ownership (figure 5). Only 22 percent of firms are women owned, and another 14 percent are owned equally by women and men. However, these trends are in flux: people of color and women are becoming business owners at an increasing rate.[9]

Several factors contribute to these disparities. Starting and growing a small business often requires a significant commitment of personal savings or investment from friends and family. Existing wealth disparities between communities are therefore reflected in disparities in business ownership. On average, Native American, Black, and Latino households and communities are less wealthy than their Asian and white counterparts, reducing their ability to finance entrepreneurship. Their networks are also less wealthy, further limiting potential sources of investment (Meschede, Darity, and Hamilton 2015). Entrepreneurs of color and female entrepreneurs may face discrimination when attempting to secure financing. One study found that Black and Latino prospective borrowers were more likely to be asked to provide additional financial information and less likely to be provided with information on loan products compared with white borrowers (Lederer and Oros 2020).

While the number of small businesses in rural counties has grown in absolute terms, this growth has occurred at a much slower rate than in metropolitan counties—just 7.2 percent compared with 30.9 between 2000 and 2018 (Wilmoth 2019). Businesses in rural areas also face challenges beyond those faced by businesses in urbanized areas. Rural businesses tend to be smaller and have lower revenues given the more limited labor supply, fewer customers nearby, and longer supply chains. Additionally, credit markets are typically more constrained in rural areas, though access to credit varies by community (for instance, Iowa, Maine, and North Dakota have relatively robust community and public banking systems, while some other mostly rural states do not). Further, local governments in rural areas may be limited in their capacity to provide or coordinate funding for economic development, reducing opportunities for business development and growth—or even stability. All these factors, combined with limited population growth or population declines in some rural areas, has led to a decline in the share of rural entrepreneurs.

Difficulties in Financing Small Businesses

One of the key requirements for starting and growing a business is capital, whether for real estate, machinery, working capital, or another purpose. Most entrepreneurs use their personal savings to finance these needs, but many cannot rely on personal savings alone and must look to additional sources for debt or equity financing (Robb and Robinson 2014). For example, approximately 72 percent of employer firms have outstanding debt (Corcoran et al. 2023).

Capital can come in many forms, and is often some combination of savings, operating profit, debt, equity investments, and grants. In the United States, many businesses benefit from a robust capital market. Nationally and locally, small business finance is a highly developed and sophisticated ecosystem, with a diversity of institutions, funding mechanisms, and products designed to serve businesses at all stages and sizes. The main providers of capital to small businesses include banks, credit unions, credit card companies, equity investors, online lenders, and mission lenders—nonprofit social impact–driven organizations that provide credit to businesses, often in underbanked communities.

Because there are so many forms of capital available, from lenders subject to different forms of regulation, it is challenging to determine the size of the small business credit market nationally. Even with respect to the extension of credit, there is no national database or comprehensive record of small business financing. The Consumer Financial Protection Bureau (2017) estimated that the small business credit market was $1.4 trillion in 2013, including term loans and lines of credit, supplier financing, credit cards, equipment leasing, factoring, SBA loans, and merchant cash advances, in that order of prevalence. Their estimate includes businesses ranging from all stages and sizes and draws from multiple data sources with different standards for collection and representativeness. As we discuss later in this report, data collected pursuant to Section 1071 of the Dodd-Frank Act may establish a record of new small business credit, but even those data will not cover equity or credit outstanding.

While debt is critical to business formation and growth, new businesses can find it costly and hard to access. Moreover, debt must be supported by some amount of equity, and equity is limited in supply—especially for start-ups in rural communities and among lower-wealth owners, who are disproportionately women and people of color. This means that many business owners are denied a loan: approximately 35 percent of firms that applied for financing reported a denial (Wiersch et al. 2022), and a further 35 percent of surveyed firms received less than the full amount of credit sought (Wiersch et al. 2022). Only 42 percent of businesses considered their financing meets met (Wiersch et al. 2022).

Our interviews and a review of the literature identify several factors driving this difficulty in finding adequate financing.

Start-ups. The risks posed by start-up businesses are particularly challenging, and lenders are less likely to provide financing to them. When financing is available, it is often more expensive than the financing offered to established businesses. Consequently, more than half of start-ups are financed through personal savings rather than conventional private sources such as bank loans, equity investment, or credit card loans.[10]

Gaps in friends-and-family financing and preexisting wealth. While loan capital is essential for established businesses seeking expansion, start-ups are often financed with capital from friends and family members. This ultimately favors entrepreneurs who have previous business success or wealthy networks, which in turn entrenches existing disparities across gender, race, and place, among other dimensions. For entrepreneurs without networks or preexisting wealth, banks or online loans may be necessary (Åstebro and Bernhardt 2003). These entrepreneurs may also need to rely more heavily on credit card debt, especially when conventional capital is inaccessible.

Collateral requirements. Small businesses often have limited collateral, and the collateral they have is more likely to be specialized equipment or inventory that is hard to liquidate and likely to depreciate. Lenders often require business owners to provide a personal guarantee to secure a loan. For many entrepreneurs, their home is the largest share of equity. This is clearly a challenge for renters but also puts owners at risk. Further, as more businesses deliver their services digitally, physical capital needs decrease. This may reduce aggregate capital demands but also limits collateral available to support debt.

Revenue variability. Although consumers can struggle with irregular incomes, the challenges are even more acute for small businesses, which can have inconsistent earnings. When monthly sales are less predictable, businesses and lenders may have decreased confidence in the business's ability to take on debt or to scale. Factoring, merchant cash advances, and revenue-based fintech lenders can fill a need for working capital. However, these products often come at a high cost, which may hinder the business's ability to make other payments and build reserves.

Business diversity. Small businesses vary in sector, size, ownership history, equipment, product or service, and market, which means they are not truly a singular asset class and require a more diverse, more responsive, and more customized lending market. Because of this and other policy-related factors, there is not as robust a secondary market for small business lending as there is for home mortgage lending, limiting lenders' liquidity.

Sectoral concentrations. For reasons related to the factors mentioned above, debt capital is more available in some industries than in others, especially those with more regular cash flows or durable collateral. Equity financing is even less equitably or broadly distributed. Because of the greater risk inherent in equity financing, investors often seek firms that can generate high investment returns, which they expect will balance out other nonperforming investments. The implication is that equity investors target firms with a rapid, even exponential, growth trajectories. As a result, roughly two-thirds (65 percent) of venture capital investment dollars go to internet, mobile and telecommunications, and software firms, even though the information sector accounts for only about 5 percent of gross economic output in the United States (Theodos and González-Hermoso 2021).

Geographic concentrations and gaps. Access to capital also varies by geography. While small businesses are a part of local economies everywhere, their access to financing differs substantially by place. This is especially true for equity investment. Three-fourths of new venture capital is invested in just three states: California, New York, and Massachusetts (Theodos and González-Hermoso 2021). Indeed, the San Francisco Bay Area, New York City, and Greater Boston alone account for 55 percent of venture capital investment (figure 7). But debt is also unevenly distributed: in many cities, small business lending in predominantly minority and low- and moderate-income neighborhoods significantly lags behind the share of active businesses in those neighborhoods (Robb, Barkley, and de Zeeuw 2018).[11]

Discrimination. Research has shown systemic disparities in access to capital for businesses owners of color (Theodos and González-Hermoso 2021). Black-owned businesses receive fewer credit approvals than do similar white-owned businesses and are often forced to apply for financing at higher rates (Lederer and Asante-Muhammad 2020; Lederer and Oros 2023).

Banking sector changes. In 1953, when the SBA was created, most small business lending was done by the nation's thousands of community banks. In the intervening 70 years, the banking industry has changed dramatically: community banks have dwindled in number and the vast bulk of banking assets have become concentrated in a limited number of national banks. Despite their benefits to small businesses, the number of community banks has declined by 30 percent in the past decade alone.

Banks continue to serve as major small business lenders, and small business lending remains an important part of the business of banks. Based on call report data, outstanding small business commercial and industrial loans totaled $538 billion in June 2021 (Board of Governors of the Federal Reserve System 2022). This lending is especially important to community banks. In its 2020 community banking study, the Federal Deposit Insurance Corporation found that community banks hold 36 percent of small business loans, compared with 15 percent of all industrial loans (Raslavich et al. 2020). Between 2016 and 2019, the small business share of total lending by banks and thrifts subject to the Community Reinvestment Act (CRA) declined, though this increased somewhat in 2020 (SBA 2022). Credit unions have also increasingly become small business lenders (NCUA 2023).

CDFIs are growing but are still small players. In the past 10 years, community development financial institutions (CDFIs), many of them non-depository nonprofit loan funds subject to fewer regulations than banks, have partially filled the gap left by the declining number of community banks. CDFIs have a mission to serve underserved communities and populations and are so certified by the US Department of the Treasury. As shared by multiple interviewees within and outside the CDFI sector, CDFIs' organizational capacity has grown dramatically in recent years, enabling them to reach a greater share of the small business market through mission-based relationship lending. Nevertheless, we estimate that loans originated by CDFIs account for less than 1 percent of small business lending.

New and emerging lenders. Small businesses increasingly are relying on finance companies and online lenders. Small businesses value conventional lenders for their favorable interest rates and terms but also place a premium on the looser standards and fast approvals that finance companies, online lenders, and fintechs provide (Wiersch et al. 2022). Fintechs, virtually nonexistent before the 2008 Great Recession, operate in several areas, including the digital lending sector (Buckley, Arner, and Barberis 2016). Many enable businesses to quickly access working capital through revenue-based models, which also mitigate the need for collateral. More recently, fintechs involved in payment systems have started lending that is both underwritten by and repaid through credit card swipes. Because of fintechs' higher capital costs and lighter regulation than banks and credit unions, their loans often come with significantly higher rates. Of firms presenting medium to high credit risk, 51 percent applied for credit with a fintech lender or a nonbank financial company (Corcoran et al. 2023). Approval rates at these institutions are higher than those at bank lenders: 90 percent of merchant cash advances are approved, compared with 66 percent of business loans (Corcoran et al. 2023). Borrowers trade the speed and relative ease of acquiring this financing for reported higher interest rates and unfavorable repayment terms.

Federal Small Business Supports

Small businesses as a policy concern did not exist until the emergence of big businesses in the period of rapid industrialization following the Civil War (Blackford 2003). Before that, practically all businesses in the country were small. Congress first acted to curb the power of emerging monopolies with the Sherman Anti-Trust Act in 1890. Federal antitrust legislation in the following decades—in particular, the creation of the Federal Trade Commission in 1914—strengthened the government's ability to limit the detrimental effects of monopolies on consumers and the economy.[12]

It was not until the Great Depression that the federal government began to recognize the special needs of small businesses as it moved to stabilize the economy, authorizing the Reconstruction Finance Corporation to make loans to the sector in 1933.[13] The US Senate and House first established committees for small business in the 1940s, but it was the establishment of the SBA in 1953 that significantly expanded the federal government's role. The SBA took over the Reconstruction Finance Corporation's role as a direct lender to small businesses and provider of disaster assistance.[14] The agency also took on the responsibilities of coordinating government-guaranteed lending with its 7(a) and 504 loans and providing business support services. However, meaningful policy reform at the SBA has been delayed, and the agency has not been reauthorized since 2000. The SBA avoided dissolution but faced significant budget cuts during the Reagan and Bush administrations.[15] Previous efforts to combine the SBA and other federal business-related agencies failed, in part because of resistance to mixing small businesses with larger firms.[16] However, the SBA administrator was elevated to a cabinet position in 2012, and the agency was tapped in unprecedented ways during and after the COVID-19 pandemic.

Other federal agencies have developed their own forms of small business supports in the decades since the creation of the SBA, including the US Economic Development Administration, established in 1965 within the US Department of Commerce; the Minority Business Development Agency, established in 1969 within the US Department of Commerce; the US Department of Agriculture's (USDA) Rural Development Program, started in 1973; Community Development Block Grants through the US Department of Housing and Urban Development (HUD) in 1974; the CDFI Fund in 1994; the Small Business Loan Fund in 2010; and the State Small Business Credit Initiative in 2010. In addition to programs administered by executive agencies, many important bills have shaped regulation influencing the small business sector, including tax policy and the CRA.

To support small businesses today, the federal government uses four broad strategies:

- improving capital access and lowering the cost of financing through loan guarantees, loans, tax incentives, and grants;
- providing and underwriting technical assistance to business owners, both directly and through federally supported organizations;
- encouraging federal agencies to buy goods and services from small businesses, both directly and indirectly (through subcontracting); and
- creating a tax and regulatory environment that can benefit small businesses.

The opening text of the Small Business Act may still offer the best articulation of the federal government's goal:

The essence of the American economic system of private enterprise is free competition. Only through full and free competition can free markets, free entry into business, and opportunities for the expression and growth of personal initiative and individual judgment be assured. The preservation and expansion of such competition is basic not only to the economic well-being but to the security of this Nation. Such security and well-being cannot be realized unless the actual and potential capacity of small business is encouraged and developed.

—Small Business Act of 1953

Mid-Market Financing

The federal government delivers capital to small businesses through multiple agencies, each with different objectives, product types, and financing relationships. Many of these programs are managed in isolation, with their own eligibility criteria and application processes. In this chapter, we discuss "mid-market" capital programs—those that provide and facilitate the provision of debt to established small businesses at loan amounts larger than microloans. We address equity investing and microlending in subsequent chapters.

Small business capital programs are delivered in a variety of ways. Some make use of guarantees, with the federal government using its balance sheet to cover a significant portion of the risk on loans made by approved private lenders. Other programs provide loans to intermediaries, such as CDFIs or Economic Development Districts. Others provide financing directly to small businesses. Still others, such as the Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR) programs, are essentially equity or grant programs.

These programs also vary substantially in terms of the funding allocated as well as the capital supported through the program. While some programs, such as SBA 7(a) and 504, are able to carefully track and publicly report lending volumes, others are either unable to provide an exact determination of the funding supported or do not publicly report loans and grants made through intermediaries. In some cases, this is due to lack of data or reporting. In others—most notably the Treasury's CDFI Fund—it is a result of the structure of the program, in which equity capital is provided to intermediaries that commingle funds from many sources. Consequently, it is impossible to calculate the full extent of federally supported small business capital because of reporting and organizational limitations.

Federal mid-market capital programs fill different niches across multiple agencies. While many of the most well-known small business capital programs are housed within the SBA, other agencies support businesses at a comparable scale in terms of appropriations and, for some years, capital provided. Some agencies focus on supporting businesses that fit characteristics related to the agency's specific mandate. For example, USDA focuses on firms in rural areas, while the Bureau of Indian Affairs provides credit enhancement to members of federally recognized tribes and groups through the Indian Loan Guarantee and Insurance program (totaling more than $125 million in 2020).[17]

Across its various programs, the federal government is generally effective at delivering capital to established and relatively larger small businesses—those that have been in business for several years and those with annual revenues in excess of a few hundred thousand dollars. Multiple interviewees noted the effectiveness of programs available to small businesses that are well collateralized and have strong balance sheets. They also expressed the opinion that the programs often lack options for start-ups, businesses with fewer than 10 employees, and businesses without collateral or friends-and-family equity.

The many and varied needs of small businesses across industries and geographies cannot be satisfied by a one-size-fits-all approach. As such, different federal agencies can align capital products with their mandates and use the tools available to them to design programs that meet small businesses' specific needs. However, this has contributed to the fragmented and disjointed environment that we see today in federal small business supports.

There is a cost to having so many programs: the number of options can be confusing and burdensome for business owners and those supporting them. For example, applications are generally not portable across programs, even within agencies, resulting in additional paperwork burdens for businesses to the point that creditworthy target borrowers turn to other financing options as a result of the confusion and inconvenience. Inconsistent regulatory standards and dated technology systems have also pushed away borrowers, lenders, and intermediaries alike, as we found in our interviews.

Small businesses are often unaware of the opportunities for federal support that might benefit them. While some will seek out these programs directly, it is more likely they will find them by working with a lender, technical assistance provider, or other adviser (such as a chamber of commerce) to identify appropriate capital solutions. These intermediaries need effective and efficient access to the range of federal programs that might benefit their clients, and small businesses need easy access to quality intermediaries. The questions, then, are (1) how hard is it for intermediaries to understand all the programs that might be appropriate for their clients; and (2) how easy is it for businesses to access quality intermediaries? Moreover, coordination among intermediaries—for example, well-designed referrals from banks to CDFIs of borrowers who are not yet ready for SBA–guaranteed loans—could also enhance program effectiveness.

Why do so many programs exist, and would the government be able to better support small businesses by consolidating its efforts under fewer agencies or reducing the total number of programs? While duplication of programs exists to some degree, particularly with state and local programs (Brash 2008), it is clear that many were designed to fill niches in terms of business sectors served, geographies, capital products, and channels for connecting with borrowers. For instance, SBIR/STTR grants enable the development and commercialization of technology, while SBA 504 loans support the purchase of commercial real estate. USDA's programs focus on rural areas and agriculture, while those of the

Economic Development Administration are targeted to other specific geographies. Each program's design is—or at least was at inception—focused on a distinct outcome. But many programs have changed little, even with the introduction of new programs and shifts in the technology and finance landscape.

The following sections summarize a selection of the key federal mid-market programs that small businesses rely on, the role they fill, and how they can better address small businesses' needs.

SBA 7(a) Loans

Background

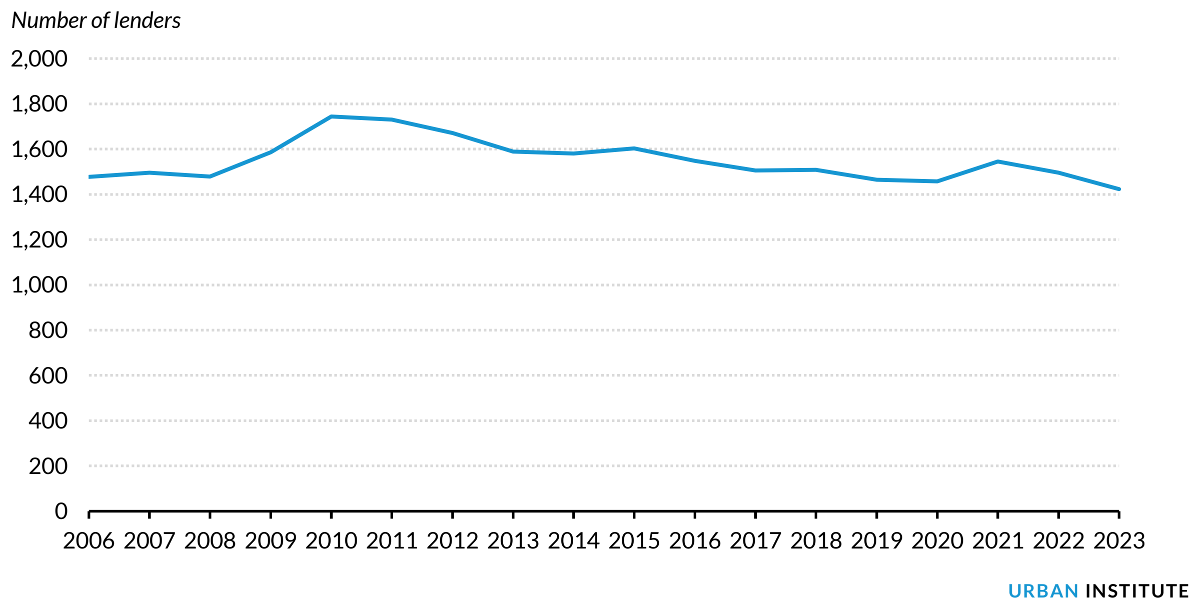
Loans originated under the 7(a) loan program are the most-used capital product offered by the SBA's partner lenders, totaling more than $25 billion in approvals in FY 2022. Businesses seeking these loans do not borrow directly from the SBA; rather, they obtain a 7(a) loan through a bank, or less commonly a CDFI, that has been licensed by the SBA to offer SBA–guaranteed loans to qualified borrowers through the Community Advantage program. Lenders must go through a licensing process before they can offer 7(a) or Community Advantage loans, and borrowers must meet both the SBA criteria and any other underwriting standards set by the lender. After approval, borrowers pay a one-time guarantee fee to the SBA and an origination fee to the lender and are then required to pay monthly interest and principal on the loan. The guarantee fee is set by the SBA with a goal of keeping the program revenue neutral, that is, unsubsidized. Guarantee fees range from 2.0 percent to 3.5 percent on most loans. The following sections describe the size and structure of the program, its subprograms and policy features, and borrower characteristics.

SBA 7(a) borrowers are required to meet the SBA's eligibility requirements[18] to qualify for a loan. In addition, borrowers must meet the "credit-elsewhere" test, which stipulates that the SBA will support only "applicants for whom the desired credit is not otherwise available on reasonable terms from non-Federal, non-State, and non-local government sources."[19] Consequently, it is expected that SBA borrowers will be undercollateralized, have lower revenue, or have a higher risk profile than that which would enable them to get conventional credit. In practice, lender understanding and application of "credit-elsewhere" standards differs (Streich 2020; Temkin and Theodos 2008).

In 2022, the SBA guaranteed and funded more than 43,000 7(a) loans with an average size of nearly $540,000. That year, nearly 1,500 licensed lenders originated at least one loan (figure 9); however, lending volume is highly concentrated, as shown in figure 10. The top 15, or 1 percent, of lenders originated 30 percent of total loan volume in 2022, and the top 150 lenders originated around 75 percent of all loan volume. The top 4 lenders alone originated 17 percent of loan volume. Some SBA 7(a) lenders focus on that product, while for others, 7(a) is one among many business loan options they provide. Lenders also specialize in particular industries, sizes of businesses, or sizes of financing. As a result, there is a wide distribution of average loan size by lender. While most lenders have an average loan size of $100,000 to $500,000, some have averages exceeding $2 million (figure 12).

FIGURE 9

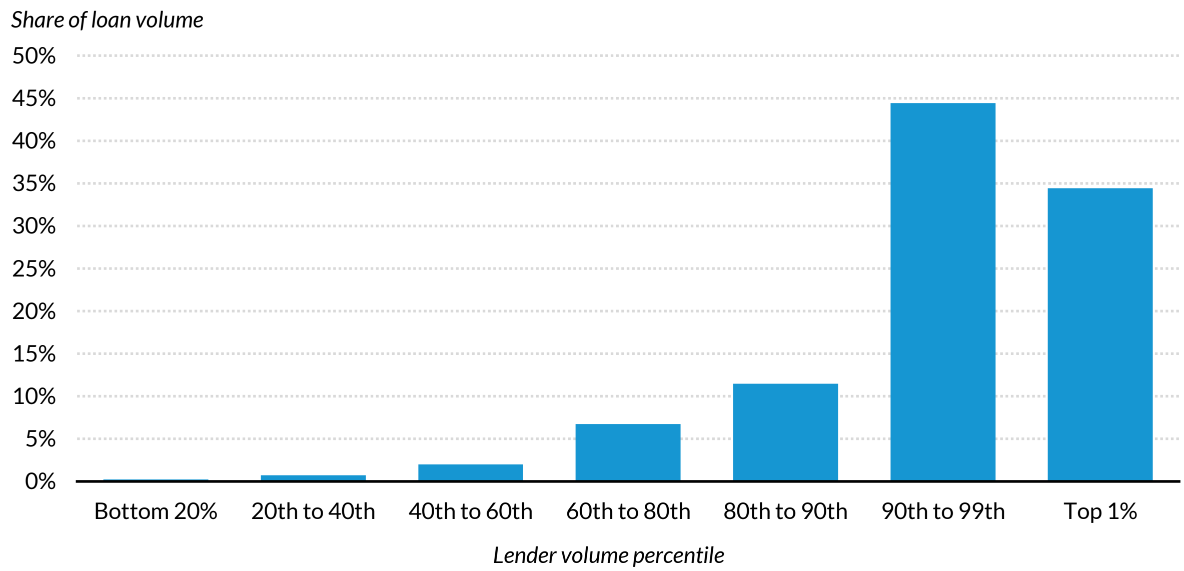
Number of Lenders Participating in 7(a), FY 2006–2023



Source: "7(a) & 504 FOIA," US Small Business Administration, 2023.
Notes: Includes any lender that originated at least one funded loan in a year.

FIGURE 10

Total 7(a) Volume by Lender Volume Percentile, FY 2023

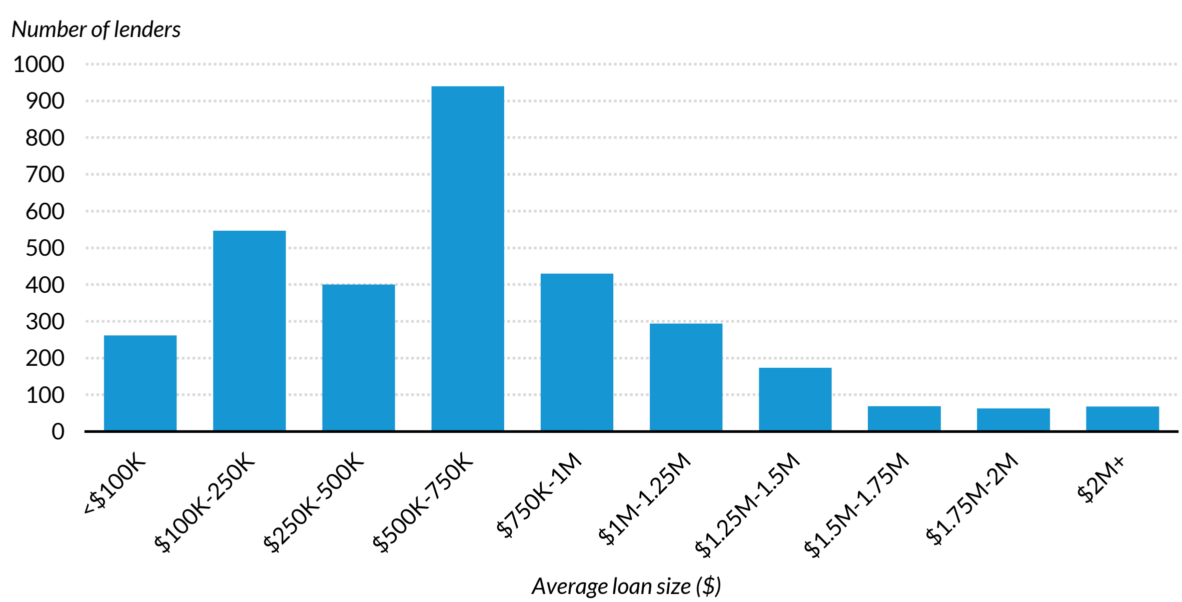


URBAN INSTITUTE

Source: "7(a) & 504 FOIA," US Small Business Administration, 2023.
Notes: Includes data from 2023. Lenders are grouped by their rank in volume of 7(a) loans originated.

FIGURE 11

Distribution of 7(a) Lender Average Loan Size



URBAN INSTITUTE

Source: "7(a) & 504 FOIA," US Small Business Administration, 2023.
Notes: Dollar values are adjusted for inflation to 2023. Includes data from 2010 to 2023.

SBA 7(a) loans encompass multiple subprograms, such as SBA Express and Community Advantage, that may vary in their interest rates, guarantee percentages, terms, or documentation required to qualify (table 1). Borrowers willing to exchange maximum loan size and a higher interest rate for speed might prefer an Express loan, while those with international business might prefer an International Trade or Export Working Capital loan. Regardless of the specific type of 7(a) loan, the mechanics are largely the same—a business seeking capital will take out a loan with a licensed lender, typically a commercial bank, a portion of which is guaranteed by the SBA in case of default. The guarantee percentage on 7(a) loans ranges from 50 percent to 90 percent depending on the subprogram.

Most 7(a) loans (84 percent in 2022) are either originated by a Preferred Lender Program (PLP) lender or are Express loans (figure). The share of loans delivered through these methods declined following the 2007–2008 global financial crisis but has risen steadily since. The PLP and Express programs are designed to reduce paperwork and deliver capital to businesses more quickly. Lenders must apply to the SBA and be approved to become PLP lenders, after which loans they originate and service can be made without waiting for SBA approval. Because of this, PLP loans have somewhat more stringent underwriting standards, such as a higher required debt service coverage ratio. In 2022, 597 different lenders originated PLP loans. Express loans, which can be provided by any licensed lender, require less documentation than standard 7(a) loans but have lower maximum loan sizes and a reduced guarantee percentage of 50 percent.

The dollar volume (figure) and number (figure) of 7(a) loans has changed substantially in the past decade. Following the global financial crisis, both the volume and number of loans declined. Lending volume increased dramatically as a result of the pandemic, reaching a record high of $36.8 billion in 2021. While lending volume in real terms has increased since, the number of loans has not, indicating an increase in the average loan size, reaching almost $540,000 in 2022. Over the past decade, 38 percent of 7(a) loans were for less than $50,000 and 59 percent were for less than $250,000 (figure). In other words, small loans dominate the program in terms of number of loans, but loan volume is mostly made up of large loans.

TABLE 1

Major 7(a) Loan Subprograms

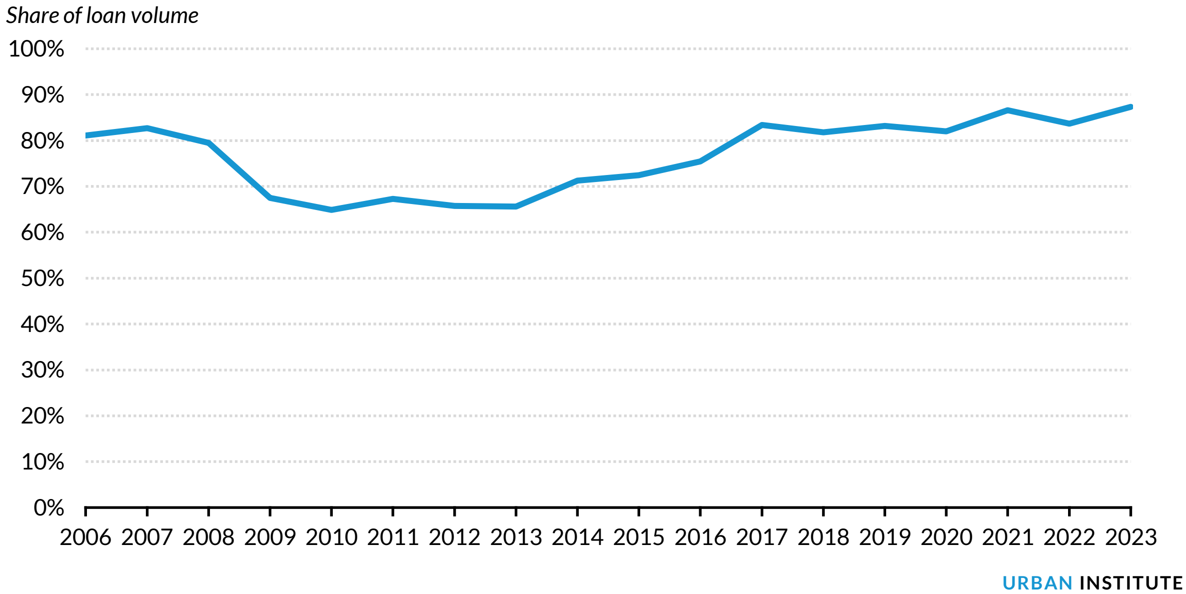
Program	Maximum loan amount	Percentage of guarantee	Use of proceeds	Maturity	Maximum interest rates	Guarantee fees	Who qualifies (benefits)
7(a) loans	$5 million	85% for loans of $150,000 or less; 75% for loans greater than $150,000	Term loan. Expansion/ renovation; new construction, purchase land or buildings; purchase equipment, fixtures, leasehold improvements; working capital; refinance debt for compelling reasons; seasonal line of credit; inventory; or starting a business	Generally 5–10 years, 25 years for real estate	Prime + 2.75% to 4.5%, depending on loan size	0% to 3.5%, depending on loan size	Must be a for-profit business and meet SBA size standards; show good character, credit, management, and ability to repay. Must be an eligible type of business.
SBA Express	$350,000	50%	May be used for revolving lines of credit (must have term-out period not less than draw period) or for a term loan. Same as 7(a)	Same as 7(a) except line of credit: Revolving plus term-out can have a maturity only up to 10 years.	Loans $50,000 or less: prime + 6.5%; loans over $50,000: prime + 4.5%	Same as 7(a) loans	Same as 7(a) loans
CAPLines	$5 million	Same as 7(a) Loans	Finance seasonal and/or short-term working capital needs; cost to perform; construction costs; advances against existing inventory and receivables; consolidation of short-term debts. May be revolving	Up to 10 years, except Builder's CAPLine, which is 5 years.	Same as 7(a) loans	Same as 7(a) loans	Same as 7(a) loans

Program	Maximum loan amount	Percentage of guarantee	Use of proceeds	Maturity	Maximum interest rates	Guarantee fees	Who qualifies (benefits)
Community Advantage	$350,000	Same as 7(a) Loans	Same as 7(a)	Same as 7(a) loans	Prime + 6%	Same as 7(a) loans	Same as 7(a) loans, plus lender must be a CDFI, Certified Development Company, microlender or SBA intermediary lender targeting underserved markets
International Trade	$5 million	90%	Term loan for permanent working capital, equipment, facilities, land and buildings, and debt refinance related to international trade	Up to 25 years	Same as 7(a) Loans	Same as 7(a) loans	Same as 7(a) loans, plus must be engaged or preparing to engage in international trade, or adversely affected by competition from imports
Export Working Capital Program	$5 million	90%	Short-term, working-capital loans for exporters. May be transaction based or asset based. Can also support standby letters of credit	Generally 1 year or less; may go up to 3 years	No SBA maximum interest rate cap, but SBA monitors for reasonableness	Maturity of 12 months or less: 0.25%; between 13 and 24 months: 0.525%; between 25 and 36 months: 0.80%	Same as 7(a) loans, plus must need short-term working capital for direct or indirect exporting, or additional working capital to increase export sales without disrupting domestic financing and business plan
Export Express	$500,000	90% guarantee for loans of $350,000 or less; 75% guarantee for loans greater than $350,000	Same as SBA Express plus stand-by letters of credit	Same as SBA Express except line of credit: revolving plus term-out can have a maturity up to only 7 years	Same as SBA Express	Same as 7(a) loans	Applicant must demonstrate that loan will enable them to enter a new, or expand in an existing, export market. Business must have been in operation for at least 12 months (though not necessarily in exporting). Loan can be for direct or indirect exporting.

Source: Adapted from "Quick Overview of SBA Loan Guaranty Programs," US Small Business Administration, 2019.

FIGURE 12

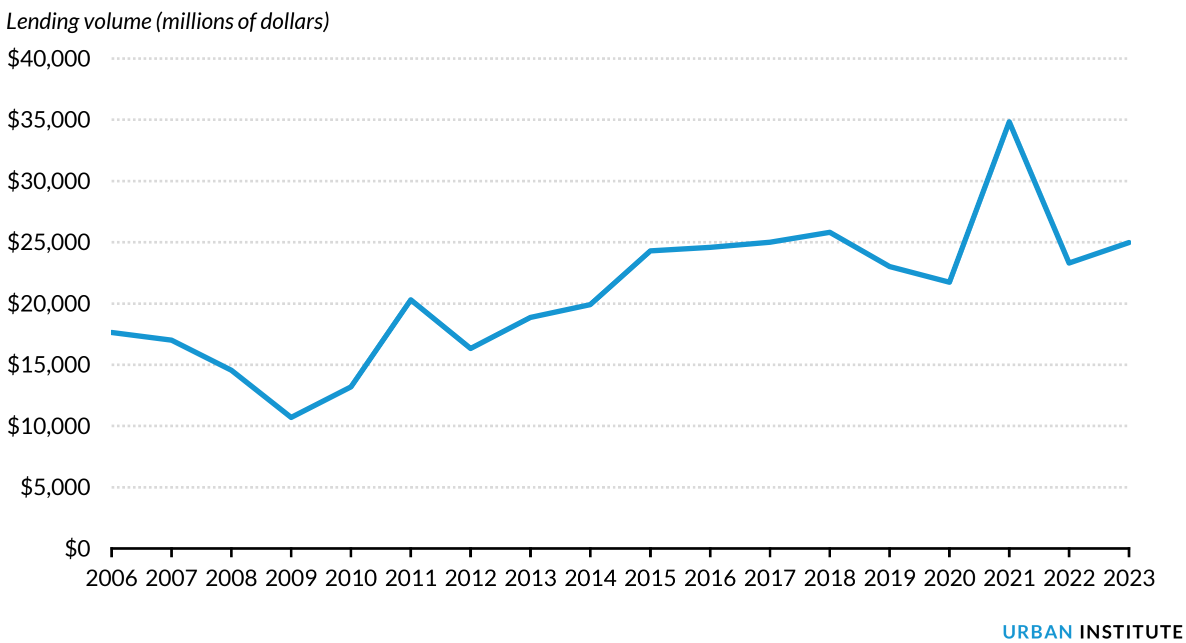
Share of 7(a) Loans Originated by PLP Lender or Express Program



Source: "7(a) & 504 FOIA," US Small Business Administration, 2023.

FIGURE 13

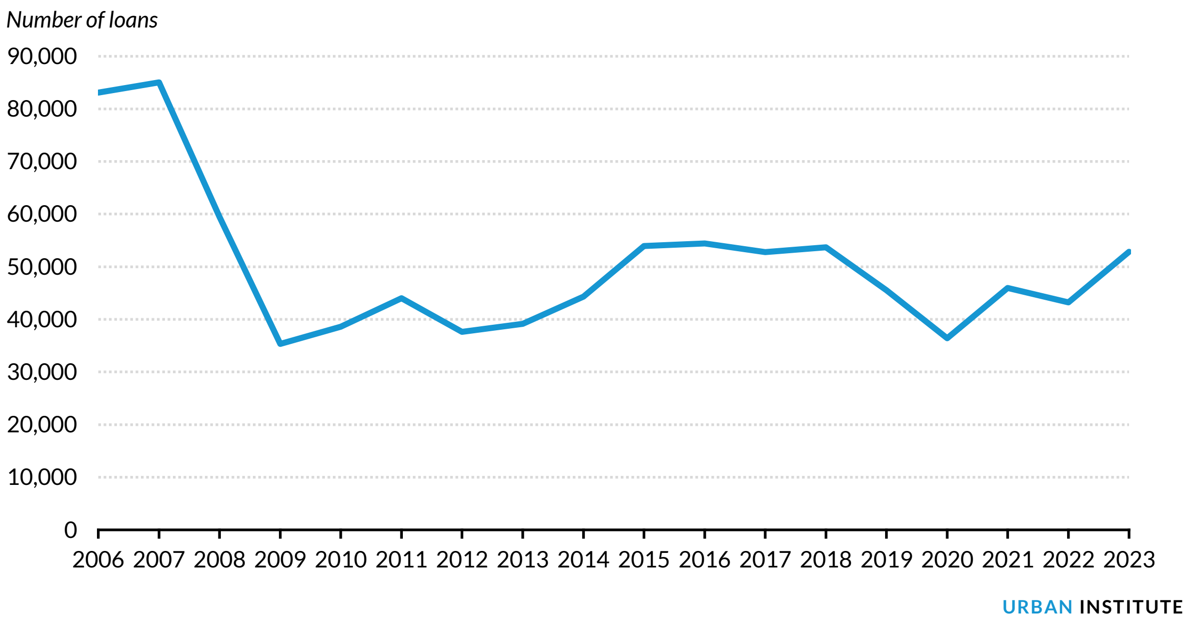
7(a) Loan Volume, FY 2006–2023



Source: "7(a) & 504 FOIA," US Small Business Administration, 2023.
Notes: Only funded loans are included. Dollar values are adjusted for inflation to 2023.

FIGURE 14

7(a) Loan Count, FY 2006–2023

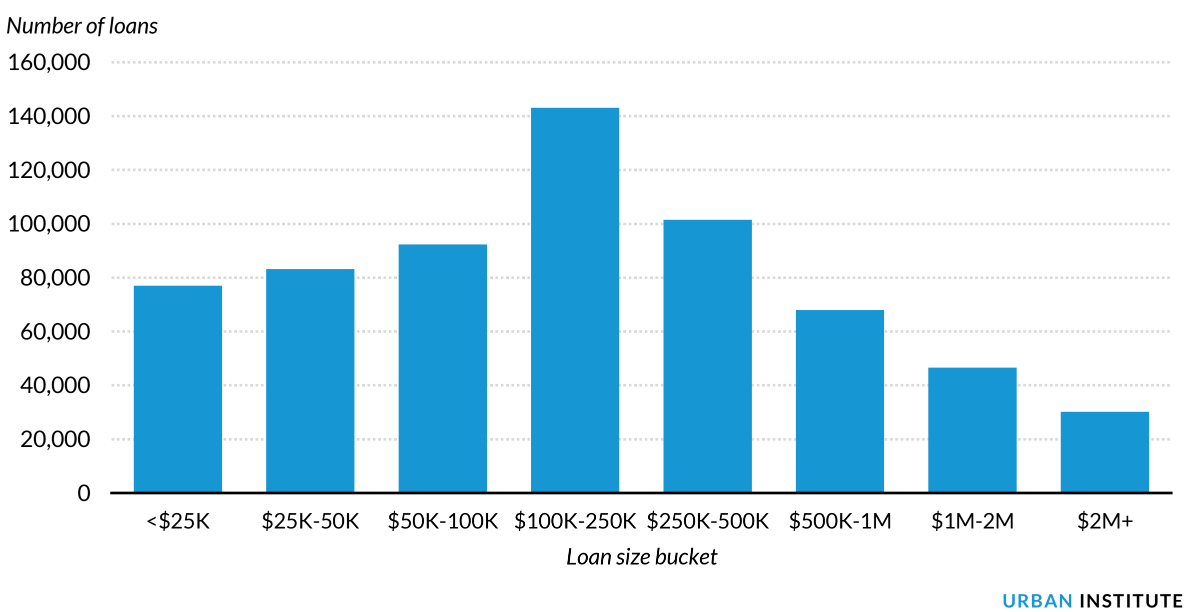


Source: "7(a) & 504 FOIA," US Small Business Administration, 2023.

Notes: Only funded loans are counted.

FIGURE 15

7(a) Loan Size Distribution



Source: "7(a) & 504 FOIA," US Small Business Administration, 2023.

Notes: Only funded loans are included. Dollar values are adjusted for inflation to 2023. Includes data from 2010 to 2022.

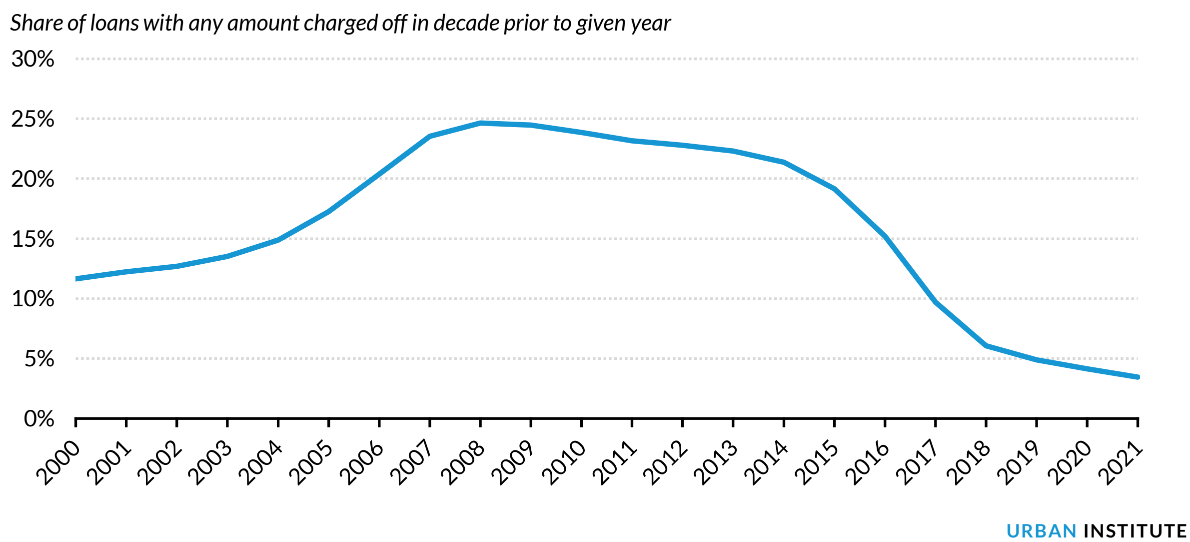
In the event of a default, the lender is responsible for the unguaranteed portion of the loan, as an incentive for lenders to do prudent underwriting. figure 2 plots the 10-year default rate for 7(a) loans in the past two decades. This is the share of loans that have been charged off as a percentage of all loans funded in the decade prior to a given year. The default rate increased in the years leading up to the global financial crisis and has declined since 2008 as healthier loans entered the portfolio. Losses are more frequent for smaller loans.

The SBA collects data on business age and owners' race, gender, and veteran status. However, the data are voluntarily self-reported, and may not be representative. In FY 2023, roughly 82 percent of borrowers provided race and ethnicity information. We present these data in figure below. Of the entire volume of loans in that year, 29 percent went to minority-owned firms, 27 percent to female-owned firms, 4 percent to veteran-owned firms, and 17 percent to start-ups or those in business for less than two years.

Borrowers represent the full range of industries in the national economy but are concentrated in the hotel, restaurant, service, retail trades, and health services industries (figure). While those industries are the most common, lending is highly diversified, representing more than 1,200 unique industries (figure). The average loan size varies by industry—less than $400,000 for general automotive repair and more than $1.5 million for car washes, for instance.

FIGURE 2

7(a) 10-Year Default Rate Over Time

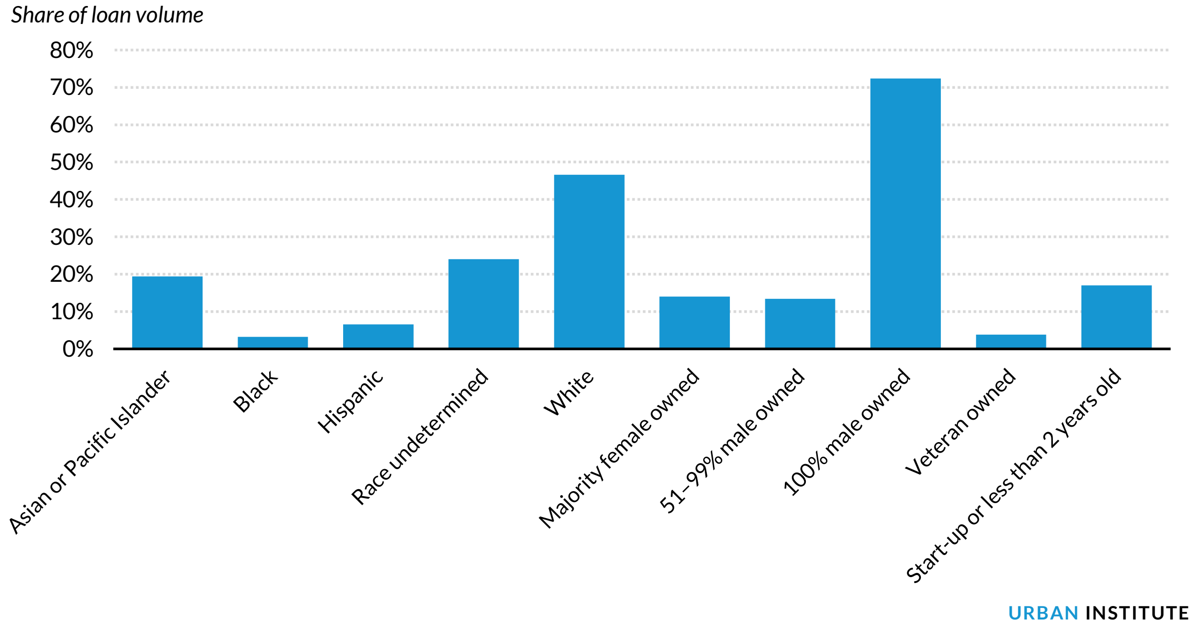


Source: "7(a) & 504 FOIA," US Small Business Administration, 2023.

Notes: Only funded loans are included. Includes data from 1991 to 2021.

FIGURE 17

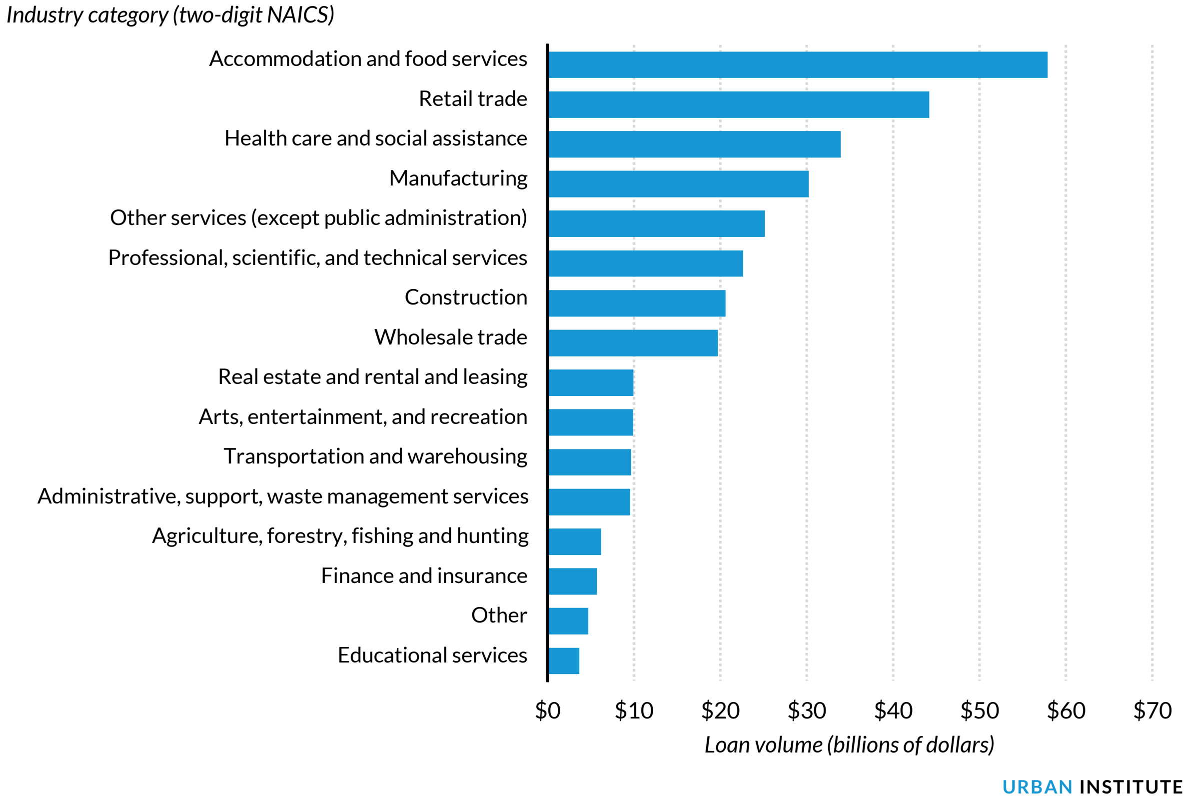
Share of Loan Volume by Owner Characteristics of 7(a) Borrowers



Source: "7(a) & 504 Summary Report," US Small Business Administration, 2023.
Notes: Includes data from 2010 to 2023.

FIGURE 18

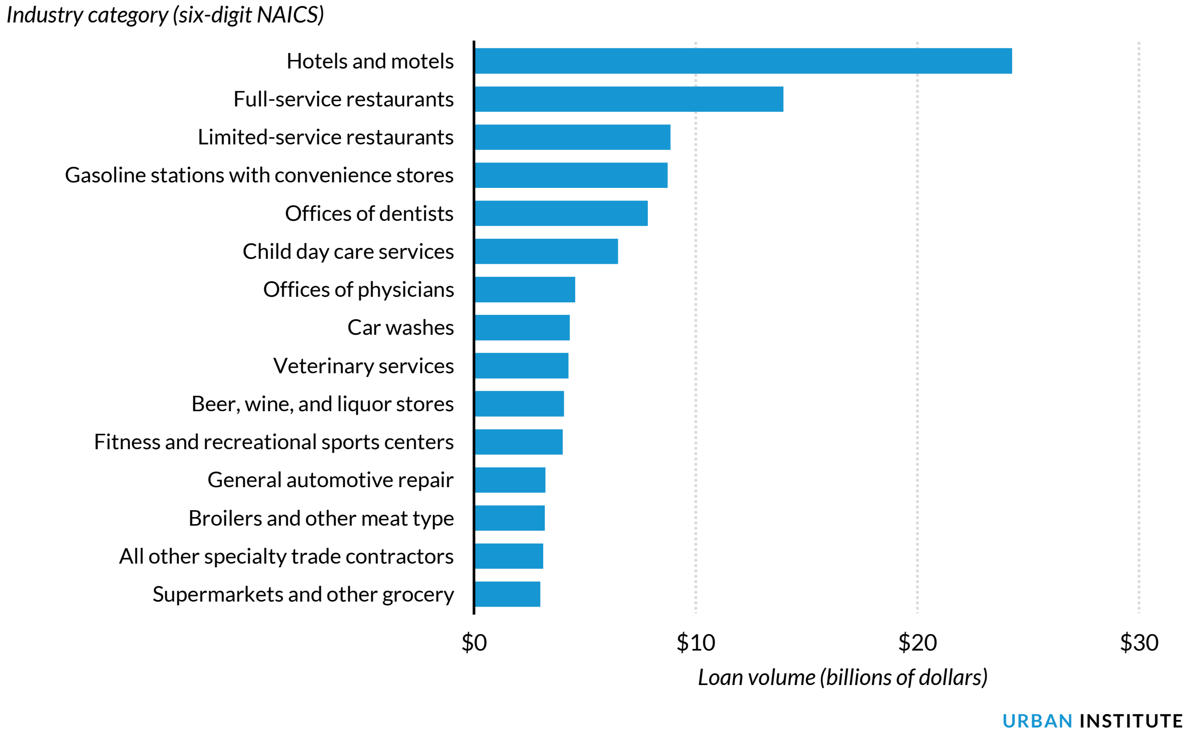
Lending Volume of 7(a) Loans by Industry



Source: "7(a) & 504 FOIA," US Small Business Administration, 2023.
Notes: NAICS = North American Industry Classification System. Dollar values are adjusted for inflation to 2023. Includes data from 2010 to 2023.

FIGURE 19

Lending Volume of 7(a) Loans by Industry, 15 Most Common 6-Digit NAICS



Source: "7(a) & 504 FOIA," US Small Business Administration, 2023.
Notes: NAICS = North American Industry Classification System. Dollar values are adjusted for inflation to 2023. Includes data from 2010 to 2023. Other industries not included. Total $187 billion.

What's Working

The 7(a) program is the largest the SBA operates in terms of loan dollar volume and number of businesses served. It also ranks among the largest of all government programs that have a direct emphasis on small businesses. While 7(a) loans may not be able to meet all the varying financing needs of small businesses across the country, they are an important economic support for the small business sector given the program's scale. In this section, we discuss what is currently working well for the program and address data availability, the costs associated with delivering 7(a) loans, and whether the program's effectiveness could by improved by including some subsidy, that is, moving away from its current revenue-neutral structure.

The guaranteed portion of 7(a) loans is not, in general, held on lenders' books, but rather sold into a robust secondary market. Congress established the secondary market for 7(a) loans in 1984, with the goals of increasing liquidity for lenders, expanding credit access for borrowers, and providing additional options for investors. While 7(a) lending data are not publicly available for years before 1991, the creation of the secondary market is regarded as an important milestone in expanding credit access for small businesses. Many interviewees commented on the importance of the secondary market, particularly its role in supplying liquidity to lenders. For many lenders, that access to liquidity is an important feature of the 7(a) program that makes the program appealing compared with other government lending programs, despite the compliance requirements.

The 7(a) secondary market is particularly important for smaller lenders, enabling them to get loans "off their books." Consequently, lenders can make additional loans, deliver capital to a greater number of clients, and collect more origination and servicing fees without tying up their own capital for lengthy periods. The SBA approves pool assemblers to securitize and sell bundles of the guaranteed portion of loans; there are currently 13 active assemblers. In 2016, $8.5 billion of loan guarantees were securitized and sold to investors, representing approximately 57 percent of eligible loans. The market price of loans sold on the secondary market typically ranged from 105 to 113 percent of the par value of the loans at that time.[20] As with many other asset-backed securities, interest rates influence secondary market pricing.

The 7(a) program is also politically popular, enjoying an uncommon level of bipartisan support. It is popular in part because it serves a wide range of businesses, advances the economic goals of both political parties, and is not costly to the federal government. The program is currently designed to be revenue neutral, while still delivering capital to businesses that lenders certify as unable to receive credit on reasonable terms elsewhere.

Finally, interviewees lauded 7(a) loans for their role in providing affordable working capital to businesses on generous repayment schedules and bringing those businesses into the conventional capital system. When the system works as it should, in the opinion of interviewees, the government can use its balance sheet to defray the risk of lending to small businesses, enabling them to access capital, stabilize, grow, and subsequently access market-rate capital without direct government support.

What's Not Working

The 7(a) program is politically popular in part because it costs the government relatively little. In most years, the program operates at a zero-subsidy level, meaning that the cost to administer the program is covered by the proceeds of guarantee fees. However, in some years, economic circumstances have compelled Congress to increase the subsidy rate, though there is some debate about the best way to calculate subsidy rates (Criscitello 2023). In FY 2020, the SBA implemented a modest positive subsidy rate to adjust for the effects of the pandemic (GAO 2020). Similar changes were implemented following the Great Recession. Thus, some interviewees describe the program as countercyclical in that it softens the effect of a tightening credit supply during economic crises. Notwithstanding the occasional crisis-driven positive subsidy years, the zero-subsidy structure has made the 7(a) program more politically popular than positive-subsidy programs, such as microloans, which have struggled to garner support. However, the zero-subsidy element of the program also raises the question of whether it is truly filling gaps in the market.

Even without subsidy, lenders find the guarantee attractive because it defrays some of the risk of lending to businesses that would otherwise be unable to access conventional credit, thus potentially expanding the credit box. The SBA relies on lenders to verify that the credit box is indeed being expanded by requiring them to apply the SBA's credit-elsewhere test, which requires lenders to affirm that the borrower would not be able to obtain credit elsewhere at reasonable terms without federal support. Some interviewees questioned the rigor of this test, suggesting that banks typically apply their own criteria for evaluating creditworthiness, with the implicit assumption that businesses that do not qualify for the lender's standard business loan would instead be directed toward an SBA loan. In 2018, Congress amended the Small Business Act, in part changing the credit-elsewhere requirement to enable the SBA administrator to conduct oversight over how lenders apply the test. This provides an opportunity for the SBA to collect better information on how lenders apply the credit-elsewhere test, with the goal of better serving the credit-challenged businesses that are the target of the program. Some interviewees expressed concerns that the program is serving borrowers who could obtain credit elsewhere, while others felt that conventional loans were either not available for 7(a) borrowers or were only available on less favorable terms. The extent to which these borrowers benefit from the SBA guarantee needs to be further explored (Streich 2020; Temkin and Theodos 2008).

If 7(a) loans continue to be zero- or minimal-subsidy, can the program adequately fill market gaps and advance the SBA's mission? Some interviewees argued that the program's benefits flow mainly to lenders, rather than borrowers, because it simultaneously mitigates lender risk and enables lenders to sell the guaranteed portion of the loans for a premium. However, lenders are still exposed to risk on the unguaranteed portion of the loan. Others added that incentivizing the private lending industry is necessary to facilitate the (often costly) delivery of small business loans, in part because they are not standardized. For smaller loan amounts especially, the fixed cost of lending yields too little financial return for many capital providers.

Yet SBA 7(a) loans often take longer to process and require more documentation than conventional loans, which means that originating them requires a considerable investment in human capital and technology. Multiple lenders we spoke with commented on the specialized expertise required to comply with SBA requirements and processes. For smaller lenders, this is a significant barrier to participating in the program at scale, or even at all. Even for lenders with more capacity for dedicated staff, the cost of participating in the program remains high, which discourages them from making as many loans as they otherwise might. Despite the changes the SBA has implemented over the years to respond to these issues and accelerate capital deployment, numerous lenders and government officials commented on the need to reduce burdensome documentation and processing times. One lender expressed frustration that staffing challenges at the SBA have necessitated outsourcing work to contractors who are not as well equipped as trained and experienced SBA staff to support lenders and intermediaries.

Thus, while 7(a) loans are attractive to borrowers because they provide capital that may otherwise have been inaccessible or more expensive, interviewees shared that a firm with limited cash on hand might instead choose a more expensive loan that can be originated faster. Additional research is needed to document how widespread this phenomenon is, which types of businesses are affected, and how the 7(a) program can be improved to better serve these businesses, as well as others that may find it difficult to access the program as it currently exists.

On the SBA side, [7(a)] is such an intensively designed program. [You have to] find people that do nothing but that. That's an issue. That's on the friction side of things.
—Lender

Recommendations

UNDERWRITING AND LOAN PROCESSING

The SBA and its 7(a) lending partners must find ways to further speed up the process to approve loans, particularly for smaller loan requests. As fintech and merchant cash advance lenders have shown, speed trumps pricing for many small business owners, especially those seeking smaller amounts of money. SBA 7(a) lenders need to get better at using cash flow data, new credit scoring models, and other technology to speed up their underwriting processes and be able to respond to an applicant's loan request within hours or days, not weeks. The SBA needs to embrace the use of alternative underwriting data by its lenders. It should also continue to experiment with allowing fintech, CDFI, and other nonbank lenders to access 7(a) guarantees—potentially within a framework that accounts for the different capital structures and supervisory and regulatory regimes under which these lenders operate—provided they are offering responsible and affordable loan products. The experience of the PPP program, while not directly transferrable to 7(a), suggests these types of lenders may be able to reach deeper into the potential borrower community than can banks.

Partnering with the IRS and other government data providers could enhance the SBA's ability to evaluate borrowers' ability to pay. Data from individual tax returns could make lending decisions more equitable for smaller businesses. An IRS application programming interface would allow lenders, with the borrower's consent, to directly access tax documentation. By allowing lenders quick access, with appropriate security and confidentiality measures, government data on borrowers (especially those whose credit files are thin) could open capital to borrowers who are otherwise unable to provide sufficient documentation.

We recommend that the SBA partner with one or a small group of responsible technology-forward lenders to develop an automated underwriting platform for SBA loans to borrowers under a certain threshold loan size to speed up processing and reduce the biases and risk aversion that create barriers between lenders and underserved borrowers. To truly speed up the process, the SBA would need to adopt the use of an automated platform as well.

In 2014, the SBA began using FICO Small Business Scoring Service (SBSS) scores, a composite of business and consumer attributes, to prescreen borrowers for selected 7(a) loans. The intended effect is to provide a reliable risk metric to underwriters to accelerate loan processing. However, the SBA still requires lenders to conduct their own underwriting, making the SBSS less useful. One interviewee questioned the point of providing the score unless the SBA allowed lenders to rely on it when making loans. Moreover, the SBSS is opaque, meaning lenders are unable to calibrate the score with their own underwriting standards. We propose that the SBA provide additional clarity on how the score is calculated, in combination with allowing lenders to underwrite based on SBSS alone. This would likely contribute to improving processing times.

Some entrepreneurs are unable to access conventional capital due to personal credit score or debt coverage issues stemming from student loan or medical debt. While it is necessary to take risk associated with high personal debt into consideration in the underwriting process, these forms of debt are unrelated to the borrower's ability to manage debt as it pertains to their business. As such, special considerations should be made for borrowers who are unable to access capital for nonbusiness–related debt.

IMPROVING CAPITAL ACCESS FOR DISADVANTAGED BORROWERS

Considering the gaps in access to capital for start-ups and other underserved businesses, it would be useful to create a "duty to serve" requirement for the SBA, akin to that to which Fannie Mae and Freddie Mac are subject. This type of requirement would stipulate that a certain share of the SBA's total guaranteed loan portfolio must be in disadvantaged areas to target the types of borrowers who need enhanced federal assistance. We imagine such a rule applying globally to the SBA, not specifically to every lender, as some are in local markets. Under such a rule, the SBA would be obligated to ensure that participating lenders are doing business in (and preferably are located in) target communities and that their underwriting standards make loans accessible to businesses in those communities.

As bank lenders begin to collect the demographic data on borrowers mandated by Section 1071 of the Dodd-Frank legislation, the SBA duty to serve rule could be expanded to measure not only the geographic distribution of loans but also the demographics of the business owners or types of businesses receiving them. We note that recent court cases—in particular, the college admissions case recently decided by the US Supreme Court[21] and a lower court opinion[22] concerning the rebuttable presumption favoring minority firms for federal procurement pursuant to Section 8(a) of the Small Business Act—suggest that, depending on how a "duty to serve" program based on loan or borrower characteristics is designed, it may be evaluated by the courts under a "strict scrutiny" standard, requiring a showing that the program both furthers a "compelling government interest" and is "narrowly tailored" to meet that interest. Having quality data about both the entire small business loan market and the SBA portion of that market will be helpful in designing and supporting such a program.

FOCUS ON SMALL LOANS

The SBA should focus its efforts to improve distributional equity by simplifying and modernizing access to small loans. Currently, loans under $50,000 make up just 28 percent of all loans by number and less than 2 percent by volume. Small loans are more likely to go to underserved businesses and, we believe, are crucial to advancing SBA's mission and developing "bankable" businesses—those that can subsequently engage with market-rate credit. Therefore, we recommend that the SBA prioritize developing customer acquisition channels for borrowers looking for small amounts of credit and implementing loan processing improvements to improve customer retention.

In addition to increasing the volume of small loans, we recommend increasing flexibility to make small loans work better for borrowers. Start-ups and microbusinesses have a wide range of needs yet have limited affordable credit options at their disposal. Small 7(a) loans should be allowed to refinance more forms of debt, have extended interest-free periods where appropriate, and offer income-based repayment options.

ADD SUBSIDY TO SERVE NEWER AND HIGHER RISK BORROWERS

Ultimately, however, for the 7(a) program to more meaningfully contribute to the mission of the SBA, it must be subsidized to some degree. This is fundamentally a question of how best to incentivize lenders to deliver loans at responsible terms to underserved borrowers. While the technical changes we have recommended will be helpful, providing credit subsidy is necessary to expand the reach of 7(a) loans to more underserved borrowers. Reducing fees for small-dollar loan borrowers is a step in the right direction. Additionally, speeding up underwriting and approvals would attract borrowers who are currently turning to faster, higher-cost alternatives. These borrowers tend to be the ones seeking smaller amounts of capital and more often include more business owners who are from underserved communities.

But to reach more businesses, including start-ups and other underserved firms, Congress will need to expand the credit box and subsidize the cost of underwriting to riskier borrowers. In part because of historical disparities in wealth, many entrepreneurs cannot access affordable credit. To meet its mission of supporting both the economy as a whole and small businesses, the SBA has a responsibility to ensure that qualified entrepreneurs have the opportunity to compete. Subsidy, we believe, is a necessary component in providing that opportunity. Subsidy could be provided in a number of ways, including as a reduced guarantee fee, a subsidized interest rate, or a higher guarantee level for, as an example, borrowers in business for less than two years whose SBSS score is some percentage lower than the regular minimum.

Many businesses that are unable to access traditional credit also cannot qualify for 7(a) loans. Others are pushed away by the paperwork burden and the time involved. Subsidizing 7(a) loans would enable some higher-risk borrowers to access the program because it would allow for lower fees or interest rates. If the SBA were to take this approach, it would be important to create guardrails to direct the subsidy to those higher-risk borrowers, as several interviewees expressed the opinion that many businesses that currently take advantage of 7(a) loans could access traditional credit on reasonable terms, suggesting they may not need the current program and certainly do not need additional subsidy.

SBA Community Advantage

Background

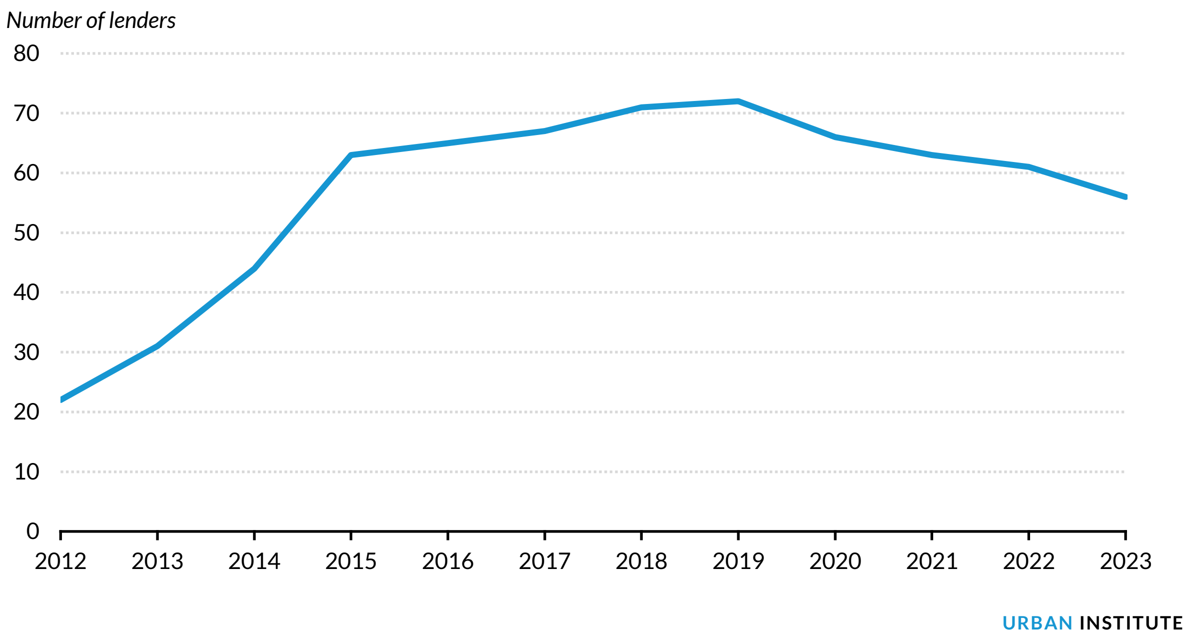
The SBA Community Advantage program is a long-standing effort within 7(a) that guarantees loans under $350,000 (previously under $250,000) originated by mission-driven lenders, with an optional management and technical assistance component. The program was established as a pilot to provide targeted support to businesses in underserved markets. Loans are 75 to 85 percent guaranteed and businesses must be located in SBA–designated low- and moderate-income (LMI) communities (SBA Office of Inspector General 2020). Since Community Advantage began in 2011, 124 lenders have participated, delivering $1 billion across more than 7,400 loans. The single-year lender count peaked in 2019 at 72 and declined to 61 in 2022 (figure). While some aspects of the program have been adjusted over time, notably with the two-year reauthorization in 2022, its design has stayed largely the same, and the 20 or so largest lenders have remained consistent as well (figure 3).

Eligible lenders must either be certified CDFIs, CDCs, or microlenders. These organizations are almost entirely non-depositories and have substantially smaller balance sheets than do 7(a) lenders. As such, they have significantly greater liquidity constraints, which makes Community Advantage attractive. Access to the 7(a) secondary market means that participating lenders can recycle their capital into additional loans.

After the Community Advantage pilot was introduced, lending volume increased annually as lenders became familiar with the program, to a peak of more than $164 million in 2018 (figure 4). Lending has decreased since, corresponding with the decline in lender participation. Loan amounts are dispersed across the distribution below the maximum size of $350,000, with most falling between $50,000 and $200,000 (figure 5). The 10-year default rate for Community Advantage in 2021, the first full decade of data, was 5.7 percent.

FIGURE 20

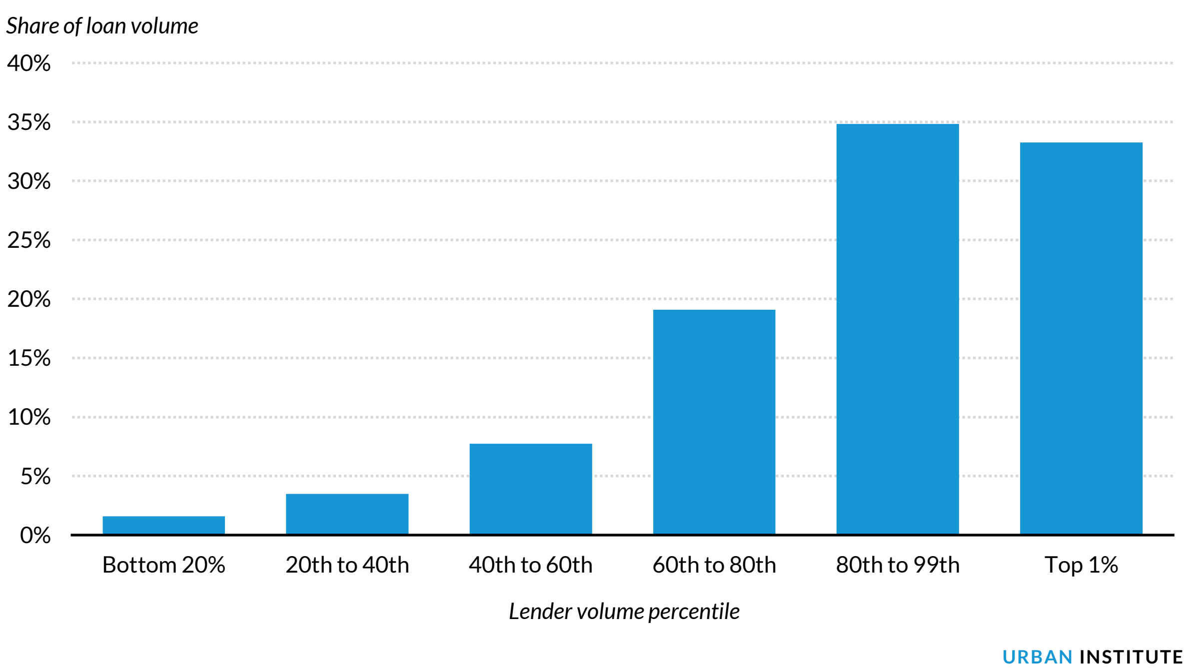
Number of Community Advantage Lenders, FY 2012–2023



Source: "7(a) & 504 FOIA," US Small Business Administration, 2023.
Notes: Includes lenders that originated at least one funded loan.

FIGURE 3

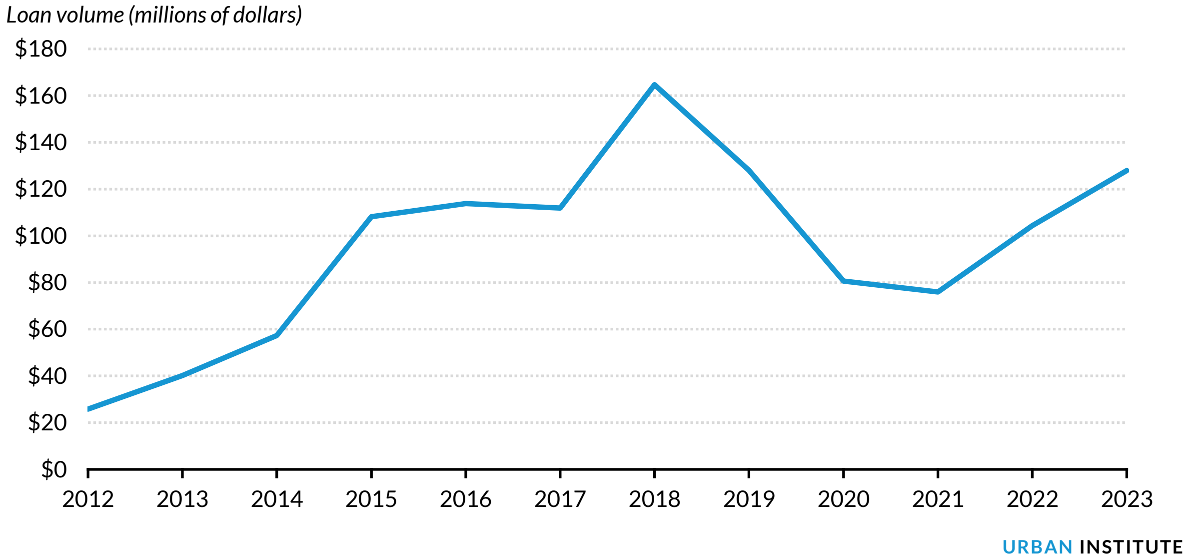
Cumulative Community Advantage Volume by Lender, FY 2012–2022



Source: "7(a) & 504 FOIA," US Small Business Administration, 2023.
Notes: Only funded loans are included. Dollar values are adjusted for inflation to 2023. Includes data from 2012 to 2023.

FIGURE 4

Community Advantage Loan Volume, FY 2012–2023

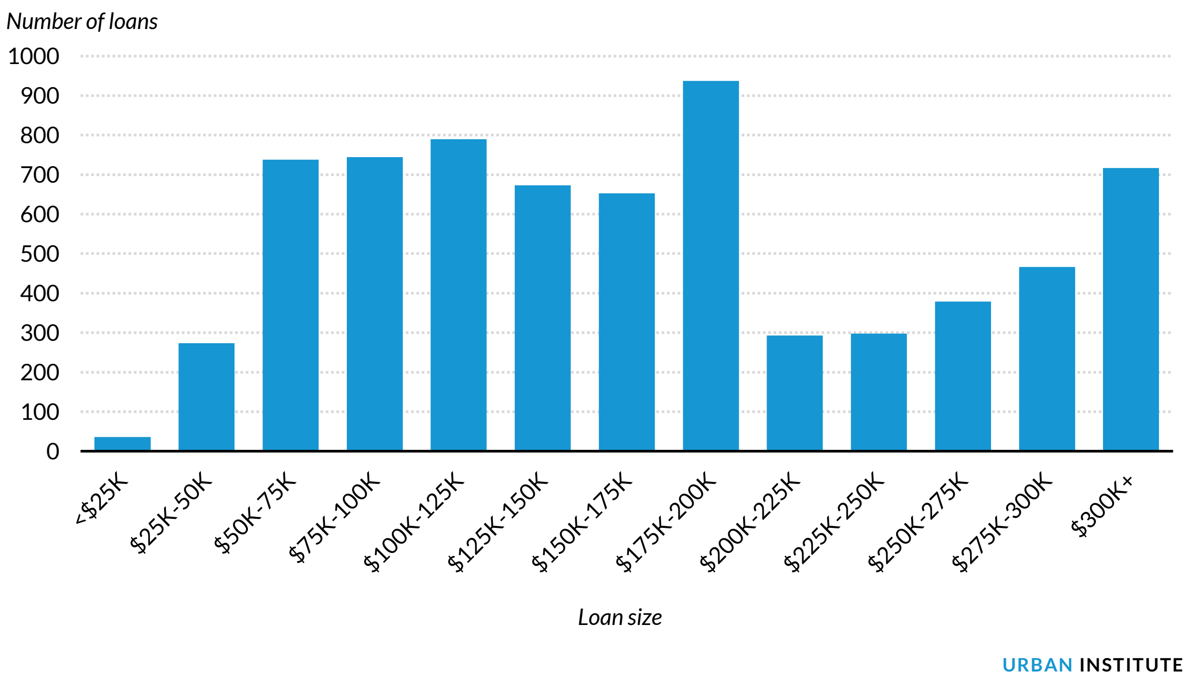


Source: "7(a) & 504 FOIA," US Small Business Administration, 2023.

Notes: Only funded loans are included. Dollar values are adjusted for inflation to 2023. Includes data from 2012 to 2023.

FIGURE 5

Community Advantage Loan Size Distribution



Source: "7(a) & 504 FOIA," US Small Business Administration, 2023.

Notes: Only funded loans are included. Dollar values are adjusted for inflation to 2023. Includes data from 2012 to 2023.

Compared with regular 7(a) borrowers, Community Advantage borrowing businesses are more likely to be owned by someone Black, female, or a veteran; more likely to be start-ups or less than two years old; and less likely to be Asian- or Pacific Islander–owned (

figure 6). Community Advantage borrowers are similarly dispersed across a range of industries; however, the most common industries differ from those represented by regular 7(a) borrowers (figure 25). This likely is the case because the businesses that make up the pool of Community Advantage borrowers tend to be much smaller than those in the regular 7(a) pool, as business size is correlated with industry.

What's Working

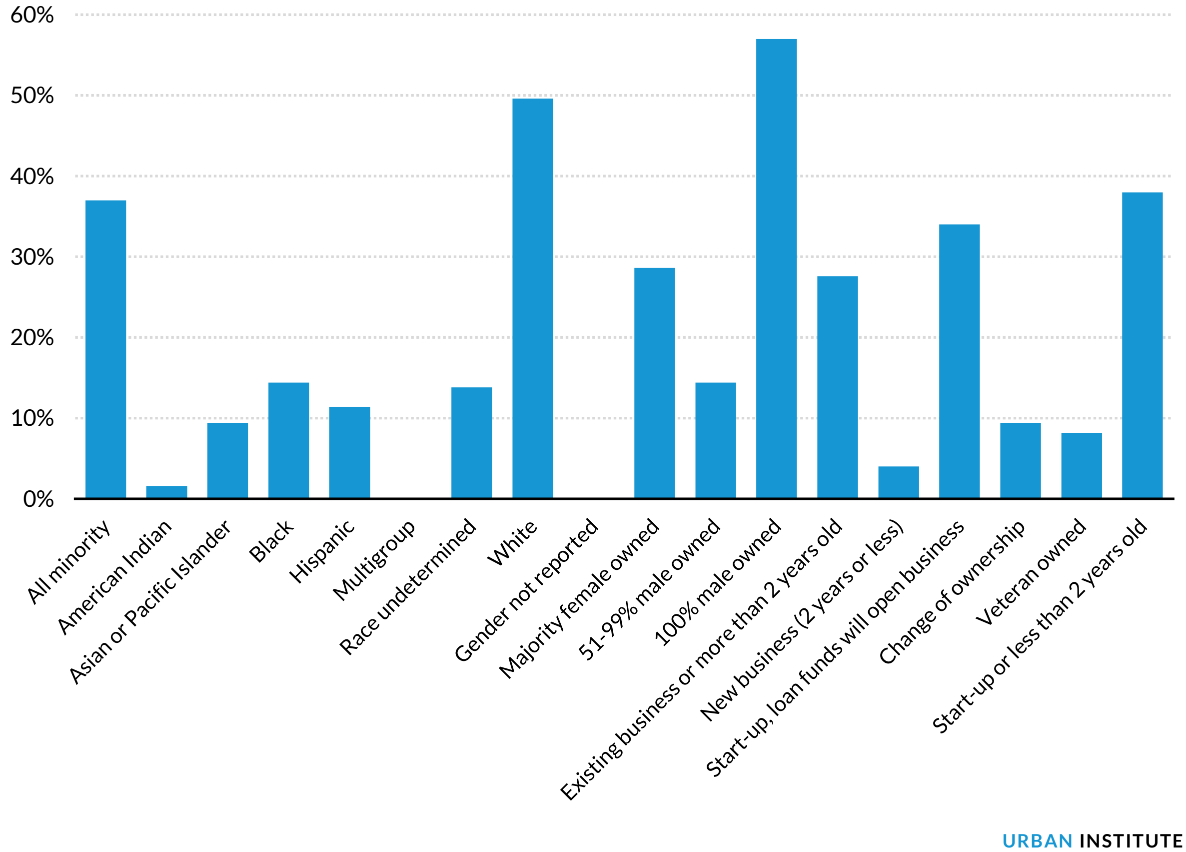
In interviews with Community Advantage lenders, we heard consistent praise for the program, despite its limited scale. The consensus is that Community Advantage enables lenders to reach borrowers who would otherwise be unable to access any sort of federal-guaranteed lending product, and certainly not a standard 7(a) loan. However, these are also borrowers whose business needs would not be satisfied by a microloan. According to one lender, they find success using Community Advantage to lend to "start-ups or businesses with very large collateral shortfalls but great cash flow."

The program seems to succeed in enabling start-ups to access more traditional kinds of capital, such as term loans, rather than having them turn to merchant cash advances or alternative financing providers. We also heard that lenders value the guarantee provided by participating in Community Advantage, which reduces their risk burden. However, Community Advantage's lower-interest and longer-term loans, compared with those of a typical CDFI portfolio, come with a cost of enhanced scrutiny and lengthier processing times.

While uncertain for many years, the future of Community Advantage was bolstered recently. The SBA no longer views the program as a standalone pilot but rather a subset of broader 7(a) lending (though Community Advantage had always operated using the 7(a) platform). Like SBLC licensed regular 7(a) lenders, Community Advantage lenders are able to make 7(a) loans but are subject to a requirement to lend to underserved borrowers, as was the case under the pilot.[23] Most active Community Advantage lenders have been issued licenses as part of the transition.[24]

FIGURE 6

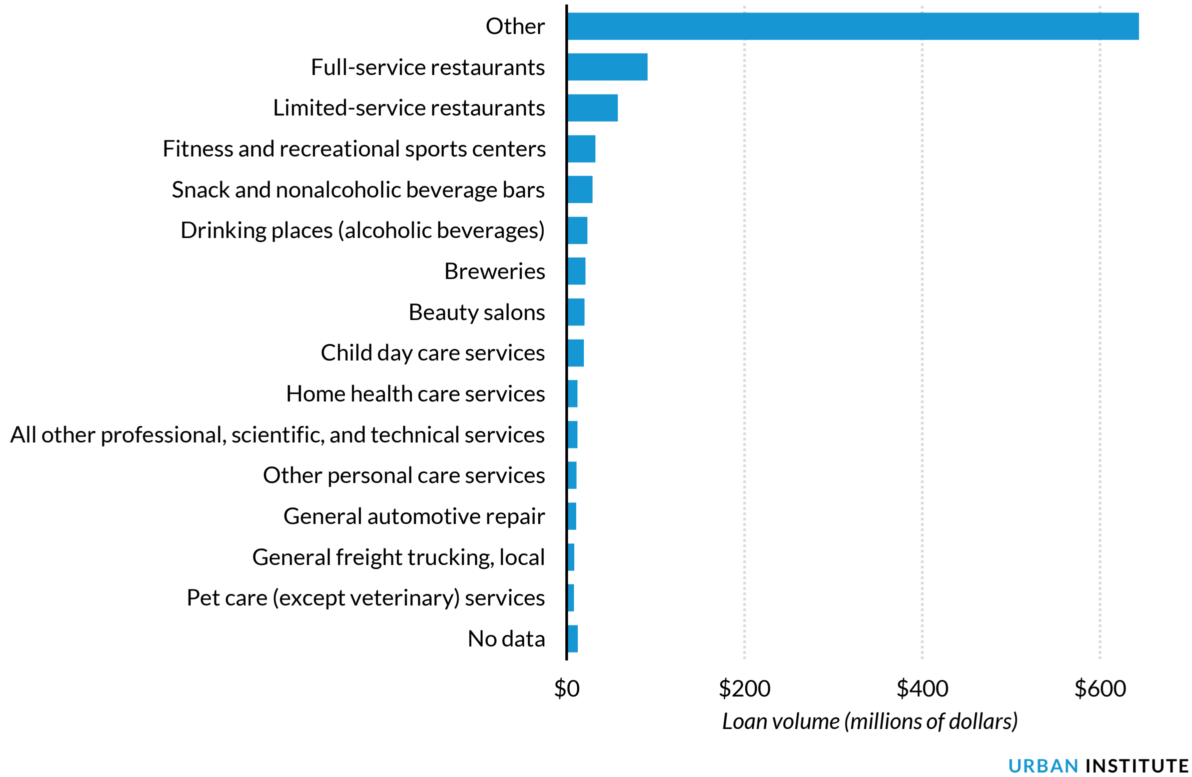
Share of Community Advantage Loan Volume by Borrower or Business Characteristics



Source: "7(a) & 504 Summary Report," US Small Business Administration, 2023.
Notes: Includes data from 2012 to 2023.

FIGURE 25

Share of Community Advantage Loan Volume by Industry of Borrowers



Source: "7(a) & 504 FOIA," US Small Business Administration, 2023.
Notes: Includes data from 2012 to 2023.

What's Not Working

Despite its overall positive reception, Community Advantage has struggled at some points and in various ways. Some interviewees suggested that even with the change of its pilot status, the SBA has treated the program as an afterthought, not dedicating the necessary resources to enable its success. Other interviewees were dismissive of the program and its partner lenders' abilities to scale significantly. In recent years, the volume of Community Advantage loans has declined, and fewer lenders are entering the program. We heard in some cases that this is due to greater availability of attractive tools to lenders, such as state capital access programs, including those developed through the State Small Business Credit Initiative.

In terms of how the program operates, multiple lenders we spoke with cited onerous loan-level documentation as a major hurdle to using Community Advantage. One stated that their own documentation is less than half of what is required by the SBA. On a per loan basis, this added cost makes it challenging to underwrite smaller loans, especially those under $50,000. Typically, the same information is required from borrowers regardless of the amount of financing they request, yet the maximum allowable fee for loans under $10,000 is $500.[25] There is one fee formula for loans between $10,000 and $50,000 and a different one for loans between $50,000 and $150,000.

Some lenders commented on the challenge of balancing the CDFI Fund requirements applied to their broader portfolio with the SBA's different requirements for Community Advantage loans, which are limited to certain geographies and, unlike the CDFI requirements, do not allow a focus on "targeted populations." Other critiques included overly stringent collateral requirements for small loans and a perceived lack of transparency around the credit box.

Some interviewees noted that there are not adequate trainings available to prepare lenders for participation in the program. The vast majority of Community Advantage participants do not have licenses to underwrite regular 7(a) loans and are unfamiliar with the relevant standard operating procedures. Without adequate assistance, the cost of learning compliance and subsequent implementation is enough to deter prospective participants. One Community Advantage lender who expressed the desire for structured trainings from the SBA mentioned that the program's auditors were valuable sources of information on how it works.

Some lenders expressed frustration that the same risk standards are applied to Community Advantage loans and conventional 7(a) loans. Because the risk profile of Community Advantage borrowers is inherently different, it seems unfair that lenders are being held to the same standards in terms of loan losses yet are still expected to lend to higher-risk applicants. Comparisons would need to be adequately risk adjusted to account for these differences.

Recommendations

CHANGES TO LOAN MECHANISMS

- Increase the permissible loan packaging fee to better cover the cost of underwriting and origination. To account for the potential impact on borrowers, partially subsidize this fee for smaller loans. Increase the fee cap for loans up to $50,000 to $2,500 and allow a 5 percent fee for loans over $50,000.
- Expand the flexibility of Community Advantage loans. Allow loans to be used as a line of credit and lenders to provide interest-only and debt restructuring options. Start-ups and especially small businesses need flexible financing to meet their needs.

- Increase the maximum loan size to $500,000 to enable CDFI lenders to handle additional volume. The cost of underwriting Community Advantage loans, despite the demand generated by their favorable terms, constrains overall supply. In part because larger loans are more profitable (because of a lower ratio of revenue to fixed costs), increasing the maximum Community Advantage loan size might give lenders a real incentive to increase their lending to businesses unable to access conventional 7(a) loans.
- Remove the requirement that borrowers provide real estate as collateral, unless the loan is for the purpose of financing real estate. Many start-ups are undercollateralized and may not own any real estate in the early stages of their business. Accepting alternative forms of collateral, or being open to unsecured loans, would expand access for borrowers.

CHANGES TO COMMUNITY ADVANTAGE PROGRAM STRUCTURE

- Rather than requiring lenders to meet multiple standards, ensure that CDFI Fund and Community Advantage standards are aligned to reduce the cost of compliance while still ensuring that Community Advantage loans go to underserved borrowers.
- As with regular 7(a) loans, Community Advantage lenders need greater clarity around the credit box. Lenders want to know the SBA's exact policy regarding, for example, the length of time since a bankruptcy or how low a FICO score is acceptable. The SBA should provide more data to lenders to accelerate the underwriting process.
- Additional SBA–funded trainings and technical assistance will be needed for new and emerging Community Advantage lenders. Such trainings will need to be responsive to specific challenges rather than just serving as high-level introductions to the program.
- The SBA should underwrite Community Advantage lenders, not each loan. This change would be a significant departure from the current loan-level guarantee structure of 7(a) loans, but it would go a long way toward speeding up the lending process on smaller loans—only those under $100,000, for example—while also reducing costs. For Community Advantage lenders with a strong history and track record, especially as pertains to keeping losses within a target band, the SBA could agree to provide a blanket guarantee. Mission-driven lenders have different credit standards than banks and lend to businesses that may produce significant losses on an individual level, while losses are mitigated at the portfolio level. Under one possible structure, participating lenders that meet well-defined criteria would be guaranteed at the portfolio level with the SBA in a first-loss position. The SBA would then evaluate lenders based

on three-year average losses to determine whether losses were within a predetermined threshold.

SBA 504 Loans

Background

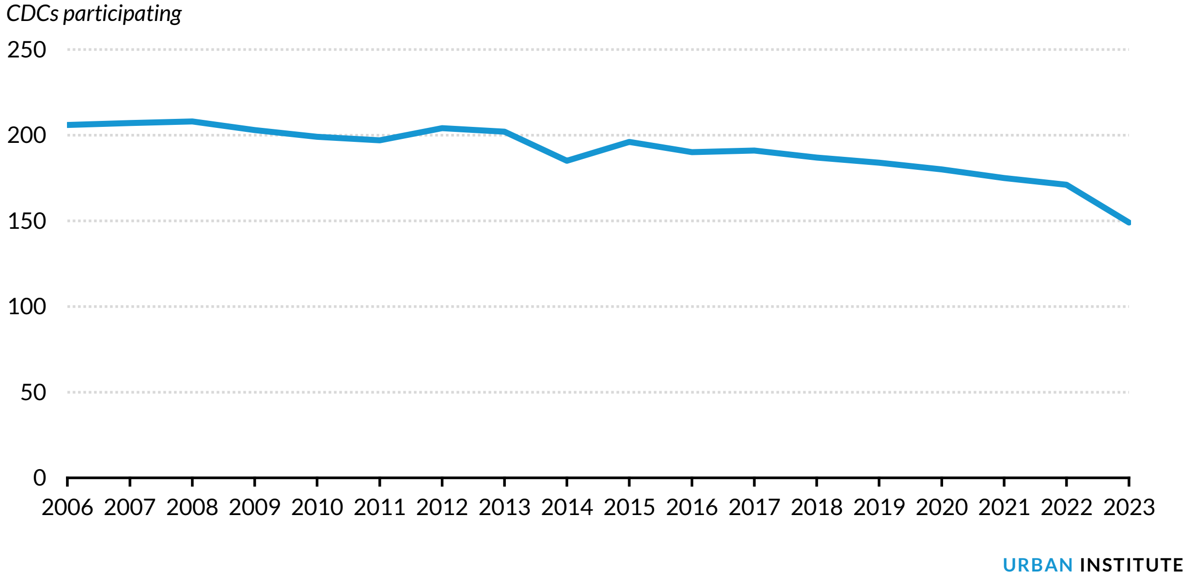
The SBA 504 loan program provides fixed-asset and refinancing loans for small businesses through nonprofit SBA–licensed Certified Development Companies (CDCs) in partnership with private lenders, including banks. Loans can be used to construct or purchase buildings, purchase land or durable machinery or equipment, or make improvements to properties. The loan term is a minimum of 10 years and a maximum of 25. A borrower must provide 10 percent equity (sometimes more), with the balance of the funding coming from the CDC (40 percent) and the lender (50 percent). Interest rates are fixed and affordable. Loan amounts generally cannot exceed $5 million. Borrowers pay a one-time guarantee fee and annual service fees, which are amortized into monthly loan payments.

The design of 504 loans enables borrowers to access financing while providing a smaller personal equity contribution than required by banks. This is accomplished by combining financing from a partnered CDC and a private lender. The CDC contribution, also known as the debenture, is guaranteed by the SBA. While the private contribution (known as the third-party loan or first trust deed), is not government guaranteed, it is at a very strong loan-to-value ratio of 50 percent. The private contribution is a conventional loan, providing the private lender with reliable regular income through interest payments.

The 504 loan program is different from many other government guaranteed lending programs because of its economic development requirement. The SBA requires that borrowers create or retain one job for every $75,000 of the debenture, or that the project they receive financing for contributes to 1 of 15 community development and public policy goals.[26] Borrowers are required to report on job creation and retention when filing an application.

FIGURE 7

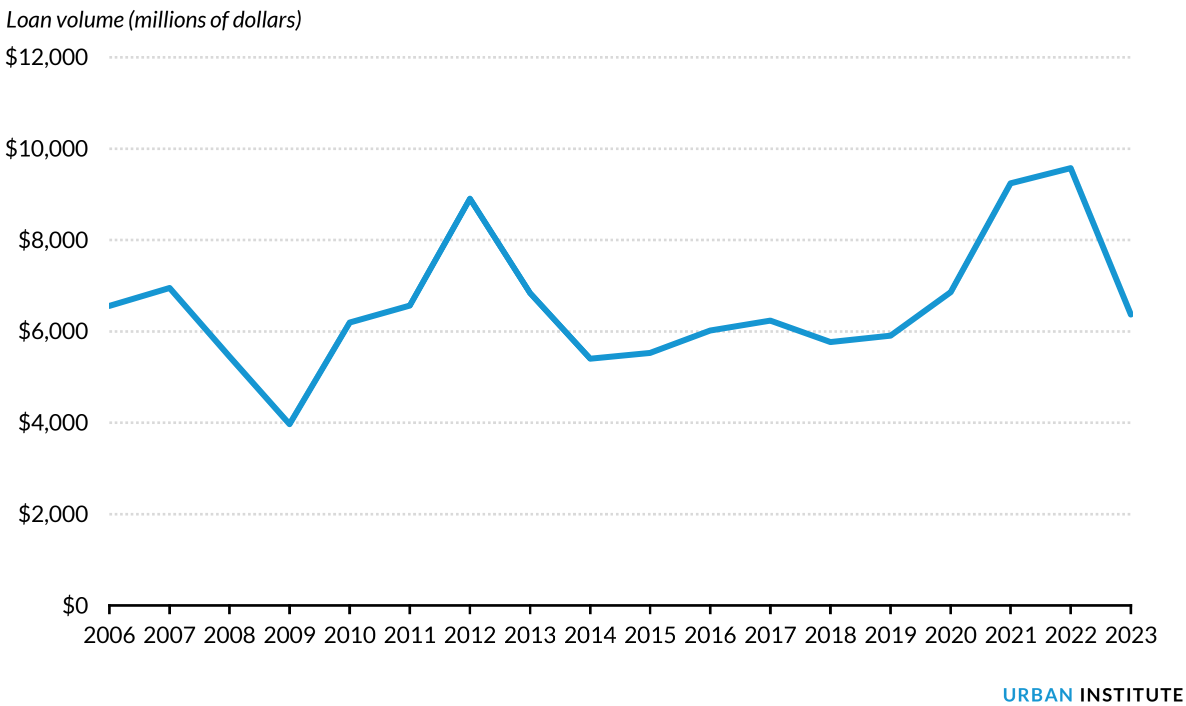
Number of CDCs Participating in 504 Loan Program, FY 2006–2023



Source: "7(a) & 504 FOIA," US Small Business Administration, 2023.
Notes: CDC = Certified Development Company. Includes CDCs that funded at least one loan.

FIGURE 8

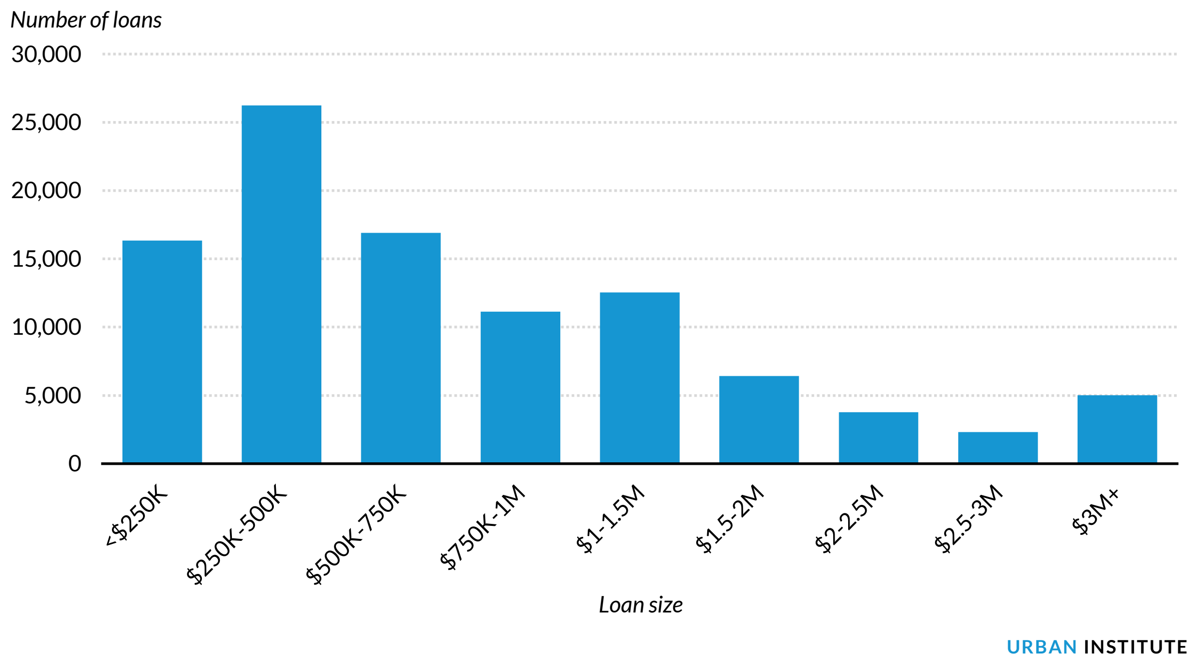
504 Loan Volume, FY 2006–2023



Source: "7(a) & 504 FOIA," US Small Business Administration, 2023.
Notes: Dollar values are adjusted for inflation to 2023.

FIGURE 9

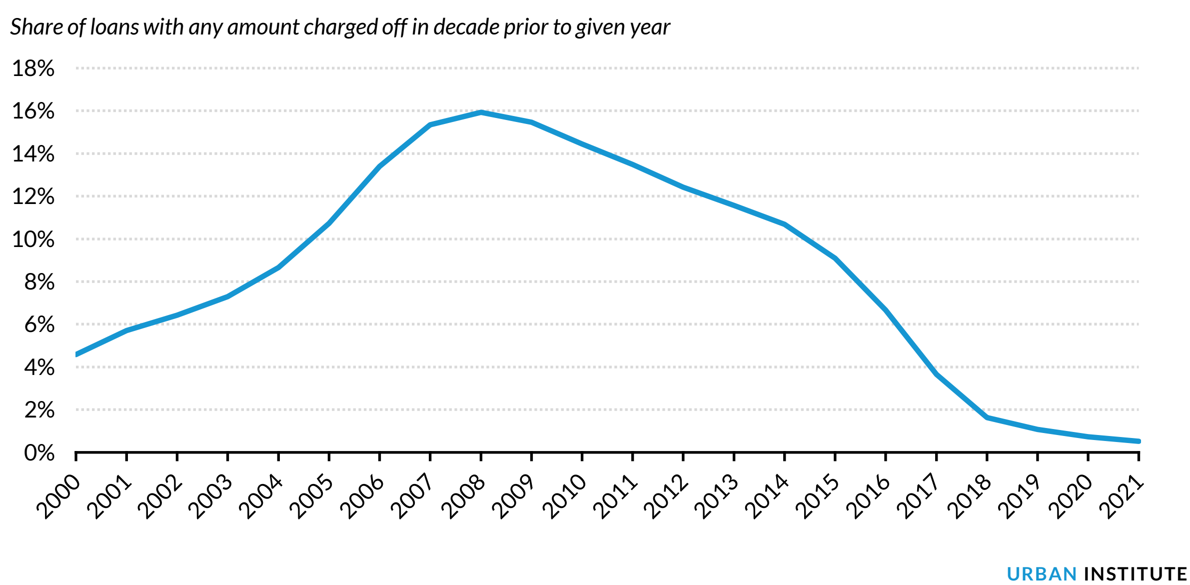
504 Loan Size Distribution



Source: "7(a) & 504 FOIA," US Small Business Administration, 2023.
Notes: Dollar values are adjusted for inflation to 2023. Includes data from 2010 to 2023.

FIGURE 10

504 10-Year Default Rate Over Time



Source: "7(a) & 504 FOIA," US Small Business Administration, 2023.
Notes: Includes data from 1991 to 2021.

The number of participating CDCs has declined somewhat, from a high of 214 in 2012 to 186 in 2021 (figure 7). In 2022, 504 regular and refinancing lending amounted to more than $4.1 billion. Lending volumes have been flat over the past decade, with an upward spike during the post–financial crisis years and during the pandemic (figure 8). As 504 loans are used for real estate purchases, they are rarely under $200,000. However, nearly three-quarters of the loans are under $1 million (figure 9).

In a similar trend to 7(a) loans, the 504 loan default rate also peaked during the global financial crisis and has since declined. However, during the entire period observed, the default rate for 504 loans has been between 3 and 11 percentage points lower, in part because of the relatively larger size of projects financed under the program.

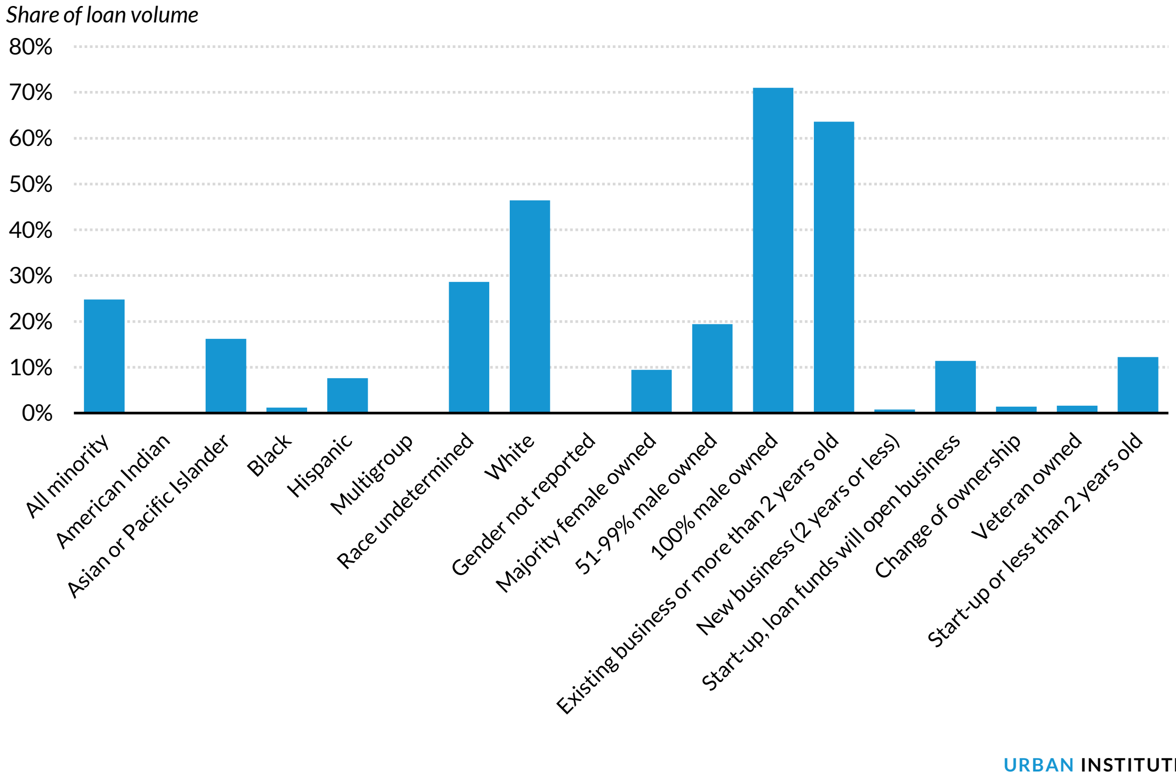
Slightly more than half of 504 borrowers belong to a racial or ethnic minority. Fewer than a third of 504 borrower firms are women owned to any degree, and just 12 percent are start-ups or young businesses, reflecting the more established business position required to purchase real estate (

figure 11).

table 2 shows the 10 largest industries represented by 504 borrowers. While more than 900 industries are represented, just 40 make up half the volume of 504 financing. The average amount of financing varies by industry. Among the most common industries, hotels and motels stand out as receiving particularly large loans on a per project basis. Those projects received more than $1.7 million on average, more than twice that of any of the other 10 largest industries. They also represent a disproportionate share of overall financing, at 10 percent. Relatively speaking, however, 504 lending is still highly diversified by sector.

FIGURE 11

Share of 504 Loan Volume by Borrower or Business Characteristics



Source: "7(a) & 504 Summary Report," US Small Business Administration, 2023.
Notes: Includes data from 2010 to 2023.

TABLE 2

504 Loan Count and Financing Amount by Industry Description

For the 10 most common industries, ranked by total number of loans

NAICS description	Number of loans 2010–2021	Average total financing	Share of all 504 financing
Full-service restaurants	4,190	$780,538	4%
Hotels (except casino hotels) and motels	3,336	$2,141,242	10%
Offices of physicians (except mental health specialists)	2,319	$850,190	3%
Offices of dentists	2,274	$672,153	2%
Limited-service restaurants	1,991	$724,582	2%
Child day care services	1,894	$894,565	2%
Offices of lawyers	1,698	$660,505	2%
General automotive repair	1,687	$494,986	1%
All other specialty trade contractors	1,108	$655,733	1%
Gasoline stations with convenience stores	1,037	$1,035,697	1%

Source: "7(a) & 504 FOIA," US Small Business Administration, 2023.
Notes: Dollar values are adjusted for inflation to 2022.

In contrast to a 7(a) Express loan, which can be originated in a matter of days, or a merchant cash advance or other fintech loan product, which can be approved within hours, 504 loans are significantly more time consuming to originate. Much of this is the nature of real estate transactions, which generally require longer timelines to secure financing and assemble a capital stack. However, 504 loans also have procedural requirements that can lengthen the process. Both the CDC and third-party lender do their own underwriting, and the loan is subject to review by SBA district offices.

A borrower looking to finance a new commercial property, for instance, will approach a CDC, or a lender will refer such a borrower to a CDC. The CDC will help them put together an application and connect with the lender. Once the transaction closes, the borrower makes separate payments to the CDC and third-party lender, at rates determined by the SBA and private negotiation, respectively. Unlike other SBA capital programs, 504 loans have a job creation requirement for most borrowers, proportional to the size of the debenture (Dilger and Cilluffo 2022b).

While the program has largely functioned similarly for decades, changes in the past few years have expanded its reach. In the Small Business Jobs Act of 2010, Congress increased lending limits for 504 deals to present-day values, and the American Recovery and Reinvestment Act of 2009 enabled the use of 504 loans to refinance debt, one of the most significant statutory changes (Dilger and Cilluffo 2022b). Notably, 504 loans could not refinance 7(a) loans or other government debt until a rule change in 2021.[27]

What's Working

Compared with conventional real estate loans, 504 loans offer lower down payment requirements, and the blended interest rate on the debenture and the CDC loan tends to be affordable. Additionally, commercial real estate loans requiring only a 10 percent down payment are hard to find on the private market, meaning that 504 loans are accessible to borrowers short on liquid assets. The fixed interest rate is also important for borrowers with thin margins, allowing them to better weather market fluctuations. In periods when interest rates are high and market credit for real estate is more expensive, a 504 loan can be more affordable for borrowers than private financing. Some CDC representatives we spoke with highlighted these two factors as key benefits of the program. By fully guaranteeing the CDC, the SBA enables borrowers to invest in real estate, generally an investment with high barriers to entry for small businesses.

Without the structure that the 504 program provides, many businesses looking to finance property acquisition or refinancing would likely need to settle for less than their desired amount of financing, considering market collateral requirements. As one CDC lender put it, the program "helps make sure the business is getting enough money."

Recent evidence supports the countercyclical role of 504. The COVID-19 pandemic resulted in credit tightening across markets, including real estate. Borrowers turned to 504 to access credit and lock in loan payments. The volume of 504 loans reached its highest point in history in 2021, until lending was paused in September of that fiscal year due to exhaustion of authorized funding.[28]

What's Not Working

Our interviewees and data analysis revealed ways in which the 504 program is not currently meeting the needs of borrowers or could be improved to save processing times and transaction costs. These critiques include reevaluating CDCs that participate in the program, removing burdensome steps in the deal closing process, removing some limitations on allowable refinancing options, and providing oversight of the job creation requirement.

Some interviewees critiqued the program for not adequately reaching smaller businesses that need federal subsidy or support. Real estate is a highly collateralized asset, and therefore often poses less risk than other types of small business lending. Real estate transactions are typically larger than other purchases a small business makes, and for smaller businesses that tend to struggle the most with accessing credit, participation in the real estate market might not be feasible.

One interviewee critiqued the SBA's oversight of CDCs, saying that some have experienced mission creep and that the program—initially intended to advance economic development by creating jobs in underinvested markets—permits CDCs to act more like specialty finance companies than mission-driven organizations. Other interviewees suggested that all CDCs should be required to reapply for certification, and in exchange, be granted more independence in executing deals, so long as they meet the SBA's requirements.

The closing process is also a significant challenge for borrowers and new or aspiring lenders. After a deal has been negotiated, district SBA counsel approval is required. The time this takes can result in losing opportune interest rates or experiencing delays in development, which can be particularly costly in real estate. Furthermore, the documentation required in the closing process is onerous. Multiple interviewees cited the complexity of the program's standard operating procedures as a major barrier to CDCs' ability to process loans.

The 504 program, designed as an economic development program, is one of few small business financing programs that include an outcome requirement as part of the program's design—specifically, a job creation requirement. The job creation requirement complements a broader goal of local business revitalization and stimulus. Despite this, some interviewees shared their belief that the requirement does not have sufficient oversight. Consequently, some businesses funded under the 504 program may not be a good fit for the economic development agenda the program is designed to advance. However, there is a tension between the goal of economic development and reducing the cost of program oversight.

Recommendations

The 504 loan program enables borrowers with limited personal wealth to access some of the most affordable business real estate financing on the market. However, it is underutilized in some respects and overutilized in others and can be too restrictive in its use. We recommend changes to permissible uses of financing, how the debt is treated, the structure of the financing, and the role of CDCs.

- SBA 504 refinancing loans should be made easier to use. Some lenders and practitioners commented that it is much easier to use 7(a) loans to refinance other government debt than it is to use 504 loans to refinance 7(a) loans. For 504 refinancing loans, the burden is on the borrower to obtain a letter from the 7(a) lender. If the lender does not respond, the borrower is unable to proceed. The same is not required of prospective 7(a) borrowers who wish to refinance 504 debt.
- The SBA should remove district SBA counsels from the loan approval process. Infrequent review periods add costly delays to the process and can negatively affect locking in 504 loan interest rates. Interviewees argued that the review process is redundant and costs borrowers and lenders more than the enhanced scrutiny is worth.
- The SBA should implement a preferred or low-documentation option for 504 loans. While 7(a) loans are increasingly provided through accelerated channels—either PLP or Express—504 loans have few options for qualified borrowers to expedite the process. While real estate lending will always take longer to process, expedited options would lower the cost of lending and subsequently enable CDCs to facilitate additional 504 loans.
- To expand the financing options available to borrowers, we recommend that the SBA allow for equity coinvestment from philanthropies and intermediaries. While the debenture structure works well for some borrowers, businesses with weaker credit histories may struggle to secure

affordable credit from the third-party lender. To fill this gap, a senior debt program allowing for nonbank investors to participate could enable more borrowers to access 504 loans.

- Many CDCs participating in the 504 loan program have changed their size and activities over time. Some, while initially closely involved in the impact goals the 504 program intends to achieve, have shifted since initially qualifying to participate.
  - » We recommend that CDCs be required to undergo regular recertification, and that the mission test for CDCs be strengthened. CDCs should be evaluated more regularly to confirm that their investments and activities are adequately focused on high-social-impact lending.
  - » As described for the 7(a) program, we recommend a duty to serve requirement be imposed on the SBA's administration of the 504 program.
  - » While economic development is a vital goal for the federal government, the 504 program is not well positioned to meet this objective. Projects are infrequently located in disinvested communities, and the program does not provide a deep enough subsidy or incentive for projects to locate there. As such, we recommend removal of the job creation requirement, which is not only a poor fit for the program but also meager in quantity and not adequately tracked or enforced.
  - » In exchange for these steps, CDCs should be granted additional discretion in the underwriting process, with the requirement that their underwriting standards align with the mission of the 504 loan program.

US Department of Agriculture

USDA supports small businesses through a range of programs, including grants, loans, loan guarantees, equity, and technical assistance through different intermediaries. These programs are facilitated by the Rural Development (RD) branch of USDA. While RD supports 18 individual or collections of programs providing capital and technical assistance, we count more than 30 programs across the agency that directly or indirectly support small businesses across a range of functions.[29] Funding for RD programs comes largely from appropriations, giving Congress a degree of control over how spending on rural development is prioritized (Casey 2018).

Many programs, some of which have existed since the 1980s, were reauthorized under the 2018 Farm Bill. Unlike most other federal agencies, USDA is regularly reauthorized through the Farm Bill every five years.[30] This enables Congress to reestablish its priorities for agricultural production, forestry, and as is relevant here, funding for rural development programs. In 2023, the Rural Business-Cooperative Service, a subdivision of RD that governs many small business–oriented programs, had a budget authority of $247 million and program-level funding (largely loan guarantees) of nearly $2.5 billion. While these funds were spread across a number of programs, the Business and Industry Guaranteed Loan program commanded a substantial share with $1.5 billion of program-level funding (USDA 2023). While small businesses are eligible for these loans, the average loan size is around $6 million, according to an interviewee. Publicly accessible data on RD programs, including the distribution of loan sizes, are limited.

RD programs are not limited solely to agricultural industries. Indeed, agricultural production programs are largely housed elsewhere within USDA, while RD focuses on other rural business sectors—such as energy, biofuels, and fertilizers—and providing value-added services to agricultural producers. RD also supports small businesses across a range of industries that serve rural areas.

To do so, USDA works with a mix of partners and intermediaries. USDA often works through banks, CDFIs, colleges and universities, local jurisdictions, and other organizations. Many programs are designed with the view that local organizations and lenders are better positioned to understand the needs of their communities and markets. Interviewees emphasized the need for flexible programs that could be adapted to meet the needs of different rural communities.

The **Intermediary Relending Program** provides 1 percent low-interest loans to nonprofits, tribes, public agencies, and cooperatives, which relend to businesses for use in start-up financing, land acquisition, equipment purchase, professional fees, and other purposes.[31] Intermediaries can receive up to $1 million at a term of up to 30 years. According to one interviewee, the purpose of lending through intermediaries is to ensure that lenders are familiar with local conditions and can reach underserved borrowers and those who do not qualify for conventional credit. However, they noted that oversight is challenging, as reporting is not required once the loan begins revolving. Granted, the cost of reporting relative to the size of the loan is relatively large.

The **Rural Economic Development Loan and Grant Program** provides funds to rural utilities to be passed through to businesses for job creation and retention purposes.[32] Originally established under the Rural Electrification Act of 1936, the program is administered through utility cooperatives that continue to be essential to energy distribution in rural areas. There are 895 co-ops serving 21.5 million customers.[33] The program had a combined $90 million budget for loans and grants in 2023 (USDA 2023).

While USDA RD's programs target a range of industries and types of businesses, it uses SBA size standards across all its programs. The smallest businesses looking for support from RD typically use Value-Added Producer Grants, which enabled agricultural producers to expand into value-added activities, and Rural Business Development Grants, which support a broad range of rural economic development activities. Rural microbusinesses may receive support through the Rural Microentrepreneur Assistance Program, which is discussed in our microloans chapter. However, that program has seen limited demand in recent years, and its mandatory appropriation was significantly reduced in the 2018 Farm Bill (Casey 2018). Some of USDA's largest programs support small businesses, though they are not limited by business size. For example, the Rural Energy for America Program has $50 million in annual mandatory appropriations providing loan guarantees supporting the installation and improvement of renewable energy systems and energy efficiency improvements,[34] and it was awarded a further $2 billion under the Inflation Reduction Act.[35] The program is open to both agricultural producers and small businesses. Other significant business programs include the Higher Blends Infrastructure Incentive Program, the Meat and Poultry Processing Expansion Program, and the Advanced Biofuel Payment Program. USDA has other programs not explicitly for small businesses but from which small farmers benefit, for instance, crop insurance.

What's Not Working

Some interviewees remarked that USDA's paperwork requirements, beyond just the time to process loan and grant applications, can turn away potential users. Environmental review was also singled out as a barrier. When prospective borrowers are pushed away because a USDA program's requirements are too cumbersome, they turn to SBA loans or even nonconventional products, such as merchant cash advances, which offer faster and easier capital at a higher cost.

Interviewees also shared that limited broadband access hinders businesses' ability to access USDA programs. In 2020, the Federal Communications Commission found that "22.3 percent of Americans in rural areas and 27.7 percent of Americans in tribal lands lack coverage from fixed terrestrial 25/3 Mbps broadband, as compared to only 1.5 percent of Americans in urban areas."[36] USDA has prioritized the issue in its initiatives such as the ReConnect Loan and Grant Program. The program is underway, providing loans and grants to support the expansion of broadband infrastructure.

Recommendations

- Continue to focus on expanding broadband access and removing regulatory barriers to participation in rural broadband programs.
- Provide better data on loan programs so program effectiveness can be assessed. For most programs, the number of businesses served, types of intermediaries, and statistics on spending, among many other data points of interest, are not easily accessible.
- Further explore how USDA loans fit within the broader federal landscape, particularly relative to loans under the State Small Business Credit Initiative and SBA.
- Standardize and streamline loan application procedures to encourage lender and borrower participation.

State Small Business Credit Initiative

The State Small Business Credit Initiative (SSBCI) is a $9.85 billion[37] federal initiative to support state-led small business capital access, loan guarantee, loan participation, collateral support, and venture capital programs. SSBCI was initially developed in response to the Great Recession, providing $1.5 billion in Treasury funds. In 2021, in response to economic challenges stemming from the COVID-19 pandemic, Congress approved a second round of the program, again with funds provided by the Treasury.

SSBCI is designed to seed a range of programs administered by states, which have discretion over how the funds are used to support businesses. Unlike many federal programs targeted toward small businesses, the implementation details were left to governors to implement through state agencies, quasi-public authorities, and private partners. Lawmakers planned for a leverage ratio of 10 times the initial funding; the first round of SSBCI achieved an overall leverage ratio of 8.95.[38]

Both rounds of SSBCI can be categorized into three types of programs: capital access programs, other credit programs, and venture capital programs. We describe SSBCI venture programs in greater detail in the equity capital chapter. Capital access programs provide portfolio-level insurance to lenders. This enables lenders—especially CDFIs, the most frequent users of these programs—to better manage risk. However, participating lenders in round one felt that the volume required to establish the loan loss reserve was prohibitively large. These programs were less utilized than initially expected in round one, and requested funding was correspondingly lower in round two.

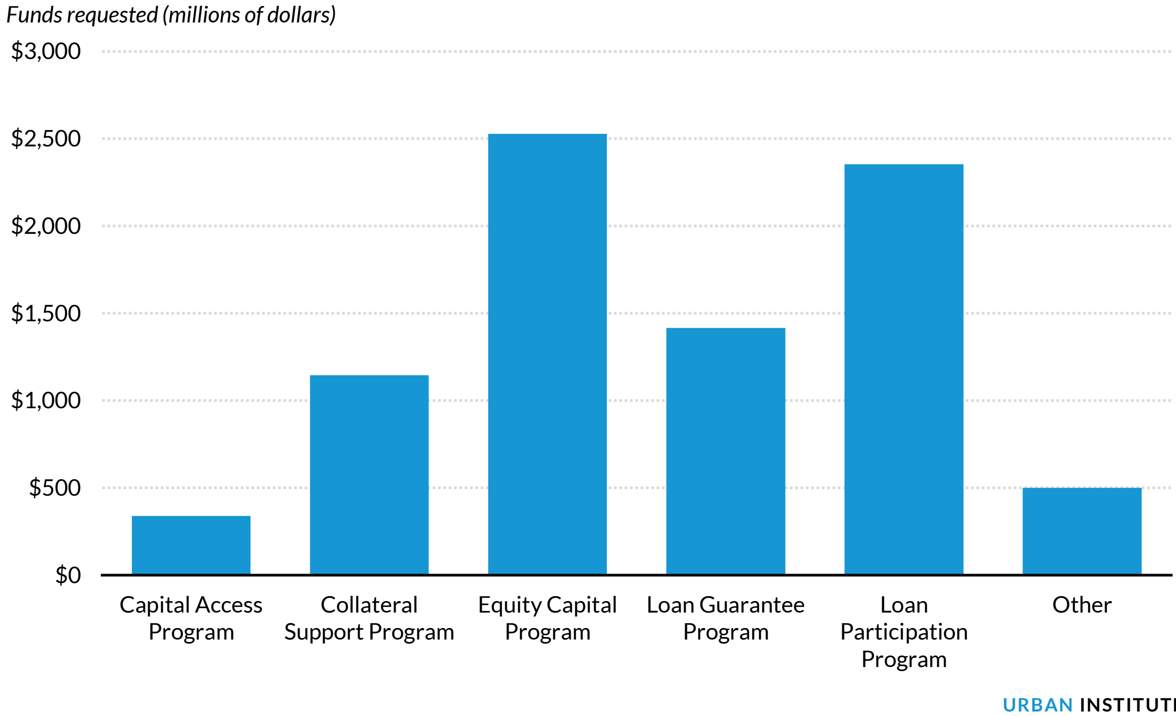
Other credit programs include loan guarantee programs, collateral support programs, and loan participation programs. Loan guarantee programs work similarly to other government-guaranteed loans like 7(a), whereby the state will take on a share of loan losses. Collateral support programs provide funds to lenders to supplement collateral for purchases of machinery, real estate, and other collateral-intensive needs. These programs have tended to service larger businesses. Loan participation programs purchase a portion of a private loan, typically with the state in a subordinate position.

In the first round, businesses supported had a median of three employees, and half had been in operation for five years or less. Of the total number of loans, 41 percent went to minority- and women-owned businesses, and 42 percent went to businesses in low- and moderate-income communities. Two-thirds of loans went to businesses with less than $100,000 in revenue. However, those loans made up less than 10 percent of total financing volume. Community and regional banks played a large role in delivering support, and CDFIs originated 54 percent of loans by count. Cumulative losses were low—1.2 percent at the time of the final report in 2017.

The new round of SSBCI, which will last until 2030, follows much of the same design as the initial round. However, it includes specific set-asides in addition to the statewide distribution. Of the initial funding, $6 billion was allocated to states by a formula, $1.5 billion was set aside for businesses owned by socially and economically disadvantaged individuals, and additional funds were set aside as incentives for tribes and very small businesses.[39] Now that states are familiar with the program's design and regulations, rollout is expected to be more effective. CDFIs are expected to play a significant role in lending through programs established under SSBCI. States have submitted plans for their initial allocation, described in Figure 12. The funds requested largely reflect the respective share of funds from round one of SSBCI, with a lower share directed toward collateral support programs and loan participation programs, and a greater share directed toward venture capital and other uncategorized programs.

FIGURE 12

Requested Funds for SSBCI Second Implementation by Program Type



Source: "SSBCI Fact Sheet," US Department of the Treasury, June 2023.

If for no other reason than the size and scope of SSBCI, policymakers and researchers will need to pay attention to its outcomes over the course of the next decade. The state-based implementation model provides opportunities for studying different lending mechanisms and program designs and understanding the administrative needs—marketing, lending expertise, and data collection, to name a few. The number of states and jurisdictions determining underwriting criteria, program design, and implementation partners may offer lessons for federal programs in the future. And, apart from extrapolating lessons, a first key question (and potential outcome) for SSBCI is whether this amount of funding can endow programs at the local level that will be sustained for years to come. A second key question is, even apart from the funds, if local capacity to administer programs will be sustained in a way that allows for states and localities to react nimbly to local needs or major economic changes. A final key potential outcome to examine is whether tribal governments being able to access funds will enable some to succeed in expanding their relationships with traditional financial institutions and expand their own financial institutions' capacity.

Economic Development Administration Revolving Loan Fund Program

Congress authorized the EDA Revolving Loan Fund (RLF) Program in 1965, but EDA did not launch the program until 1975. Under the program, EDA provides grant funding to RLF operators—local governments, political subdivisions, and nonprofit organizations—to enable them to establish and run lending programs for small businesses. We have completed a separate report on the design and functioning of the EDA RLF program and include recommendations for its progression (Theodos et al. 2024).

Since the program began, EDA has awarded 454 RLF operators a total of 955 grants to set up loan funds (Theodos et al. 2024). Most RLF operators have received one or two RLF grants, though a small number of operators have received five or more grants (Theodos et al. 2024). In this sense, the RLF program does not operate similarly to the SBA Microloan program, which makes more frequent awards to intermediaries.

EDA awards typically range from $500,000 to $2 million. RLF operators are typically required to contribute matching funds to the RLF: they need to leverage $2 of non–RLF funding on average for every $1 of EDA funds invested. (Some program requirements, including the leverage ratio, were set aside for recent stimulus funding.) RLF funds are expected to revolve for at least 10 years, after which time they “defederalize” and the operator can choose to continue or discontinue the program. Operators are required to develop and adhere to an RLF plan, which outlines how the entity will operate the fund successfully and reach its stated economic development goals (OIG-DOC 2015).[40]

RLF operators made nearly 7,000 loans from 2010 to 2022, or somewhat fewer than 600 loans per year. RLF operators typically offer fixed low-interest loans to businesses that struggle to access traditional bank financing.[41] Indeed, rates under the program have been low, averaging below 4 percent from 2020 through 2022 (Theodos et al. 2024). Most loans have terms between 5 and 10 years.

Microloan Programs

Background

The practice of microlending or microfinance is often associated with international development work in the Global South, but the United States also has a rich history of various forms of microfinance. In the United States, the first experiments with microlending began in the 1970s (Widyaningrum, Bhat, and Lee 2019), with some of the early efforts mirroring the model of the Grameen Bank in Bangladesh and peer-group lending models in Latin America (Ashe 2000). While the SBA remained active in this era in providing or facilitating loans to small businesses, growing evidence demonstrated that private lending, supplemented by the traditional lenders of the SBA's credit programs and the Revolving Loan Fund (RLF) of the Economic Development Administration (EDA), were not adequately reaching very small businesses (Dilger 2022). Congress became convinced that a new loan program was necessary and created the SBA Microloan program in 1991 as a five-year demonstration (Dilger 2021). Congress later created the USDA Rural Microentrepreneur Assistance Program (RMAP) in the 2008 Farm Bill (Benson, Lawhorn, and Cilluffo 2023).

The SBA and USDA define a microloan as a loan of $50,000 or less. There are several avenues available for small business owners to pursue loans of this size, all of which have benefits and trade-offs. Traditional lenders like banks tend to issue only larger small business loan amounts, as they can be made more profitably, whereas banks' cost structures and typical pricing make it virtually impossible for a bank to make money on a smaller business term loan. That leaves prospective microloan borrowers the options of credit cards, equipment leases, factoring, or a merchant cash advance—all of which can be quite expensive (Weaver, Brown, and McShane 2016). Credit cards carry fairly high interest rates, especially for borrowers with less than perfect credit. They also do not require the discipline of regular principal payments, as term loans do. Equipment leases can be a good option, but they cannot be used for working capital needs and can also come with high interest rates. Merchant cash advances have become widespread in recent years since the Great Recession but are generally offered at a high cost and for a short term, with APRs often running into the triple digits.[42]

The cost a lender incurs in originating a loan is determined by three main factors—operating costs incurred by the lending entity, potential losses associated with the specific loan, and the cost of capital for the lending entity (i.e., how much it is paying to borrow the money it is lending out). Lenders seeking to make a profit will account for all three of these to calculate the interest rate and fee they charge on the loan. Nonprofit lenders use philanthropic grants and loan capital borrowed at below-market rates to keep interest and fees charged to borrowers relatively low.

Interest rates on small business microloans can range from 8 percent to upwards of 300 percent, depending on the type of lender. One CDFI representative we interviewed told us that his organization had gone through an elaborate exercise to calculate its true cost to originate loans and what it would need to charge clients to break even. They calculated they would need to charge between 70 percent and 80 percent interest on their smallest loans of $5,000 to be able to offer them with no outside subsidy. Because larger loans generate more interest and larger fees, this breakeven percentage went down as loan size increased, with loans larger than $50,000 being profitable at rates around 8 percent to 10 percent. CDFI microlenders vary across all kinds of dimensions—market served, amount of technical assistance provided, salaries paid to employees, etc.—which means their costs of making loans will vary, but this example illustrates the challenging economics that pertain here.

In this chapter, we focus on federal programs supporting microlending, though it should be noted that a number of CDFIs offer microloans without taking advantage of the programs described below by relying on private philanthropy and loan capital borrowed from banks, foundations, and states and localities. The principal reasons some CDFI microlenders choose not to use the federal microloan programs are (1) they come with restrictions that limit the flexibility of the lenders in responding to the needs of their markets, and (2) they impose administrative burdens that slow down lending and add cost. (One example of an administrative burden is the SBA's requirement that lenders obtain a borrower's "wet signature" on loan documents, even as electronic signatures have become widely accepted in the small business lending world.)

Federal Microloan Programs

The federal government supports microlending through numerous agencies and programs, including the SBA, USDA, EDA, and Treasury. Some programs provide financing to intermediaries, such as nonprofit lenders, whereas other programs provide financing directly to businesses, such as providing financing to new farmers to acquire land. Most of them require borrowers to participate in technical assistance programs. For example, the SBA Microloan program provides intermediaries with grants for technical assistance programs, and the intermediaries are required to provide technical assistance to loan recipients (see our technical assistance chapter for more information on business development support programs). A summary of the most common microfinancing programs is provided in table 3, and the subsequent sections provide an overview of federal microfinancing programs.

TABLE 3

Summary of US Federal Small Business Microfinance Programs

Program	Federal support	Loan delivery channels	Maximum business loan size	Technical assistance required	Federal funding	Volume
SBA Microloan program	Low-cost loans to lender intermediaries and grants to fund technical assistance	Nonprofit lender intermediaries (roughly three-quarters are CDFIs)	$50,000	Yes	$73 million in FY 2023[a]	5,055 loans totaling $82.6 million (FY 2022)[a], with an average loan amount of $16,557 (FY 2021)[b]
CDFI Fund Financial Assistance awards (within Treasury)* *(discussed in a subsequent chapter)*	Grants to CDFIs that can be used to support microlending, either as loan capital or for technical assistance, technology, or other expenses	CDFIs	$2 million	No	$194 million in FY 2023[c]	$194.1 million to 252 organizations in FY 2023[h]
USDA Farm Service Agency Microloan Program	Two types of loan financing—Operating Loans and Farm Ownership Loans. Operating Loans cover approved operating expenses such as start-up costs, seed, utilities, or land rents. Ownership loans cover expenses such as purchasing land, expanding an existing farm, or constructing a new farm structure.	Direct from USDA or through an intermediary	$50,000 per loan; $100,000 total	No	$35 million in FY 2023 for Farm Service Agency loans, of which some are microloans[e]	3,496 loans totaling $92 million for FY 2022[f]

Program	Federal support	Loan delivery channels	Maximum business loan size	Technical assistance required	Federal funding	Volume
USDA Rural Microentrepreneur Assistance Program	Loans and grants to organizations for technical assistance (Provides funding to organizations to provide technical assistance to borrowers or potential borrowers. Grants will not exceed 25 percent of the organization's total outstanding microloan balance.) Grants to support microenterprise development (Provides funding to organizations to provide support and training to microenterprises in rural areas that have experienced significant outward migration.)	Intermediaries called Microenterprise Development Organizations (MDOs). These can be nonprofit entities, Native American tribes, or public institutions of higher education. MDOs must demonstrate a record of supporting or a plan to support micro-enterprise development, such as through technical assistance.	$50,000	Yes	$30 million in FY 2023[e]	$5.3 million across 73 recipients (6 loan applicants, 67 grant recipients) in FY 2022[g]
EDA Revolving Loan Fund (within US Department of Commerce)	Grant funding to lender intermediaries	Local governments, political subdivisions, and nonprofit organizations	Varies	No	$39.5 million in FY 2023[d]	About 7,000 loans from 2010 to 2022, totaling $7.1 million[d]

Sources:

[a] *FY 2024 Congressional Budget Justification*, US Small Business Administration, March 13, 2023.

[b] *Small Business Microloan Program*, Congressional Research Service, March 30, 2023.

[c] "Community Development Financial Institutions Fund," US Department of the Treasury.

[d] Theodos et al. (2024).

[e] USDA (2023).

[f] *2024 USDA Explanatory Notes—Farm Service Agency*, USDA.

[g] *2024 USDA Explanatory Notes—Rural Business-Cooperative Service*, USDA.

[h] "US Treasury Awards in Excess of $194 Million to Spur CDFI Investment in Distressed and Underserved Areas across the Nation," CDFI Fund, February 28, 2023.

SBA Microloan Program

As highlighted in the introduction, the US nonprofit lending sector has a history of providing microloans to small businesses, with the earliest programs modeled after microlending practices from Bangladesh and Latin America. While the SBA Microloan program was established in 1991, it was not the first SBA program to provide small business loans. In 1964, the SBA established a pilot lending program called "6 on 6" (Dilger and Cilluffo 2022). This program made loans of up to $6,000 for a six-year term to disadvantaged aspiring entrepreneurs. Additionally, through the Economic Opportunity Act of 1964, the Office of Economic Opportunity established the Economic Opportunity Loan Program, which was later housed under the SBA. The program, which continued through 1992, initially provided direct loans of up to $25,000, although the maximum loan subsequently increased several times, reaching $100,000 by 1976. Since its inception, the Economic Opportunity Loan Program focused on targeting very small businesses, often minority owned and in low-income communities, and provided technical assistance and training to disadvantaged entrepreneurs. This history is important because it highlights the existence of almost 30 years of federal microlending directly to small businesses before the establishment of the Microloan program we have today.

The SBA Microloan program was initially introduced in 1992 as a five-year demonstration project, which is a project supported by federal grant funding to test new ideas and program structures.[43] The program became permanent in 1997 and continues to be a significant source of funding for small businesses. It delivers capital to small businesses through approved nonprofit intermediary lenders, most of which are CDFIs. The SBA's website currently lists 168 approved intermediaries. Among other requirements, intermediaries must have a track record of at least one year of lending before they can qualify. The purpose of the SBA Microloan program is to provide financial resources to intermediaries to enable them to offer affordable small business loans and technical assistance to small businesses unable to qualify for conventional financing. Since the launch of the program, it has provided intermediary lenders subsidies in the form of below-market loan capital and grants to fund the provision of pre- and post-loan technical assistance to borrowers (GAO 2019). Many of the intermediaries are participating in other federal microlending programs, with 73 percent having been certified by the CDFI program run by the Treasury, 27 percent participating in the Community Advantage program, 18 percent participating in the USDA RMAP, and 13 percent also operating as Women's Business Centers (GAO 2019).[44]

Intermediaries designate a geographic service area when applying to participate in the program—sometimes one city or county, or sometimes a whole state or multiple states. They are not allowed to expand their service area without SBA approval.

When the SBA introduced its Microloan program in 1991,[45] it featured a maximum allowable loan amount to borrowers of $25,000. The maximum was increased to $35,000 in 2001 and to $50,000 in 2011, where it remains today. Qualifying nonprofit intermediaries are eligible to borrow up to $7 million, cumulatively, at a low interest rate (five-year Treasury rate minus 1.25 percent) with a 10-year term. These are very favorable terms compared with the interest rates and terms available from most CRA–motivated bank investors, which are the most prevalent alternative sources of capital for CDFI microlenders.

According to Urban's survey of SBA–supported businesses (Hayes 2008), just about a quarter (24 percent) of businesses participating in the Microloan program were using the loan to start their businesses, and fewer than half of participants were accessing financing from other funding sources. In addition, compared with recipients of other SBA funding sources—such as 7(a), 504, and the Small Business Investment Company (SBIC) program—the Microloan program had the highest share of supported businesses reporting that SBA financing was very important to their businesses' success (Hayes 2008). Further, compared with other programs, the Microloan program survey respondents were the most likely to report that without support from the program, they would have had to change their business plans altogether. The results from this survey highlight the important role the Microloan program has played in providing financing to businesses that may not be able to access affordable financing otherwise (Hayes 2008).

The SBA Microloan program also offers grants to intermediaries to support technical assistance services for current and prospective borrowers (Dilger and Cilluffo 2022). The amount of the overall grant pool for intermediaries varies from year to year depending on congressional appropriations, but the SBA strives to provide each intermediary with a grant equal to at least 15 percent of the outstanding debt it has from the SBA, with a maximum grant size of 25 percent of debt outstanding. In some years, the SBA provides additional grant money based on an intermediary's ability to meet two "performance incentives"—the number of loans made in the previous fiscal year and the number of active borrowers in the previous fiscal year. Two of our interviewees who had familiarity with the loan portfolios of several intermediaries told us that some "game" the system by making multiple small loans to single borrowers to score better on the performance incentives and receive more grant funding.

Each intermediary is also required to maintain a cash reserve equal to 15 percent of the outstanding balance of SBA microloans it has on its balance sheet, although after five years in the program, an intermediary can request that the reserve amount be lowered to 10 percent.[46] These funds must be deposited in a bank account in which the SBA is given a security interest. This is also the case with the proceeds of the SBA's loan and all subsequent payments by borrowers. The SBA maintains a security interest in the intermediary's outstanding SBA microloans as well. This high level of control over a CDFI's balance sheet by an investor is unusual, even for a government program.

The SBA also imposes an upper limit on the interest rate and fees an intermediary can charge to borrowers, which is equal to the interest rate paid to the SBA plus 7.75 percent, or 8.75 percent for loans under $10,000. In 2019, the average interest rate charged by SBA Microloan intermediaries was only 6.55 percent, so many are choosing not to charge the maximum amount allowable. The SBA also imposes restrictions on how the technical assistance grant can be used, requiring that at least 50 percent of the grant be used to provide post-loan technical assistance, with the rest to be used for marketing and pre-loan technical assistance. There are a host of additional restrictions and requirements imposed on the intermediaries by the SBA, which can be found in the agency's microloan standard operating procedures—a document that runs 70 pages.[47]

PROGRAM PERFORMANCE

In 2021, under the SBA Microloan program, the 140 SBA microloan intermediaries active at the time made 4,510 microloans totaling $74.7 million—an average of 32 loans per intermediary with an average loan size of just over $16,500, an average interest rate of 6.55 percent, and an average annual loan volume of $534,000 (Dilger 2022). The overall number of loans made by intermediaries has been gradually increasing since 2010, with a small decline in 2021 (5,890 loans made in 2020) (Dilger 2022).

The SBA also reported that more than 18,000 small businesses received technical assistance through the Microloan program in 2021. This is four times the number of loans made that year, indicating that a large portion of technical assistance services are going either to applicants who did not receive loans (at least so far) or to those who received loans in prior years.

Most SBA microloans (62 percent) go to existing businesses. The US Government Accountability Office (GAO) estimates that approximately 80 percent of SBA microloans go to borrowers who fit into one of the program's target demographic categories, with 46 percent of loans going to women and 39 percent to people of color (GAO 2019). Four percent went to veterans, who make up an estimated 6 percent of small business owners, and 16 percent of loans went to low-income small business owners.[48] In 2018, 75 percent of loans went to businesses located in urban areas, slightly below the share of the US population that lives in urban areas.

According to the most recent Congressional Research Service report (Dilger 2022), the SBA does not collect adequate data on defaults to determine programwide default rates for microloan borrowers. As mentioned above, intermediaries are required to maintain a loan loss reserve fund, equal to 15 percent of the outstanding balance of their "notes receivable from Microloan borrowers," which is meant to cover any losses as a result of delinquencies or defaults. The loan loss reserve fund is typically sufficient to cover the costs of defaults by small business borrowers, meaning the vast majority of intermediaries are able to repay the SBA as agreed. The SBA's loss rate ranged between 1.6 percent and 2.3 percent between 2016 and 2021 (Dilger 2022). The same CRS report found that the SBA estimates an average 7 percent default rate among end borrowers, aligning with data collected by an organization called ScaleLink, which purchases portfolios of CDFI–issued microloans.[49]

WHAT'S WORKING WELL

Participant lenders, small business owners, and field observers interviewed were supportive of and felt positively about the Microloan program, noting that while it is not perfect, it still provides critical financing to small businesses. One interviewee reflected, "I do believe it creates good credit opportunities for businesses, so I think that's worked well…I have very positive views of the microlending program." Another interviewee added, "I would just say I'm a huge fan. I think that has been a program where groups have had a real opportunity to start small business lending…I think the barrier to entry is low in terms of figuring out how to work with the SBA and what they want you to do and all the compliance and all that sort of thing."

Additionally, other participants' comments highlighted successful shifts the program has been able to make, which could be attributed to bipartisan support for the program: "I've not seen it devolve. I've seen it evolve. I've seen things like the cap [on loan size] raised, I've seen underwriting criteria, that is minimum underwriting criteria, be altered. I've seen our need for loan loss become—we became liberated to a certain extent. We got at a certain volume where we no longer had to have 15 percent; we could bring 10 percent. All of that was success." Another person added, "I think there is a view, a bipartisan view, a consensus view that this is a good program that ought to continue."

Further, while there were responses related to challenges with the technical assistance requirements, some participants also highlighted the upside of the strong presence of CDFIs and other mission lenders using the program to connect with and advise businesses. As one interviewee reported, "At least for this moment, and this economy, having people on the ground who do [technical assistance], having organizations on the ground that are committed to it, that can differentiate between a business that really needs help and a business that doesn't, that has, as their goal, trying to revitalize communities and businesses, I think is worth having for an extremely small investment [by] the federal government."

Interviewees generally agreed that the Microloan program is currently filling an important financing gap, and without it, many businesses and entrepreneurs would go unsupported or would end up with high-cost loans. Outside of the SBA, the principal source of capital for US microlenders is CRA–motivated investments from banks. Unfortunately, some parts of the country, such as rural areas, are not within the CRA assessment areas of many banks. This means that in some places, the SBA is the primary or even sole entity from which a microlender can borrow. Intermediaries spoke favorably about the low interest rate charged by the SBA, the long-term nature of the loans made by the SBA to intermediaries, and the fact that the SBA loan comes with a grant to fund the intermediary's provision of technical assistance. Multiple intermediaries noted positively that the SBA grant is more or less "guaranteed" every year. As one interviewee noted, "One-year grants that are super competitive are pretty useless in this world." The SBA Microloan program is viewed as a reliable, long-term source of funding.

CHALLENGES FACED

In addition to providing detailed accounts of positive experiences and value added from the program, there were several areas identified for improvement. Multiple interviewees described the Microloan program as prescriptive and restrictive, citing caps on loan sizes and interest rates, prohibitions on the sale of loans to third parties, a 72-month limit on loan terms even if a loan has been restructured, and a large quantity of rules and reporting requirements. Multiple interviewees bemoaned the structure and management of the program in relation to intermediaries, saying they set the tone that there is little trust in intermediaries to carry out the mission of the Microloan program and lend responsibly. Program participants said they felt this was understandable when the program was first created and microlending in the United States was a relatively new phenomenon, but many of the restrictions seem outdated today.

Program caps on interest rates and fees that intermediaries can charge borrowers only exacerbate the challenging economics associated with microlending. Smaller loan amounts mean less interest and smaller fees paid to lenders, yet the cost of making a small loan is not much smaller than the cost of making a larger one. In addition, intermediaries are required to maintain a cash reserve equal to 15 percent of the outstanding SBA Microloan program loans on their balance sheets. Because it is required to be a cash reserve—versus a noncash accrual—this requirement essentially adds a 15-cent cost to every dollar an intermediary deploys in loans. The 15 percent cash reserve requirement also constrains the amount of capital an intermediary can deploy. The SBA's required security interest in microloan portfolios was cited as an onerous condition. Other lenders to CDFIs do not tend to take a security interest in individual loans, and the fact that the SBA does can make it hard for CDFIs who use the SBA program to borrow money from others. These factors combined have negative implications for an intermediary's liquidity and operating revenue, inhibiting its ability to originate large volumes of microloans. Additionally, there is not an established secondary market for SBA microloans as there is with the 7(a) program. If such a market existed, it could potentially balance out some of the liquidity constraints the program inherently produces.

The Microloan program's conditions and restrictions make it relatively costly to administer. As a result, several of the high-volume CDFI microlenders we interviewed either avoid the program or use it sparingly because of the inefficiencies. Referring to the SBA Microloan program, one interviewee noted, "It did not work for us. When we looked at the restrictions on lenders, it was going to tie our hands in terms of pricing in a way that was not sustainable…I will confess, we've stopped taking a hard look year after year at the Microloan program…It was a pretty quick and easy 'no' because of the lender constraints."

As mentioned, the SBA provides annual grants to intermediaries, which are meant to offset some of the lenders' costs. While interviewees praised the fact that the grants were reliably provided every year, they expressed frustration that the amounts of the grants depend on annual congressional appropriations and are therefore in inconsistent amounts, making them difficult to predict and fully rely on. Multiple interviewees criticized the SBA requirement that grant recipients spend 50 percent of the money on post-loan technical assistance, which is not necessarily a cost that microlenders need to incur. Some interviewees reported it was an offer or requirement that relatively few microloan borrowers want. A final challenge with the SBA microloan grant funding is that the lenders receive it only well after loans have already been made—a further strain on liquidity. Interviewees said it would be far easier to run their business if they received a predictable amount of subsidy on a more regular basis, perhaps quarterly. One participant described these tensions as follows:

> In my view, it has a potentially useful role for a tiny organization just getting started, but if that organization is going to grow, they have to walk away from the program relatively quickly. It's kind of an easy entry into the sector potentially, but it's not a long-term solution. It's not a good solution for anybody that's trying to actually grow…It puts constraints on the lender, so it squeezes the margins they can charge to their borrowers. They provide technical assistance funds, but they tell you how they need to be used, so they basically are requiring you to either lie to them or to invest significant resources in a type of technical assistance that high-scale lenders would tell you isn't really that useful.

Another interviewee also noted that the program can be a good way for a microlender to start out. However, they observed that the requirement that an intermediary have one year of lending experience before being approved by the SBA can present a barrier to groups in parts of the country with very little access to private capital.

In addition to having implications for liquidity, the structure of the program requires lenders to take on the full risk of the loan. This inevitably causes microlenders to be conservative in their approach to credit. Many of the people we interviewed made the point that if the small business lending "ecosystem" is going to better reach underserved business owners, it is necessary for lenders to widen their credit boxes and take on more risk. Lending to people who lack savings, do not own homes, and who live paycheck to paycheck is inherently riskier because they are more vulnerable when the business gets in trouble. Relying too heavily on credit scores to determine risk automatically begins to exclude borrowers who have faced systemic and historical discrimination in gaining access to and building wealth. However, the current structure of the program does not offer any form of credit enhancements for loans to borrowers who face credit challenges. In comparison, and rather ironically, the 7(a) program, which primarily serves wealthier business owners, provides significant credit enhancement in the form of a guarantee as high as 85 percent.

Most of the intermediaries felt that the use restrictions on the annual grant were not helpful and created more limitations than benefits. They applauded the change from a 75/25 to a 50/50 split between post-loan technical assistance and pre-loan technical assistance, but most argued that there should be no restriction on the use of the grant. While it is true that most borrowers could probably benefit from high-quality technical assistance, the majority do not want it, do not have time for it, or are not helped because the quality is not high. When the Microloan program was created, the assumption was that higher-risk borrowers would need post-loan technical assistance to ensure they repaid their loans. However, technical assistance can impose burdens on business owners who are already stretched thin. A study conducted by the Association for Enterprise Opportunity showed that only a small number of businesses are interested in training and mentorship as a part of seeking financing (AEO 2016). The report argued that business owners are already stretched so thin that additional services outside of their immediate needs may be considered unnecessary and burdensome.

RECOMMENDATIONS

Several changes to the SBA Microloan program could help the program expand in volume while deepening its impact.

- **Increase and restructure grants to intermediaries.** The SBA should explore ways to modify its current grantmaking structure to provide a flat, predictable grant for every loan made (with the grant size shrinking as the loan size increases, under the assumption that the lender makes more income on larger loans). The SBA should remove restrictions on how the grant funding can be used, allowing lenders to make their own decisions about how to deploy the subsidy.

Congress should also increase the total appropriation of grant funding to increase the average size of grants made to intermediaries. Finally, grants should be made more frequently, such as on a quarterly basis, to help intermediaries with operating liquidity.

- **Increase loans to intermediaries.** The larger SBA intermediaries we spoke to are constrained by the maximum cumulative loan size of $7 million from the SBA and could easily make more loans if the capital were available. We recommend increasing the maximum loan size for SBA loans to intermediaries. The SBA incurs minimal losses on these loans, so there should be no reason not to increase the overall amount. At minimum, maximum loan sizes should increase incrementally, perhaps automatically adjusting for inflation. This adjustment would undoubtedly help enable the continued growth of higher-volume intermediaries.
- **Increase maximum loan size to borrowers.** The maximum loan size that intermediaries are allowed to provide under the program has been fixed at $50,000 since 2011. We recommend increasing the maximum loan size to $75,000 to better reflect the reality of today's economy. While there are a number of SBA 7(a) and Community Advantage loans made in the $50,000 to $75,000 range, the typical Microloan program borrower will not qualify for those programs.
- **Increase interest rate and loan fee caps.** The subject of interest rates charged to borrowers is challenging. While few of our interviewees want a public program to increase interest rates to microbusinesses, the economics of providing small loans to small and higher-risk businesses are challenging. Banks rarely make microloans to these types of businesses,[50] and the more responsible fintech lenders are charging APRs in the 30 to 40 percent range, while merchant cash advance lenders can charge APRs into the triple digits. Some intermediaries we interviewed advocated for a cap of 15 to 18 percent, while others felt even 36 percent—the maximum rate that can be charged to military personnel on consumer loans under the Military Lending Act—would be acceptable on the smallest loans. Even credit unions can lend at rates up to 18 percent. Overall, increasing the allowable interest rates up to 18 percent, or even higher on the smallest loans, would allow intermediaries to expand their credit boxes and lend to higher-risk borrowers.
- **Establish a credit enhancement solution.** If the Microloan program included some kind of credit enhancement from the SBA, it would not only enable intermediaries to widen their credit boxes and serve more customers but would also make it easier for them to sell their loans to third parties (if allowed by the SBA), freeing space on their balance sheets to do even more lending. Credit enhancement could come in many forms, including partially funding the loan

loss reserve, providing a partial guarantee on each loan that falls within certain criteria, or using a capital access program.

The above recommendations apply to the SBA's relationship with all its intermediary microlenders. The recommendations that follow could apply to all intermediaries or might be adopted as part of a newly created "track" for the more experienced ones that have proven they can successfully manage a portfolio. After a certain number of years, or after a certain number of microloans have paid in full (with losses on the overall portfolio staying within acceptable parameters), an intermediary could "graduate" to a different, less restrictive relationship with the SBA.

- **Remove or reduce the loan loss reserve fund requirement**. The requirement that intermediaries maintain a cash reserve of 15 percent is burdensome. We recommend conditionally removing the 15 percent (or 10 percent after five years of program participation) cash loan loss reserve requirement based on an intermediary's other reserves or its net asset ratio. Interviewees felt that 15 percent is too high and that the SBA should look at an organization's overall financial position, as other lenders to microloan intermediaries do.
- **Make SBA loans to intermediaries unsecured.** The SBA lends money to microlenders on a secured basis, in contrast with the unsecured loans provided by most banks, foundations, and individuals. By taking a security interest in the underlying loans, the SBA is showing less confidence in its intermediaries than do other institutions, which can send the wrong signal to other potential lenders. This practice also restricts intermediaries' flexibility in managing their balance sheets.
- **Loosen the restrictions on loan sales, loan restructures, and signatures.** SBA Microloan intermediaries expressed frustration at not being allowed to sell SBA microloans to banks, which will often pay attractive premiums for CRA–eligible small business loans. Loan sales are also an increasingly important way some high-volume microlenders manage their balance sheets to avoid falling below minimum net asset ratios imposed by their creditors. Allowing loans to be sold in a secondary market would be one tool to alleviate liquidity challenges. Establishing a true secondary market for microloans will not be easy but has enormous potential to drive scale. Demonstrating patience with struggling borrowers is a hallmark of CDFI lending, and more flexibility in restructuring is needed in the SBA Microloan program.

USDA Microloan Programs

FARM SERVICE AGENCY MICROLOANS

The USDA Farm Service Agency Microloan program is aimed at providing "small, beginning farmer, niche and non-traditional farm operations"[51] with flexible access to credit and alternative types of loans for smaller operations. There are two types of loans available—operating loans and farm ownership loans. Operating loans are for expenses such as start-up costs and annual expenses, whereas ownership loans are for approved expenses such as purchasing a farm, constructing new farm buildings, or paying closing costs. Borrowers may borrow a total combined maximum of $100,000, with a maximum of $50,000 per loan program. Operating loans are repaid over a maximum term of 7 years, whereas ownership loans are paid over a maximum term of 25 years. Loans are made directly to borrowers through local Farm Service Agency offices (as opposed to the SBA Microloan program, which only funds loans made through intermediaries). Interest rates are set by the regular Farm Service Agency loan rates at the time the loan is made.[52] In 2022, the rate was 4.75 percent. In FY 2022, there were slightly fewer than 3,500 loans made, totaling roughly $92 million.

USDA RURAL MICROENTREPRENEUR ASSISTANCE PROGRAM

Administered by the Rural Business-Cooperative Service, the Rural Microentrepreneur Assistance Program (RMAP) provides loans and funding for technical assistance to qualified Microenterprise Development Organizations (MDOs), which in turn provide microloans and technical assistance to microentrepreneurs, defined as "rural sole proprietorship(s) or business(es) with less than 10 employees."[53] In addition to being located in a rural area,[54] potential borrowers must demonstrate credit limitations, which include an inability to access capital from other traditional sources.

For MDOs participating in the program, interest rates are set at 2 percent for their first five years of participation and at 1 percent thereafter. MDOs are not required to make any payment back on loans for two years, and an MDO's total aggregate debt cannot exceed $2.5 million. In 2022, the RMAP program provided a total of $3.3 million in grants to 67 recipients and $2 million in loans to 6 applicants. MDOs provide fixed-interest-rate microloans of less than $50,000 to entrepreneurs to cover development or start-up costs of microenterprises in rural areas.[55]

Economic Development Administration Revolving Loan Fund Program

We describe the EDA Revolving Loan Fund (RLF) program in the Mid-Market Financing chapter of this report. However, we mention the program briefly here because it can be used for microlending. RLF operators made nearly 600 loans per year from 2010 to 2022, typically with low and fixed interest rates.

RLFs have considerable flexibility with respect to the sizes of loans they make under the program. While loans range in size from less than $10,000 to more than $3 million, roughly one-third of the program's loans were microloans from 2010 to 2022.

Equity Investments

Equity investments provide capital to an investee in exchange for an ownership stake in a company. In contrast to debt, an equity investment conventionally requires that a firm give up a portion of its ownership to the investor. On the other hand, equity financing typically allows firms to access capital without the payment of periodic interest and without specific repayment schedules. Equity investors make money through dividends or through sale of their interest in (i.e., their share of) the company, either individually or in connection with sale of the firm, rather than through collected interest on loan principal. Equity investors typically face more financial risk than lenders. For example, if a firm fails or is sold for a low price, investors may lose some or all of their investment. On the other hand, if a firm runs into financial difficulty, interest and principal payments must still be made to lenders, while equity investors do not need to be paid dividends. And if the firm ultimately fails, creditors receive liquidation proceeds before equity investors do.

While equity capital is highly valuable for firm growth and broader economic development, the federal government has historically done more to help small businesses access debt than equity. In fact, the public sector has done relatively little to help broaden the availability of equity financing to operating businesses in geographies and industries that are not already well served by the private market, such as those in lower-income communities or minority-owned businesses. One challenge with equity financing is that there are very few small businesses that are suitable for equity investments because equity investors tend to favor larger, less risky transactions with promising returns. Large programs that seemed to have promise as equity finance tools—such as New Markets Tax Credits (NMTCs), Opportunity Zones (OZs), and SBICs—have not adequately facilitated pure equity finance to businesses and communities. One federal program with traction is the State Small Business Credit Initiative (SSBCI), which expired in 2016 but was reintroduced in 2021. Unfortunately, the SSBCI's state-run structure introduces challenges, and some states remain on the sidelines. Other promising programs include Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR) programs, which provide R&D funding for promising technology-based small businesses with the ultimate objective of commercialization and can lead to further seed investments if the products prove to be successful. However, these programs are highly competitive and only focused on firms in the technology sector. Additionally, although CDFIs and other mission lenders strive to make debt available to a wide swath of firms at reasonable terms, mission- or impact-oriented equity is still relatively rare.

Small businesses could benefit from…somewhere between friends and family and a bit more established investors.
—Interviewee

Facilitating the provision of equity capital to operating businesses is challenging for the federal government for several reasons. First, equity investments do not typically have regular repayment timelines as loans do. While this is part of the appeal of equity investments for business owners, it creates a challenge for no- or low-cost federal programs providing capital to investors. The feasibility of these programs often hinges on regular repayment structures, which are intentionally not part of the equity investment model.

Second, equity investments are customized to each business in a way that debt investments are not. This usually means higher transaction costs, which will cause investors to gravitate toward higher investment amounts and, consequently, larger firms. One interviewee said, "The sweet spot, depending on how the program is structured, is a million EBITDA [earnings before interest, taxes, depreciation, and amortization]…To justify the transaction costs, you have to be worth people's time and the legal costs. There's a reason why these things get done at larger sizes." Another interviewee agreed and explained that the focus on larger deals shuts out certain segments of businesses: "If you're not going to make $1 million in revenue, you won't even be considered."

A third challenge is that expertise in making equity investments into operating businesses is lacking in much of the United States. As discussed in the introduction, venture capital is highly spatially concentrated within a few metropolitan areas. This creates a cycle where limited deal flow leads to limited expertise, which leads to continued limited investment. As one interviewee noted, "With the current capacity of stakeholders and markets to absorb the capital, unless coupled with [a technical assistance] piece to build investable deal flow in markets where it doesn't exist, even subsidized money will flow like water where there are deals. As much as capital is always a challenge, talent really is the challenge."

There's just this history of the federal government, Congress, recognizing that equity, risk capital, is really important for businesses, and it is…They keep trying to do it, and they haven't succeeded.
—Mission lender

Nevertheless, the federal government has rolled out a number of programs over the years that have at least intended to stimulate the ability of small businesses to access equity capital. We summarize and describe the key programs in table 4.

TABLE 4
US Support for Equity Investing

Program	Government agency/level	Investor type	Description	Annual funding level for investments in operating businesses
Opportunity Zone (OZ) tax incentive	Treasury, IRS	High-net-worth individuals, corporations, investment funds	Investors receive tax benefits if they invest capital gains in operating businesses or real estate located in designated OZs	An estimated $205 million in annual tax expenditures for operating business equity investments[a]
EDA's Build to Scale (B2S)	EDA	Angel investor networks and investment funds	A portfolio of grant competitions to bolster venture capital intermediaries, investment funds, and firms	$50 million for FY 2023; average of $21 million from 2010 to 2019
New Markets Tax Credit (NMTC) Program	CDFI Fund, IRS	Banks and other corporations with tax liabilities	A tax credit worth 39 percent of the original investment that Community Development Entities make in Qualified Active Low-Income Community Businesses in low-income communities	An estimated $10 million in annual tax expenditures for operating business equity investments[b]
State Small Business Credit Initiative (SSBCI)	Treasury	Venture capital funds and angel investors	Flexible funding for state small business financing programs, which include credit support and access, and support for venture capital activity	$9.85 billion, $2.5 billion of which will go toward equity investing, potentially for the 10-year life of the program[c]

Program	Government agency/level	Investor type	Description	Annual funding level for investments in operating businesses
Small Business Investment Company (SBIC) program	SBA	Investment funds	Licensed SBICs use their own capital, plus funds borrowed with an SBA guarantee, to make equity and debt investments in qualifying small businesses	Provided $3.8 billion in leverage in FY 2022. Amount for equity is unknown.
America's Seed Fund/Small Business Innovation Research (SBIR)/ Small Business Technology Transfer (STTR)	National Science Foundation and SBA	Direct government investment in firms	Through contracts or grants, the US government invests in small businesses doing R&D in strategic areas	$4.3 billion for grants, contracts, and cooperative agreements in FY 2022

Sources: Partially adapted from Theodos and González-Hermoso (2021) by the authors, using data from Michael Novogradac, "Bullish Opportunity Zones Equity Raising Continues Despite End of Basis Step-Up Benefit," Novogradac (blog), April 21, 2022; Theodos and González-Hermoso (2021); Theodos et al. (2021a, 2021b).

Notes:

[a] We estimate this first by taking the total estimated average tax expenditure over four years provided by the Joint Committee on Taxation (2022), which is $5.7 billion. We multiply this by an estimate provided by Novogradac that 3.5 percent of OZ funds are going into operating businesses.

[b] We first estimate the present value of the federal tax expenditures under the NMTC program, which is $1.85 billion in FY 2023. See Theodos, Stacy, Teles, et al. (2021b) for a description of how that figure is calculated. We next calculate the share of NMTC projects through 2019 reported to the CDFI Fund where the purpose is financing an operating business and the transaction type is an equity investment. Roughly 1 percent of NMTC projects and 0.5 percent of NMTC investment amounts are equity investments in operating businesses.

[c] The SSBCI program was originally appropriated for $10 billion in funding, but $150 million was rescinded in 2023.

Federal Equity Supports

In this section, we review learnings from six of the federal supports for equity investing presented above. We begin with a deep dive on the SBIC program. For each program, we describe how it works, what is working well, and any challenges.

The Small Business Investment Company Program

The SBIC program, established by the SBA in 1958, was developed as a solution to address the lack of equity financing products offered or supported by the SBA. This was a time before venture capital was practiced in its current form, when the SBIC program was a cutting-edge development helping advance the field of equity investing (Mallaby 2022). Indeed, SBICs accounted for the bulk of all venture capital in the 1960s (Bean 2001; Lerner 2009).

The program does not provide direct equity investments to firms, but rather provides loans to SBA–licensed investment funds known as SBICs. Capital is raised by issuing government-backed securities, known as debentures, to private investors. SBICs then make investments in small businesses. Generally, investment funds are responsible for raising their own private equity capital (referred to as “regulatory capital”), which the SBA matches with debt capital at a 2:1 ratio. In other words, for every $1 of private equity raised, the SBA will provide $2 of debt capital. The program runs on a zero-subsidy basis and without annual appropriations from Congress through fees charged to SBICs, such as a 1 percent fee on leverage commitments, a 2 percent fee when “drawing against” leverage, and an annual fee on outstanding leverage (GAO 2016, 5).

To apply, prospective funds start by filling out a Management Assessment Questionnaire, which includes questions related to the fund’s investment decisionmaking, strategy, and governance structure. The Management Assessment Questionnaire also asks about the fund management’s investment track record and performance; detailed financials, such as how the fund calculates fees and distributions; and their 10-year forecast (Dilger and Cilluffo 2022a). SBICs must be privately managed, for-profit investment companies and can be structured as corporations, limited partnerships, or limited liability companies.

A prospective SBIC fund is assessed against several criteria, with the most emphasis being placed on the qualifications of the management team. The SBA assesses the history, composition, and experience of the management team, specifically whether they demonstrate comparable investment experience of successful investments and add value and whether there is evidence demonstrating good deal flow and the ability of the fund to manage cash flow.

In addition to these guiding criteria, there are also financial obligations that funds must meet to qualify, including a nonrefundable application fee of $10,500 and a final licensing fee of $36,900 (Dilger and Cilluffo 2022a). There is also a minimum regulatory capital requirement of $5 million, which must be raised before an SBIC license is issued. In some cases, the SBA will require a prospective fund to have $20 million or more in commitments to limited partners.[56] Additional costs may be incurred by the fund if it hires counsel to assist with the application process.

There are two types of SBICs—leveraged, which borrow debenture debt from the SBA as described above, and unleveraged, which do not, relying solely on private capital. Over the years, the SBA has experimented with a variety of subprograms, including:

- **Specialized Small Business Investment Companies (SSBICs)** focused on investing in companies run by entrepreneurs who face social or economic disadvantage. The SBA stopped granting new SSBIC licenses in 2016, though some SSBICs that were already approved are still operating.
- **Impact SBICs** were required to invest at least 50 percent of their funds into areas of critical national priority, which include underserved communities and the education and clean energy sectors. The SBA licensed nine impact SBICs before 2017, when it announced it would accept no new applications.
- **Early-stage SBICs** were required to invest at least 50 percent of their funds into companies that have yet to achieve positive cash flow from operations in any fiscal year. The SBA licensed five early-stage SBICs before closing the application process in 2017.
- **Participating securities** were created in 1992 to encourage actual equity investments in early-stage companies (versus the mezzanine debt provided by most SBICs to later-stage companies). The program was discontinued in 2004 because participating funds experienced high losses in the wake of the dot-com bubble bursting in the early 2000s.

The debenture structure requires that funds make regular payments to the SBA, with payments usually starting before the fund's investment generates financial returns. Unleveraged SBICs do not receive leverage from the SBA but rather raise all necessary capital from the private market, with banks making up a significant portion of the investment. Bank investments in SBICs are exempt from certain regulations, such as the Volcker Rule. Banks can also receive CRA credit by investing in an SBIC.

The SBA highlights numerous benefits to becoming an SBIC.[57] Many of these benefits relate to the value of accessing leverage, which increases returns to the private equity investors. Using leverage also lessens the burden of capital raising and allows funds to spread financing across more businesses, as well as helping funds scale.

There are currently 308 licensed SBICs, which manage more than $22 billion in private capital and more than $12 billion in SBA leverage.[58] Four in five SBICs (247) are debenture SBICs, meaning that they access SBA leverage. The number of licenses has hovered between 290 and 315 over the past 10 years, with the breakdown between different license types being relatively consistent. The SBA has been increasing the number of new debenture licenses each year, while slowly phasing out participating securities and SSBICs. There has also been a slow increase in the number of nonleveraged SBICs.

There are restrictions and guidelines on the amount of leverage available, regulatory capital sources, and allowable investments. Individual SBICs have access to a maximum of $175 million in leverage, and total fund sizes vary from $30 million to upwards of $225 million (Dilger and Cilluffo 2022a). In terms of regulatory capital, they are permitted to receive a maximum of 33 percent of regulatory capital from state or local government entities. While there are not restrictions on industry, stage, or geography, there are restrictions on the size of businesses in which SBICs can invest. The program is targeted at small businesses, though the definition of what counts as small is expansive. SBICs are required to invest in businesses defined as "those with no more than 49 percent of employees overseas, less than $19.5 million in tangible net worth and average after-tax income for the preceding two years of less than $6.5 million; or businesses qualifying as small under the SBA's NAICS industry code size standards" (Dilger and Cilluffo 2022a, 1). SBICs are also required to invest at least 25 percent of their funds into smaller enterprises, which are defined as "[companies] with a net worth of less than $6 million and average after-tax income for the prior two years of less than $2 million."[59]

Typically, investments made by SBICs are across a vast range of industries, geographies, and stages. Most SBICs focus on a stage of investment and a geographic area. There are also specific debentures available for investing in low- or moderate-income areas (LMI zones).[60] These LMI debentures allow SBICs to defer interest and fees owed to the SBA for the first five years, as long as they invest in businesses that have at least 50 percent of their employees or tangible assets located in an LMI zone. Interest payments are also discounted.

Despite being framed as a program that promotes equity investments, most SBIC funds offer debt products or debt and equity, which do not often make stand-alone pure equity investments. Most SBICs focus on later-stage investments and mezzanine financing. Between 2016 and 2021, more than 75 percent of $29 billion in SBIC financing to small businesses had a debt component.[61] Less than 20 percent of this financing was in the form of patient capital. There is a perception among users of the SBIC program that investments with debt features are less risky than equity investments, which is one of the reasons why equity investments have been less common than debt investments (GAO 2016). The biggest reason is the requirement that SBICs using leverage begin making interest payments to the SBA right away, which in turn means the investee needs to pay interest as soon as the investment has been made.

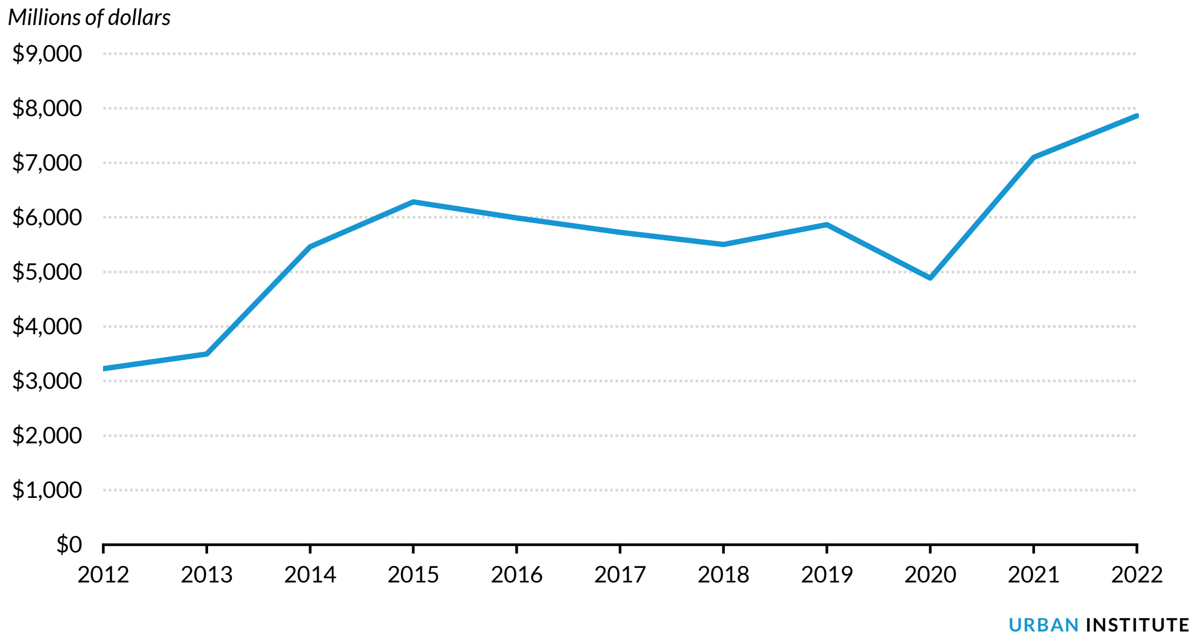
The SBIC program has changed since its inception and continues to evolve. The program was first introduced in 1958, and until 1992, debentures were the only form of leverage allowed. The Small Business Equity Enhancement Act of 1992 introduced participating securities—a new form of leverage that allowed the SBA to purchase securities, giving the SBA limited partnership interests in SBICs, and featured a payment structure under which SBICs would “pay the SBA a prioritized payment (preferred return) and a profit share when the SBIC realized profits.”[62] This program became an attractive tool for investing in start-ups and early-stage businesses, which, at the time, were nascent internet and technology start-ups that proliferated during the unprecedented expansion of technology companies tied to the internet. However, following the burst of the dot-com bubble, the program experienced significant losses, as many of these businesses proved unsuccessful (Park 2019). The participating securities feature of the SBIC program was terminated in 2004 over concerns about significant losses for the SBA.

In 2022, new changes were proposed to address the ongoing lack of equity financing as well as address some of the barriers to entry in the program, and a new rule was issued in 2023.[63] The changes include adding an accrual debenture for “accrual SBICs” and “reinvestor (fund-of-funds) SBICs,” which would be a new type of leverage that offers a debenture (i.e., a loan) that accrues interest over a 10-year term, where the SBA guarantees both the principal and unpaid interest. This would mean that payments on the debenture would be due after the 10-year period rather than semiannually as in the existing debenture structure. The debenture can be prepaid. The hope for this new approach is to provide an alternative borrowing structure that is constructed to align with the cash flow patterns of equity-oriented investment funds and longer-duration strategies.

The new rule also brought changes to the licensing requirements—including the introduction of a tiered fee structure, under which new funds are charged lower licensing fees—in an attempt to lower some of the financial barriers to SBIC licensing. Other changes are also being implemented, including changes to other fees, licensing requirements and processes, capital requirements, waterfall structures, reporting, and monitoring.[64]

FIGURE 13

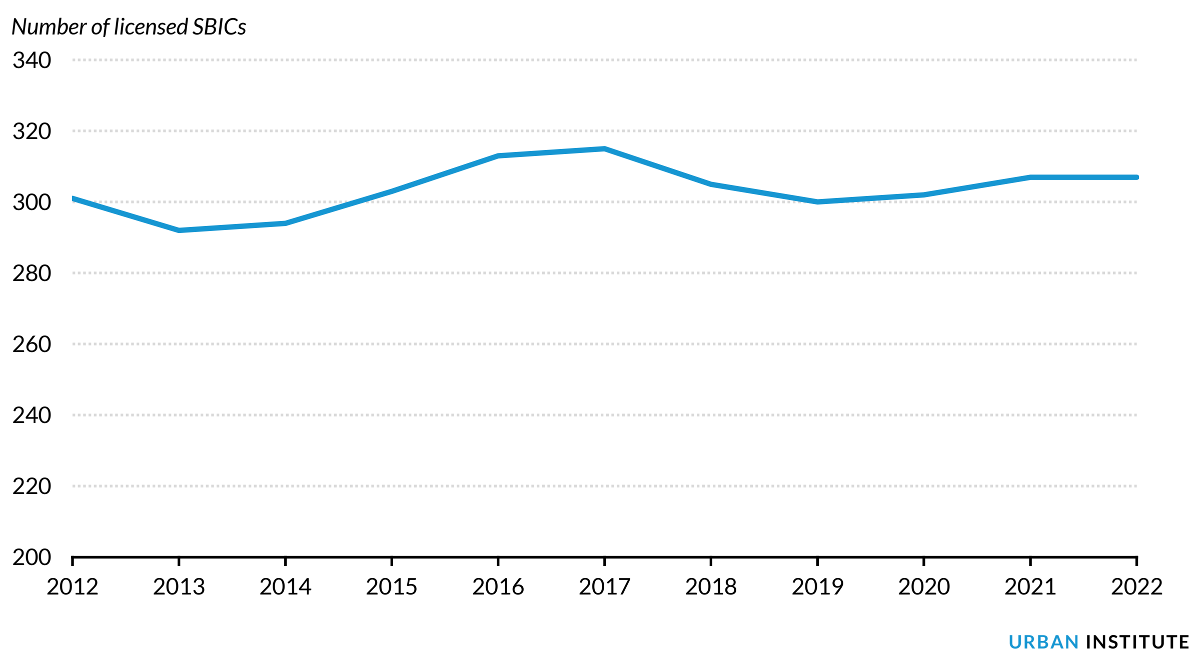
Total Dollar Volume of SBIC Investments, 2012–2022



Source: US Small Business Administration.
Note: Investment amounts adjusted for inflation to 2022.

FIGURE 14

Number of Licensed SBICs, 2012–2022



Source: US Small Business Administration.

In terms of who the SBIC program is reaching, the most recent data (FY 2022) indicate that roughly 20 percent of SBICs' financing went to businesses located in LMI communities. Data indicate that out of the total number of businesses supported by SBICs, only 9 percent of nonleveraged and 6 percent of debenture SBICs went to women-owned, veteran-owned, or minority-owned businesses.

WHAT'S WORKING

Reflecting specifically on the SBIC program as a financing tool, many interviewees said that the program is "generally very successful," which they attributed to the rigorous licensing process that has kept the pool limited to a small number of firms with specific capabilities. As one participant noted, "It has merit earning the license."

The program's success in providing financing is in part due to its ability to leverage private capital, and the program's financial soundness has helped it garner political support. As noted in a Congressional Research Service report, "The structure of repayments ensures that the government will not suffer significant losses" (Dilger and Cilluffo 2022a, 31). Interviewees also said that private sector participation remains consistent because the SBA provides a good customer service experience.

Additionally, while it has not done much historically to facilitate traditional equity investments to small businesses, the program has provided financing to many well-established businesses (Dilger and Cilluffo 2022a). The SBIC program demonstrates slightly better geographic distribution when compared with private venture capital funds. Further, there is a segment of the market that struggles to access private equity and venture capital, especially businesses that are not in high-growth industries like technology. Although not purely private equity financing, the SBIC program fills a gap by providing an alternative or a middle ground between traditional debt and accessing private equity.

WHAT'S NOT WORKING

Interviewees identified several challenges with the SBIC program, which we detail below.

High barriers to entry in SBIC licensing mean a lack of diversity in funds and less of an appetite to innovate or experiment. A common theme expressed throughout our interviews was the SBIC program's high barriers to entry. SBIC licenses require significant management capacity and a history of high-quality transactions, a minimum of $5 million in private capital raised, and the expenditure of substantial funds to cover legal, licensing, and processing expenses. Licensing costs were significant, including those paid to consultants to help navigate the process. This is important because there may be disparate impacts of these standards by race: according to program data, there are only 49 minority-owned SBICs out of almost 300. More minority firms are often considered to be "emerging" because "they control a smaller share of capital" and have less experience managing a fund. This is a disadvantage when trying to raise funds, as investors prefer to invest in more well-established SBIC funds (Hawkins 2023).

The 2023 regulations aim to address barriers to entry and make the application process less burdensome, such as by lowering the cost of licenses and creating different fee structures depending on the size of the fund. Some interviewees expressed hope that the flexibility and lower hurdles in the 2023 rule will help, though other interviewees are skeptical they will be sufficient to make notable gains in program diversification.

SBIC does not adequately facilitate capital to businesses unable to access traditional financing. A theme expressed by our interviewees is that the SBIC program does not meaningfully help the federal government support smaller or less-established businesses. Many interviewees discussed the disconnect between the demand for smaller investments and the lack of incentives in the SBIC program for funds to make smaller investments. They stated that the types of businesses that should benefit from a government equity program generally need smaller investments, but smaller equity investments are not feasible for SBIC funds. Indeed, multiple interviewees cited a lack of impact focus for the program. As one interviewee reflected, "The SBIC program is not explicitly an impact program. Or the impact is just sort of in general, 'Let's provide financing to small businesses.' But their definition of small business is pretty big."[65] There have not been mandates or incentives in place to ensure or encourage targeted investments in low-income communities or to certain businesses or owners. Interviewees agreed that investment decisions under the SBIC program are largely based on returns and investor benefits rather than community impact.

A lack of an impact emphasis is not, industry representatives observed, reflective of deficiencies among operators. It reflects who participates and basic program design features. Interviewees also observed that the SBIC program has not traditionally sought out mission finance providers, such as CDFIs, to participate. Even beyond this, the SBIC program has limited subsidy embedded in it, meaning there is less potential for risk-taking or lower pricing, as well as early repayment requirements. This has caused funds to favor businesses that demonstrate early repayment and strong growth potential—precisely the types of businesses the private market already serves.

SBIC often provides debt rather than stand-alone equity. Many interviewees noted that one of the major problems with the SBIC program is that SBIC funds tend to provide debt or side-by-side debt and equity investments rather than stand-alone equity investments. This is in part related to the way the SBA debenture structure works, in that funds are required to start paying back investments quickly and on a structured schedule. As a result, debenture SBICs often structure their investments similarly, rather than as equity investments that are repaid when an investor exits, often years after the investment is made. A typical debenture SBIC investment is in the form of mezzanine debt, which is debt that can be converted to equity later. Further, these mezzanine debt investments tend to be in much larger amounts than the amount of early-stage equity small businesses require, resulting in a tilt toward established businesses with steady revenue that can reliably make payments on time. As one interviewee said, “There’s just this history of the federal government, Congress, recognizing that equity, risk capital, is really important for businesses…They keep trying to do it, and they haven’t succeeded.” Other interviewees are hopeful that the 2023 additions of accrual SBICs and reinvestor SBICs will help expand equity capital under the program.

State Small Businesses Credit Initiative

The SSBCI was established by the Small Business Jobs Act of 2010 and is administered by the Treasury. The first round of SSBCI lapsed in 2016, but it was re-funded by the American Rescue Plan Act of 2021. SSBCI provides federal funding to states for several forms of small business capital support and technical assistance, including venture capital programs. Participating jurisdictions are expected to leverage $10 of private investment for every $1 of SSBCI funding. (This is true for the full state funding and may result in higher leverage ratios in equity financing to compensate for lower ratios in debt financing.)

As discussed previously, there are three main types of SSBCI capital provision efforts: capital access programs, other credit programs, and equity/venture capital programs. (There is also a technical assistance grant program under SSBCI.) States could propose multiple capital programs and were encouraged to develop programs that are responsive to and in alignment with the challenges and priorities in their local context. At the time of writing this report, 40 states included equity capital programs as part of their SSBCI plans that were approved by the Treasury.[66] There are four states with applications still pending.

While it is too early to draw lessons from the current SSBCI program, the prior version of the program provides insight on how states performed in relation to equity and venture capital and the impact SSBCI may have going forward. What is clear is that the success of the program is dependent on the ability of states to deploy the funding appropriately. In the first round of the SSBCI program, states took longer than initially anticipated to spend down the funds provided to them. One of the reasons for this was states not having preexisting business support programs and the necessary infrastructure to distribute funds quickly. States relied on the appetite and willingness of banks and lenders to participate in this program to distribute funds but ran into issues with multistate banks, which were "reluctant to participate in the program due to the variation of SSBCI programs across the nation," with each one requiring a different approach and having different parameters (Dilger, Driessen, and Levin 2022, 14). The expectation for the new round of funding is that some of the infrastructure developed from the previous round remains in place and that states and lenders have an adequate level of familiarity for the program to function more efficiently.

Although program success varied widely across states, the program generally provided a promising source of venture and equity financing to small businesses, especially in markets where this type of financing may have been previously lacking. In the first round, venture capital programs received the largest amount of funds (around $300 million), supporting a mix of 48 programs (GAO 2011; CREC and Cromwell Schmisseur 2016). The support for venture capital allowed states to "revitalize programs lacking sufficient support" or establish new programs in places where there were perceived gaps in the availability of venture capital in the business ecosystem (CREC and Cromwell Schmisseur 2016, 62). Most programs (83 percent) had a fund structure, meaning they used private funds managed by nonstate actors (selected through a competitive process to administer and invest SSBCI dollars) or state-supported entities (SSE), which are state-funded specialized nonprofits or intermediaries with a public benefit mission (CREC and Cromwell Schmisseur 2016).

Research on these programs found that nearly two-thirds of investments (63 percent) were made to businesses that are considered early or seed stage (CREC and Cromwell Schmisseur 2016). Businesses supported were very small (median number of employees was four), and more than three-quarters of businesses were not older than five years. SSBCI funds made up approximately 15 percent of "the average investment round" for businesses (CREC and Cromwell Schmisseur 2016, 78). Some states developed "evergreen" funds for their programs, which function like revolving loan funds for equity investments in that revenue on investments can be redeployed to other investments and remain open. These funds can play an important role in providing pre-seed and seed-stage investments. Some interviewees thought the program has indeed worked in some states to reinvigorate venture capital ecosystems, support job growth, and address a gap in equity-type financing supported by the federal government. Others felt that the program was less successful, given that some states struggled to put guardrails in place to ensure the vehicle was used for meaningful and productive investments (CREC and Cromwell Schmisseur 2016).

While the previous round appeared impactful in many cases, interviewees highlighted that the ability to implement the program was dependent on underlying market conditions. Capital absorption capacity is a necessary element for initiatives to be impactful, and not all states had the markets or demand to make venture capital investments viable. Interviewees highlighted the need for networks of supporting organizations, such as incubators, to bolster the health of the underlying ecosystem so that businesses have the capacity for growth and funds have attractive deals and opportunities in which to invest. Relatedly, there is a need to ensure that interests between private sector actors and the public sector are in alignment. Interviewees commented that the states that did well were ones that took a leadership position in the program by setting clear objectives and targets in line with the realities of their specific ecosystems. In some instances, states felt that the fund structure was not viable and tended to coinvest or operate mainly through the state-sponsored entity structure. There is also a sense that the leverage requirements are a limiting factor. The impact of SSBCI funds may be diluted when they require so much private funding, use a traditional fund structure, and drive investments that would have taken place regardless. Other factors that influenced the implementation of the program were state regulations, such as regulations that precluded some states from being able to hold securities (CREC and Cromwell Schmisseur 2016; GAO 2011).

There are several changes to the new SSBCI program worth noting. Most significantly, the dollar value is appreciably larger given the total SSBCI budget allocation. In terms of share, roughly one-third of funds either approved or requested are going to venture capital programs (Fooks, Cromwell, and Schmisseur 2023). There is also a requirement that a credit program demonstrate "a reasonable expectation that it will achieve a 10:1 private financing ratio (the ratio of small business lending and investment to the federal contribution amount)," which would require states to have a fairly strong commitment from private sector investors and lenders to coinvest, as well as enough capital absorption capacity to match this level of investment (Dilger, Driessen, and Levin 2022). There are also additional incentives for state programs that are focused specifically on meeting needs of businesses owned by socially and economically disadvantaged individuals (SEDI) and very small businesses. In some cases, these types of investments may be perceived as higher risk and not viable for venture capital or equity-based financing. However, this change could also yield important outcomes for states supporting emerging fund managers and funds that target SEDI businesses.

Opportunity Zones

Congress created the OZ program with the Tax Cuts and Jobs Act of 2017. Each governor selected, and the Treasury approved, qualified OZ census tracts in each state in 2018. The program is administered by the IRS.

The program works by incentivizing investment of capital gains into projects and businesses in 8,764 zones across all 50 states, the District of Columbia, Puerto Rico, and four US territories. Investors place capital in a Qualified Opportunity Fund, which then makes investments in projects and businesses. Investments made by Qualified Opportunity Funds into OZs can generate benefits for investors through (1) a temporary deferral of taxes on previously earned capital gains, (2) a discount of 10 or 15 percent on capital gains taxes owed, and/or (3) the permanent exclusion of taxable income on new gains representing returns on the OZ investment. (The first two benefits have lapsed, but the third, the largest, is still available.) Apart from a few "sin" businesses and investments in financial firms, few types of businesses are excluded from the program. There is no minimum or maximum investment.

OZs were framed by the bill's sponsors as an economic growth and job creation program. Per the IRS, "Opportunity Zones are an economic development tool—that is, they are designed to spur economic development and job creation in distressed communities."[67] However, several analyses have found that the vast majority of OZ capital has been invested in real estate (Coyne and Johnson 2022; Kennedy and Wheeler 2021; Theodos et al. 2020). One estimate finds that only 3.5 percent of the investments made through the OZ program have gone toward equity investments in operating businesses.[68]

The OZ program is little used for equity investment in operating businesses for several reasons. Unlike with real estate projects, operating businesses can move and cease to be eligible for the program. There are also limits on how much of a business's income can come from non–OZ communities, a requirement with which it is much easier for a real estate project to comply than an operating business. Deployment rules and investment time frames also pose obstacles. Investors have 180 days after realizing their capital gains to invest them in a Qualified Opportunity Fund, and the fund then has to deploy the capital within a set time frame. While investors with capital gains need to deploy in the near term, venture capital and other operating business equity funds typically want to receive capital commitments and draw them only as they identify the right opportunities. Moreover, OZ investors typically want to remain invested for 10 years to realize the permanent exclusion for new gains and exit as soon as possible after that. Venture capital and other operating business equity funds, however, want to exit an investment whenever the time is right to sell the business to a new investor. This makes it difficult to maintain the minimum capital deployment levels required by the IRS.

Even if an investor is willing to leave the money in an operating business for 10 years, structuring the equity exit is challenging. As one investment professional related, "How can we figure out a way where you get your equity back whether it's through equity repurchase, whether it's through us bringing in other partners to the deal. That's not an easy thing to solve for. I think that's part of why it's been so hard to get operating businesses included in the OZ framework" (quoted in Theodos et al. 2020). These timing challenges are far more easily overcome with investments into real estate projects.

OZ have been further criticized for their geographic emphasis. A recent analysis of OZs indicates that, in general, they benefit a "narrow subset of tracts in which economic conditions were already improving prior to implementation of the tax subsidy" (Kennedy and Wheeler 2021) and that zones with investments are generally better off than zones without investments along a variety of indicators (Coyne and Johnson 2022).

Opportunity Zones were supposed to be equity for businesses. They weren't.
—Mission lender

Build to Scale

Whereas the OZ, NMTC, and SBIC programs are meant to incentivize or provide capital to invest in operating businesses, the Build to Scale (B2S) program functions differently. The program does not provide investment capital but rather helps build the capacities of fund managers to deploy capital.

The B2S program, administered by EDA, was created in 2010 to help build local entrepreneurial ecosystems (Theodos et al. 2021a). Previously named Regional Innovation Strategies, the program offers two categories of grants (Theodos, Edmonds, Teles, et al. 2021b). The Capital Challenge grant (formerly Seed Fund Support Grant) provides operational support for early-stage investment funds, angel capital networks, or investor training programs. Through its Venture Challenge (formerly i6 Challenge), the program provides grants on a competitive basis to intermediary organizations supporting new business ventures.

Interviewees generally reflected positively on the B2S program, while also noting its limitations. One interviewee stated, "Build to Scale is a great vehicle for regions to define their own needs and own solutions." We heard opinions that B2S provides valuable resources for building the capacity of investment funds within regions. Another interviewee shared, "The EDA program is one of the best in building that capacity."

We also heard a few challenges associated with the program. Some commented that while they appreciated EDA's capacity-building work, they regretted the restriction against using the dollars for investments, saying the program “doesn’t bring actual capital to the table.” While providing capital for investment is not the intended design of the B2S program, these sentiments reflected that interviewees did not feel that the other federal tools discussed here adequately met the need for subsidized capital for equity investing. Another challenge we heard is that the B2S program simply is not big enough to meaningfully expand the number of venture capital hubs across the United States; there are too many regions that do not receive funding, and those that do require additional years of investment to build a self-sustaining equity capital ecosystem. As one interviewee put it, “How much bigger B2S should be? … In building capacity of regions, you need a sustained $100 million of capital and the actual dollars that they can put to use.”

New Markets Tax Credits

The NMTC program, jointly administered by the CDFI Fund and the IRS, was authorized in 2000.[69] The program provides federal tax credits to subsidize a wide range of projects including commercial and retail developments, industrial and manufacturing facilities, schools, community spaces (e.g., museums), housing, mixed-use projects, and investments in operating businesses or nonprofit organizations.

The program works by competitively awarding to Community Development Entities (CDEs) the rights to use or sell the tax credits each year. CDEs are certified by the CDFI Fund. Large corporations, banks, real estate developers, governmental entities, mission-based lenders, and nonprofits can all be certified as CDEs, either directly or by creating affiliate organizations (Theodos et al. 2021c). CDEs provide taxpayers with access to credits against their federal income taxes worth 39 percent of the Qualified Equity Investments (QEIs) they make into CDEs, with the credits spread over seven years. After CDEs sell the credits to investors, they use the capital they receive to make Qualified Low-Income Community Investments into projects in low-income communities.[70]

Despite its initial intent to support operating businesses in lower-income communities, NMTCs are largely used to finance real estate. By one estimate, just 21 percent of NMTC financing goes to operating businesses for non–real estate purposes (Abravanel et al. 2013), and the investment is more typically structured as debt or a forgivable grant than as an equity investment. Reporting to the CDFI Fund indicates that just 0.5 percent of investment under the NMTC program is for actual equity investment in operating businesses.[71]

Several reasons have been cited for the low proportion of NMTC financing going into equity investments in operating businesses (Abravanel et al. 2013; Elphick 2021; Stanhope 2018). CDEs must keep “substantially all” of their NMTC funding invested in qualifying projects for at least seven years.

Unlike real estate projects, operating businesses can move, and therefore pose more compliance risk. Operating businesses are also more likely to fail than real estate investments and are more likely to need investors to wait more than the typical seven-year NMTC period for their exit. Meanwhile, either a failure or a shorter investment period would mean that CDEs have to redeploy any NMTC funds that are repaid, which results in additional work, expense, and compliance risk. Real estate projects also typically produce more regular income than equity investments in operating businesses, which makes underwriting easier. And equity investments in operating businesses are typically smaller in size, meaning the NMTC program's sizable transaction fees (mostly paid to attorneys and accountants) represent a larger share of project financing, meaning the federal subsidy is less valuable. A handful of CDEs have used the program to make equity investments in operating businesses, but most of the NMTC industry has not pursued this approach.

The federal government really does not have a program for equity for businesses, which is shocking…New Markets was supposed to be equity for businesses, but it is not.
—Mission lender

Recommendations

Access to equity capital is key to regional and national economic prosperity and wealth creation (Mallaby 2022). With the creation of the SBIC program in the mid-20th century, the federal government was initially at the cutting edge of innovation in equity investing. Yet despite some promising efforts, the federal government's role in encouraging equity investing is too narrow, misdirected, and underresourced. Programs that have intended to advance equity investing in operating businesses, such as NMTCs, OZs, and SBICs, have been almost fully devoted to real estate or have principally delivered debt products.

The good news is that equity investing, from pre-seed to later stage, is more developed in the United States than in any other nation and is more developed now than in years past. The volume and sophistication of equity investing is unparalleled, and the federal government does not need to intervene to increase the manner and form of equity investing that is already happening. Yet with extreme geographic, industrial, and owner demographic concentrations evident in equity investing across the country, there is a clear role for the public sector to expand access to businesses that are not already well served. Several measures could help this happen.

- **Create a new community development venture capital program.** Smaller-dollar equity investments, pre-seed and seed-stage investments, and equity investments made by funds willing to accept moderate returns are simply not widely available in the private market. Public subsidy can help and could be effective when paired with market discipline, tools, and expertise.
  - **How much subsidy is needed?** We can draw from some cases in the United States as well as international examples from Canada, Germany, Sweden (Theodos and González-Hermoso 2021), Israel, and New Zealand (Lerner 2009). Likely as little as 10 percent in public subsidy dollars would be needed to incentivize private, mission-driven capital to make community development venture capital investments.
  - **Program structure is important to get right.** The federal community development venture capital program should vet funds of funds and subsidize those, rather than vetting investments. This puts the public sector in the limited partner position but does not preclude holding the private sector accountable. Accountability can be achieved through competitively awarding funds based on impact, incentivizing investments in locations and firms not well served by the market, and prioritizing making smaller investments. Unlike the lower-cost debt the government provides to SBICs, these monies would be provided as flexible grants to advance investment priorities.

- **Learn from and build on the State Small Business Credit Initiative.** The SSBCI program represents a promising and substantial infusion of new resources in support of social purpose equity investing. It is too early to draw firm conclusions from state venture capital programs, but policymakers should carefully study their outcomes and observe how they relate back to underlying design features. While SSBCI has a fairly long implementation timeline, it is not a permanent program, and starting and stopping efforts (as from SSBCI's first iteration to the second) is burdensome and expensive. So too is it unnecessary and inefficient for each state (especially small states) to develop their own approach and set of programs. Future SSBCI efforts can be incorporated as part of a standing community development venture capital program, making use of both the learning and the implementation expertise developed under SSBCI. The leverage ratio currently mandated by SSBCI should be lowered, and states should also be required to invest some of the money they earmark for venture capital as grants to be used by funds making smaller equity investments with a focus on disadvantaged communities.

- **Provide robust funding to cover start-up costs for emerging fund managers and ecosystem developers by expanding the EDA B2S program.** The B2S program offers a model to follow but is currently too small to reach the geographic areas and groups that have historically lacked access to equity capital.
- **Modify NMTC program regulations to better allow the program to be used for venture capital investments in operating businesses.** Currently, CDE applicants to the program are evaluated in part on the percentage of the equity investment dollars they receive (QEIs) that they plan to invest in the form of Qualified Low-Income Community Investments—the higher the percentage, the better. Because the transaction costs for an NMTC deal are quite high but do not vary much with deal size, there is a clear incentive to do larger deals. The program regulations could be modified to recognize that CDEs making equity investments in operating businesses (which tend to be smaller than those in real estate deals) will need to direct more of the QEI proceeds toward transaction costs. Consideration should also be given to changing the rules around how capital gains upon exiting the business investment are treated so investors do not fail to meet the "substantially all" test (whereby 85 percent of a QEI must remain deployed).[72]
- **Make substantial reforms to the OZ program.** OZ projects and attempted projects to date demonstrate that incentive structure appears the least workable for operating business investments and projects with the greatest impacts on equitable development (Theodos et al. 2020). The program should (1) support mission-driven funds that are accountable to the community; (2) restrict qualifying OZ investments more narrowly; (3) allow only those investments that pass a "but for" test; (4) restructure the tax benefits to determine incentive size based on the impact; (5) broaden who can invest; (6) require transaction reporting; and (7) conduct a rigorous certification process for Qualified Opportunity Funds (Theodos 2021).
- **Help the SBIC program live up to its potential.** Recent program reforms—including the accrual debenture and staggered licensing fee—have been promising, and the program should be watched closely to see how it progresses. But we anticipate more will be needed if SBICs will again be a cutting-edge tool to advance equity investing to the benefit of entrepreneurs and communities. To that end, the SBA should prioritize, incentivize, encourage, and support the establishment of SBICs with a social mission, including unleveraged SBICs. Among existing SBICs, the SBA should again be subject to duty to serve–style goals so that early-stage and small businesses, businesses in LMI communities, and businesses owned by socially or economically disadvantaged people participate in sufficient numbers.

- **Pilot a friends and family–style grant program.** Angel investors and venture capitalists do not always provide the type of equity that very early or slower-growth businesses need. But these businesses can be important anchors in communities, serving residents and building wealth. The federal government should pilot a program that provides equity-like products, such as forgivable equity when paired with debt from an approved lender. In this sense, the program is akin to down payment assistance provided to first-time homebuyers. Requiring that the equity be paired with debt helps ensure that businesses are viable, as lenders will underwrite the loans. CDFIs are logical implementation partners for this line of work, but these programs could also leverage the use of revolving loan funds or evergreen funds. This model was developed and successfully implemented in Chicago (Theodos and González-Hermoso 2019) and is ready for broader piloting. Other alternative financing models could include revenue-based financing that does not take an ownership stake.
- **Incentivize impact but do not overdo burden.** Part of the challenge with creating impact-focused financing mechanisms is the trade-off between putting in place the guardrails and regulations needed to ensure adequate targeting and making the incentive structure attractive enough that the financing tool will actually be used. Often, guardrails and incentives to invest end up being in competition rather than being complementary. When the federal government has attempted to prioritize impact in financing mechanisms, the approach has been to use stringent regulations and requirements to steer funding to low-income communities, including detailed reporting of and commitments to specific impact measures, which can be costly and labor intensive. As one interviewee said, "What you end up with is you create this impact fund program that has this special category for impact funds that have all these extra requirements of having to invest in low-income communities…If you're going to ask funds to do something extra and more difficult, you need to give them the resources to be able to do that."

The CDFI Fund

Background

The CDFI Fund was established by the Riegle Community Development and Regulatory Improvement Act of 1994. The CDFI Fund is housed within the US Department of the Treasury and was created for the purpose of promoting economic revitalization and community development through investment in and assistance to CDFIs. It operates several programs in support of CDFIs and low-income communities, including the Bank Enterprise Award Program, the NMTC Program, the Capital Magnet Fund, the CDFI Bond Guarantee Program, competitive grant programs for CDFIs, and others. We focus primarily on the CDFI Fund's competitive grant programs, known as the Financial Assistance (FA) Awards programs, as they are most relevant to supporting small business lending and venture capital investing.

As of the most recent update, there were 1,487 Treasury-certified CDFIs, including nonprofit loan funds, banks, credit unions, and community development venture capital organizations.[73] To be certified as a CDFI, and thus become eligible for FA awards, a financial institution must designate and serve one or more "target markets" or "target populations." The target markets are geographic—consisting of one or more "investment areas"—while the target population(s) are based on demographic characteristics such as income and ethnicity.[74] For a financial institution to continue to qualify as a CDFI, 60 percent of its annual investments (by both the number and the dollar volume of loans) must benefit its target market(s).

In the case of small business loans, the determination of whether a loan "qualifies" toward the 60 percent threshold is currently tied to the geographic location of the business, the demographics of the business owners and/or employees, and/or the demographic characteristics of the business's customers.

In December, the CDFI Fund announced some revisions to its methodology for determining whether to certify an organization as a CDFI. Under its newly revised rules, there will also be an evaluation of whether the financial institution is offering "responsible" financial products, with consideration given to factors such as pricing and transparency of disclosures.

The CDFI Fund makes FA awards annually through a competitive process. CDFIs submit a lengthy application that includes both written answers to questions and tables of data that summarize past performance and future projections. The CDFI Fund first looks at several financial ratios to see whether

CDFIs are in line with “minimum and prudent standards” (MAPS), which the fund considers minimum eligibility criteria. In the past, these included the following financial ratios: net asset ratio, self-sufficiency ratio, current ratio, operating liquidity ratio, deployment ratio, portfolio at risk, loan loss ratio, and loan loss reserves as a percentage of loan portfolio. The CDFI Fund never made the target percentages of the MAPS public, and we do not know if they were the same for all CDFIs or if they varied based on the type of lending a CDFI does. Currently, applicants can describe and justify their own standards and show how they are meeting them. Once applicants have cleared this bar, the MAPS are not used to determine who receives an award or the size of the award.

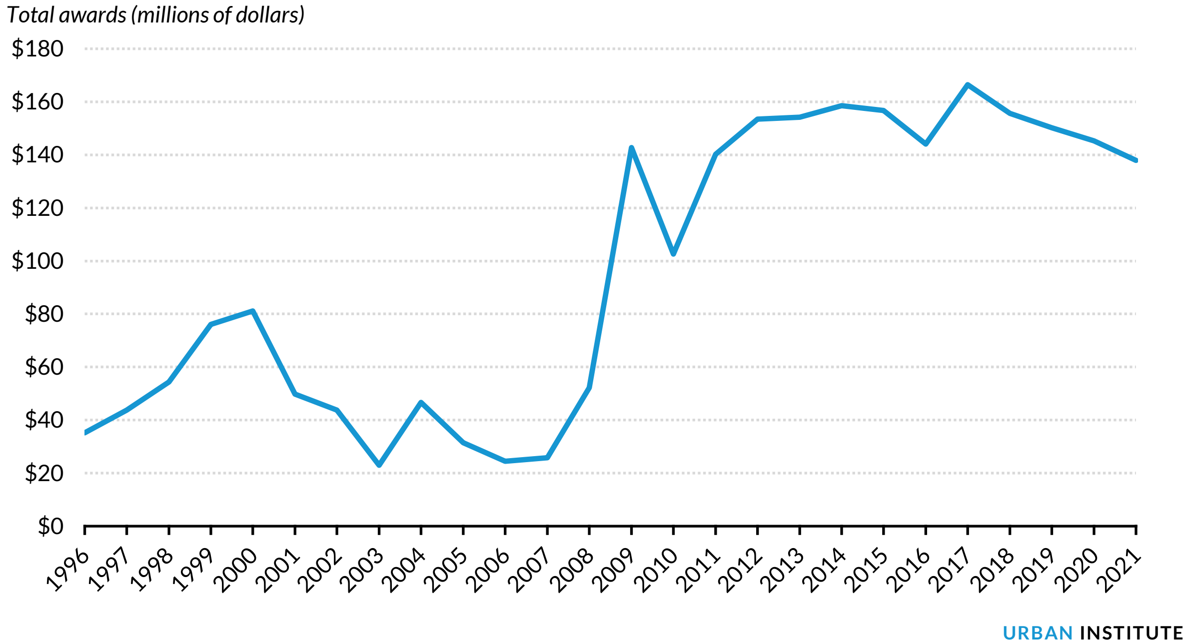
A group of on-staff and outside readers selected by the CDFI Fund score the applications. CDFI Fund staff then conduct additional analyses internally based on certain policy objectives, including geographic distribution of awards and historical performance measures. They then divide the appropriated funds among the top-scoring CDFIs according to a formula that is not publicly available.[75] Not all successful CDFIs are awarded the same amount; instead, there are usually several tiers of award amounts.

The CDFI Fund makes FA awards in amounts that are significant, at least for smaller CDFIs. In recent years, FA awards have ranged from about $100,000 to $1 million. In addition to the regular annual FA awards, Congress will occasionally authorize a one-time additional round of funding for CDFIs (which are not technically considered part of the FA program but may operate similarly), usually in response to a natural disaster or, most recently, in response to the pandemic.

As shown in figures 32 and 33 below, the total amount of CDFI Fund FA awards has grown significantly since the program’s inception, while the average award amount peaked in 2015 and has been dropping since.

FIGURE 15

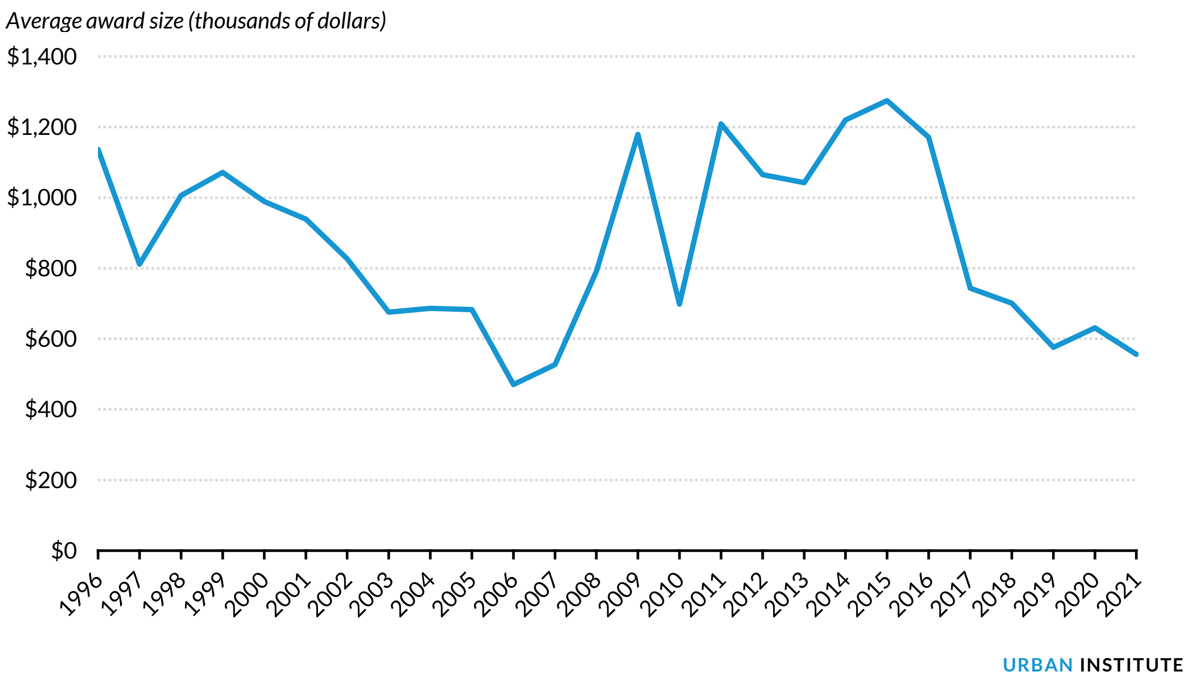
Total CDFI Fund Financial Assistance Awards to All Awardees



Source: CDFI Fund Searchable Awards Database, https://www.cdfifund.gov/awards/state-awards.

FIGURE 16

Average CDFI Fund FA Award Amount



Source: CDFI Fund Searchable Awards Database, https://www.cdfifund.gov/awards/state-awards.

These trends indicate that the fund has been making awards to a greater number of CDFIs on an annual basis. Some interviewees who were focused on increasing the overall scale of small business lending by the CDFI sector argued that giving out small awards encourages the proliferation and ongoing operations of small CDFIs, virtually all of which do their own marketing, underwriting, servicing, and more. This means the CDFI Fund is supporting a system that some interviewees criticize as inefficient and lacking scale. As one person put it, "Both investors and the CDFI Fund are perpetuating a system that is limiting the growth of CDFI small business lending to target markets."

Other interviewees were more concerned about having a deep impact in the communities served by CDFIs and argued that smaller, place-based CDFIs are better able to make "difficult loans" and support the most disadvantaged borrowers than are larger CDFIs. Some respondents suggested that there may be a middle path, with smaller CDFIs outsourcing some functions to larger CDFIs or service providers and focusing on what they do best in local communities. One CDFI sector leader noted, "Smaller CDFIs with close connections to community should become originators and loan servicers and table fund their loans or refer them into larger pools and capital providers to ensure liquidity and scale. This could be facilitated by the CDFI Fund in collaboration with larger CDFIs that have the capacity to vertical[ly] integrate up the capital chain."

What's Working

Interviewees within and adjacent to the CDFI sector identified several strengths of the FA programs. They expressed confidence in the application and review processes and praised the CDFI Fund for its ability to operate several programs with lean staffing.

FA recipients articulated that the most important feature of the grants is that they come with far fewer restrictions than funding from most other government programs and private funders. The CDFI Fund does require that FA awards be expended for activities in the following five categories: financial products, financial services (insured depository institutions only), loan loss reserves, development services, and capital reserves (insured depository institutions only). But these are broad categories. One CDFI leader reflected that FA awards make a difference because "they fund you and say 'go make loans'" rather than prescribing specific processes.

Unrestricted funding from the CDFI Fund helps CDFIs make more and riskier loans. An observer shared that with expanded FA awards, CDFIs can take on greater risk than banks are willing to do, even with an SBA guarantee. FA awards help facilitate greater risk in lending by increasing CDFIs' unrestricted net assets. A higher net asset ratio also lowers the risk of lending to a CDFI, which can result in better interest rates on the money it borrows. Saving on interest can lead to more financial strength for the CDFI or lower rates charged to its small business customers, or both. A higher net asset ratio also means the CDFI has more "cushion" in the event of loan losses, which means it can choose to make riskier loans if its management and board want to. Thus, the unrestricted FA awards enable CDFIs to borrow more from banks and other lenders to fund loans and to make riskier loans. The equity (rather than debt) nature of the FA award also provides the CDFIs with capital for enhancing technology and trying new products.

Nearly everyone interviewed felt that additional funding for the FA programs would be an effective investment, especially if the design challenges noted below were mitigated. One lobbyist noted that Congress has confidence in the CDFI Fund to administer programs, as evidenced by the large increase in CDFI funding as part of the federal pandemic relief response.

What's Not Working

We also identified areas of the FA programs that could be improved.

FA awards are unpredictable. Several interviewees expressed frustration that it is hard to plan for the future not knowing whether they will receive a large CDFI Fund FA grant in any given year. A CDFI might win an FA award four or five years in a row and then get shut out in year six, even if they demonstrate stronger performance. Said one CDFI executive, "We were seeing double-digit growth in lending to our target market year after year and consistently getting FA awards. Then, in a year when we originated more dollars than before, we did not receive an award." CDFIs applying for FA awards feel they are occasionally given a "time out." We should note that there is no written or official policy at the fund regarding this practice. One interviewee suggested that if there is such an informal policy, it should be made transparent. "Maybe you can only win an award four or five years in a row, then you have a one-year break." There was significant disagreement from others about the merits of such a policy.

FA awards are not tied to performance. Several interviewees said the CDFI Fund's effectiveness in supporting small business lending was hampered because funding for CDFIs that lend to small businesses is not explicitly tied to performance. Past performance is given consideration during the evaluation process for FA awards, but that seems to be the only real accountability. If a CDFI receives a large financial award from the federal government, the only way it can be held accountable for poor performance over the award period is to not receive future awards. One person suggested making the awards restricted grants, with the funding released from restriction only as performance targets are reached. Another proposed awarding the funds on more of a rolling basis: "You want an FA 2.0 that says you'll be awarded on a competitive basis, depending on how much leverage you can get or how many loans you can make. It needs to be some kind of performance-based process with a more transparent way of awarding those dollars in real time, like on a quarterly basis rather than a giant annual allocation." Admittedly, since some borrowers or markets are more difficult and costly to lend to than others, there would be a need to award bonus dollars for loans that meet certain criteria or are located in challenging geographies.

Some argue that we need to rethink how smaller CDFIs lending to small businesses operate. Several interviewees observed that most CDFI small business lenders make very few loans yet have "soup to nuts" operations, which means there is duplication and inefficiency in the sector. One CDFI executive posited that by continuing to fund so many CDFI small business lenders, the CDFI Fund and other funders are "elongating the period of time for CDFIs to really get their act together, instead of actually supporting the behaviors that would allow the industry to mature." Some argued that small CDFIs can achieve deep impact in the most difficult markets, but there was general agreement that there is a need for more collaborative models and some consolidation.

The FA award scoring process does not always consider off-balance-sheet lending. For a loan, or a portion of a loan, to count toward a CDFI's FA and certification goals, it must at some point sit on the CDFI's balance sheet. Several CDFIs have begun selling portions of the loans they originate to banks and other investors to alleviate pressure on their net asset ratios or because they can command an attractive premium from CRA–motivated bank buyers. In almost all cases, the CDFI continues to service the loan and maintain the relationship with the borrower, while also maintaining a portion of the loan risk. This structure would appear to deliver full "credit" to the CDFI only if it holds the whole loan on its balance sheet for at least a short period. However, CDFIs with major balance sheet constraints may want or need to originate loans directly onto the balance sheets of other entities, including special purpose vehicles such as limited liability companies. In addition, most CDFI small business lenders are nonprofits and therefore cannot receive true equity investments, though some are setting up limited liability companies or limited partnerships that allow them to accept equity investments and open a new source of capital. There was confusion among interviewees about whether the CDFI Fund would give credit for this type of off-balance-sheet lending.

Current rules do not allow most community development venture capital funds to receive FA awards. Although multiple CDFIs are introducing debt products with equity-like features, community development venture capital CDFIs are the only ones making true equity investments in small businesses. Many new businesses do not generate revenue right away, so financing them with debt is not appropriate or desirable. Community development venture capital CDFIs provide the equity that early-stage, high-growth companies need to launch and ultimately create jobs in CDFI target markets. Unfortunately, since almost all venture capital investing is done through off-balance-sheet special-purpose vehicles, it is impossible for most community development venture capital organizations to qualify for FA awards. To qualify for an FA award, an entity must already have a track record of lending or investing. Venture capital funds, however, raise all their capital (housed in a special-purpose vehicle) before they do any investing. As one observer reflected, it would be highly impactful to be able to include FA funding in the capital stack of a community development venture capital fund.

Recommendations

Many interviewees recommended that the CDFI Fund prioritize support for small business lending and lenders. The target market for CDFI small business lending—young companies and companies owned by entrepreneurs with little experience and/or access to capital from friends and family, including many entrepreneurs of color—requires specialized support, underwriting, terms, and servicing over the life of the loan. The loans are characterized by their small size, short maturities, and limited or no collateral, making them inherently more costly and risky. All these characteristics make these loans more costly per dollar lent than real estate loans, and in contrast to CDFI real estate lenders, CDFI small business lenders have less access to capital markets and other sources of financing. In addition, the field is developing technology that holds promise for reaching significant scale in lending to the target market. Development and deployment of this technology, especially beyond some large industry leaders, will require support from philanthropic and government sources, including the CDFI Fund. An executive at a large national CDFI said, “If I were a policymaker, I would absolutely be advocating for set-asides or a specific focus on small business in the community finance space.” He was echoed by a longtime lender to CDFIs, who said that “half of the FA funding should go to small business lenders.”

Additionally, specialized support for CDFI small business lenders is long overdue. The question, then, is how to structure such additional support for small business lending.

Financial Assistance Growth Fund for Small Business

Building from suggestions we heard from interviewees, we recommend creating a new dedicated Financial Assistance Growth Fund for Small Business (SB-FA). There is a strong precedent for dedicated FA funding for high-need uses and communities, including Disability Funds–Financial Assistance (DF-FA), Persistent Poverty Counties–Financial Assistance (PPC-FA), Healthy Food Financing Initiative–Financial Assistance (HFFI-FA), the Capital Magnet Fund for housing, and the Native Initiatives program.

Depending on the risk level of the borrowers the government wished to target, the CDFI Fund could provide a significant amount of equity capital (e.g., $1 million) to individual small business–lending CDFIs that were willing to commit to making a specified number of loans, in a multiple of the capital provided. If the CDFI Fund wished to target especially risky loans, the multiple could be relatively low; conversely, if volume were more important, the multiple could be higher.

Several people working for or lending to CDFIs suggested that these organizations could do far more if they were not as dependent on philanthropy to cushion the risk of such loans. Noting that raising philanthropic capital probably costs a CDFI 20 cents for every dollar raised, one person suggested the government provide CDFIs equity "to get these organizations out of the business of having to raise philanthropy to put up as equity in their financing, [lowering] their effective cost of capital so that they can deliver more loans to more small businesses that are relatively new."

The SB-FA award could come with other covenants and conditions (relating to, for example, loan size and the speed with which the money had to be deployed). There are, at present, a limited number of small business–lending CDFIs whose business models would enable them to use these funds effectively and at scale to reach currently underserved businesses, but this form of investment would also help grow the sector. The combination of the CDFIs' mission and the fact that the CDFIs would have their own money at risk will help lead to positive outcomes and a deeper reach into the pool of businesses needing loans.

With respect to structure, we recommend that SB-FA awards have a substantial pay-for-performance element, under which CDFIs are rewarded for significant increases in volume but also receive bonus funding for lending successfully to the most difficult-to-serve small businesses. We recognize that the pay-for-performance approach may not work well for new CDFIs that need to build up net assets before they can do meaningful lending. The CDFI Fund has in the past carved out a portion of funding for "small and emerging" CDFIs and could address the needs of those CDFIs that way.

Improve FA Award Making

In addition, we recommend the following three adjustments to the traditional FA program.

Better distribute awards over time. We recommend that the CDFI Fund better distribute awards over time and not restrict the number of years in a row that a CDFI is eligible for an FA award without clear criteria and advance notice. This will enable CDFIs to better plan their business flows and capital needs and reduce the time and effort spent preparing applications.

Clarify how off-balance-sheet lending is given consideration. Making use of special-purpose vehicles can enable CDFIs to undertake more risk, access equity (as opposed to debt) capital, and offer investors a security interest in underlying loans, among other benefits. The CDFI Fund should recognize off-balance-sheet lending that reaches a CDFI's target market in the FA award review and certification process.

Make community development venture capital funds eligible for FA awards. New legislation is needed to clarify that the CDFI Fund can (and should) take into account the parent organization's overall track record in awarding FA funding toward a newly launched venture capital fund.

Business Development Support

Multiple federal programs provide services to foster the establishment, growth, and sustainability of small businesses. In most but not all cases, the federal role includes funding, oversight, and data tracking, with programs administered at the state and local levels, and often working through nonprofit providers. Many of these nonprofit providers access or raise nonfederal support as well, and several of the federal programs require grantees to raise matching funds to access the federal support.

Technical assistance comes in the form of counseling, coaching, training courses and materials, mentoring, business incubation, technology services, or other types of assistance. Support can be offered to groups or individuals, virtually or in person. Business development support can be asynchronous and noninteractive (e.g., videos), asynchronous and interactive (e.g., apps, web tools), or synchronous (e.g., a course or regular group meeting). Federally funded technical assistance services are often reactive (e.g., responding to an inquiry from a business owner), but some providers perform outreach and community engagement strategies.

The content or intended goals of assistance can cover a variety of topics. Owners may get help developing a business plan, preparing for or accessing a loan, or dealing with other employment, marketing, legal, tax, procurement, or financial matters. Some programs are geared toward a specific industry, geography, group, type of owner or firm (e.g., women owned), or intended outcome (e.g., procurement). In addition to federally supported efforts, states, localities, philanthropies, and large corporations such as banks also support business development services, sometimes through the same groups that receive federal support. The result is a complex array of programs and providers, combined with still incomplete coverage.

Federal Program Background

We have identified more than two dozen programs that offer some form of technical assistance services. While the SBA is the largest funder and administers the most programs, several other federal agencies including the Treasury, USDA, HUD, the US Department of Transportation, and the US Department of Defense (DOD) also offer technical assistance programs.

Table 5 provides a summary of federally supported small business development programs and shows budget appropriations for these programs for FY 2018 to FY 2023. As the table highlights, the SBA's Small Business Development Center (SBDC) program is the largest program, in some years constituting a majority of federal investment in business development services. Other large technical assistance programs include the Community Navigator Pilot Program, technical assistance as part of the SBA Microloan program, and the State Trade Expansion Program (STEP).

The US Department of Commerce underwrites technical assistance programs through the Minority Business Development Agency (MBDA) for "socially or economically disadvantaged" businesses and coordinates the participation of all federal agencies in increasing support for minority businesses (Lawhorn 2023). The MBDA supports training for minority business owners to become "first- or second-tier suppliers to private corporations and the federal government" (Dilger, Levin, and Blackford 2021). The Department of Commerce also funds business assistance through the EDA. The EDA's Trade Adjustment Assistance for Firms (TAAF) program helps businesses that have been harmed by increasing imports of competitor products to develop and implement recovery plans (Theodos, Edmonds, Teles, et al. 2021a). The Department of Commerce also supports US Export Assistance Centers, which act as support hubs for small businesses that are either expanding or looking to start an export business (Ilias, Hanrahan, and Villarreal 2013).

The US Department of the Treasury is supporting business development services through the SSBCI, funded through the American Rescue Plan Act. The initial act included $500 million to fund technical assistance, $100 million of which went to the MBDA to bolster the agency's work, with significant other funding allocated to the states.

The Community Development Block Grant (CDBG), administered by HUD, is a flexible block grant to states and localities. In an average year, 1 to 2 percent of CDBG funding goes to underwrite technical assistance to small businesses.

USDA runs a range of programs with technical assistance offerings. USDA comprises 15 agencies that focus on different but sometimes overlapping aspects of farming, food production and distribution, conservation, and rural development. Each agency has a set of programs or focus areas, many of which offer funding opportunities and technical assistance. A few of these programs are highlighted in appendix B.

The Department of Transportation, a major issuer of contracts whose work expanded significantly with the Infrastructure Investment and Jobs Act of 2021, runs 11 regionally based Small Business Transportation Resource Centers to assist small businesses that are or may become contractors to the department or under other federally funded contracts.

Multiple agencies run Mentor-Protégé programs aimed at pairing small businesses with more experienced businesses with similar and complementary services to partner on federal contracts. These include the Department of Energy, the Department of Homeland Security, NASA, the SBA, and the Department of Transportation. Lastly, there are APEX Accelerators, which are aimed at assisting new and existing federal contractors to develop and prepare bids, as well as provide overall business advising support. While managed by the DOD, APEX Accelerators (formerly known as the Procurement Technical Assistance Program) connect small businesses with contracting opportunities across many government agencies. The program establishes centers through cost-sharing agreements. These centers serve as a resource hub for businesses to learn how to successfully compete for federal contracts. Centers are expected to collaborate significantly with federal agencies to deliver robust programming, and the DOD plays a strong role in shaping and influencing the strategy of the centers.

TABLE 5

Overview of Federal Technical Assistance Programs

Program	Created	Description of program	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023
Small Business Development Centers (SBA)	1979	SBDCs offer a range of support through individualized counseling services. SBDCs are located throughout the US, with 62 lead service centers that manage over 900 outreach locations.	$131.4 million	$131.1 million	$136.4 million	$136.9 million[a]	$140.0 million[b]	$140.0 million[b]
Community Navigator Program (SBA)	2021	Developed as part of the American Rescue Plan Act, this program funds various entities to partner with the SBA in a hub-and-spoke model to provide historically underrepresented small businesses with access to a network of hyperlocal support services.	-	-	-	$11.6 million	$119.9 million	$30.0 million[c]
Microloan Program Technical Assistance (SBA)	1991	The Microloan program offers technical assistance to borrowers and prospective borrowers. The SBA does not require borrowers to participate in technical assistance programs and training, but lending intermediaries will often require beneficiaries to participate, in part because the intermediaries are eligible for operating grants, which are tied to the amount of technical assistance they provide. There were more than 20,000 microloan borrowers accessing technical assistance in 2019.	$31.6 million	$34.0 million	$34.7 million	$44.8 million	$58.2 million	$41.0 million
Women's Business Centers (SBA)	1989	WBCs connect women entrepreneurs to programs and services offered by SBA district offices and offer business development services for women entrepreneurs.	$17.3 million	$16.7 million	$18.1 million	$26.4 million	$22.6 million	$27.0 million
State Trade Expansion Program (SBA)	2011	STEP makes awards to states, which in turn make competitive grants to businesses seeking to increase exports.	$18.0 million[d]	$18.1 million[d]	$19.0 million[d]	$16.0 million[d]	$24.3 million[d]	$20.0 million[d]

		Business development services are an eligible grant use.						
Veterans Outreach Programs (SBA)	Multiple	There are multiple programs geared toward assisting and supporting businesses owned by veterans and service-disabled veterans, including programs aimed specifically at women veterans. These programs mainly provide training services and counseling to businesses; some programs focus specifically on supporting businesses to tap into federal procurement.	$12.6 million	$12.2 million	$14.6 million	$13.8 million	$13.8 million	$17.5 million
Service Corps of Retired Executives (SCORE) Business Mentors (SBA)	1964	SCORE is a program staffed by volunteer mentors who offer free or low-cost advice and support to small business owners on an ongoing basis. The program also provides other services such as training, online workshops, and on-demand courses.	$11.5 million	$11.7 million	$11.7 million	$12.2 million	$14.0 million	$17.0 million
Federal and State Technology (FAST) Partnership Program (SBA)	2001	The FAST program provides grants to eligible business support organizations to assist small businesses participating in or interested in participating in the Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR) programs.	$3.0 million[e]	$3.0 million[f]	$3.0 million[g]	$4.0 million[h]	$5.5 million	$10.0 million
Program for Investors in Microentrepreneurs (PRIME) (SBA)	1999	The PRIME program provides grants to organizations (such as MDOs and CDFIs) to deliver capacity-building services to small businesses. These competitive grants are targeted at disadvantaged microentrepreneurs and very-low-income persons. To be eligible, applicants must demonstrate a record of delivering technical assistance and other services to disadvantaged entrepreneurs. Grantees must also match 50 percent of the award with nonfederal dollars (CDBG funds are allowed as a matching source).	$5.3 million	$4.9 million	$5.6 million	$5.2 million	$7.2 million	$8.0 million

7(j) Management and Technical Assistance Program (SBA)	2013	The 7(j) program provides technical training covering a wide range of topics, such as marketing, accounting, contract management and compliance, and business financial health to eligible businesses (mainly focused on owners living in low-income areas, high-unemployment communities, and other economically disadvantaged groups). In FY 2023 and FY 2024, there are changes planned that will have a specific focus on assisting businesses with winning federal contracts.	$3.1 million	$3.5 million	$3.9 million	$3.3 million	$2.5 million	$4.0 million
Native American Outreach Program (SBA)	1992	The Office of Native American Affairs offers free technical assistance across a wide range of topics, such as marketing, operations, and opportunity development and capture. Programs and resources are available through existing SBA district offices, SBDCs, or CDCs.	$695,000	$2.2 million	$1.6 million	$1.9 million	$1.8 million	$4.0 million
Mentor-Protégé Program (SBA)		Eligible small businesses (protégés) gain capacity and win government contracts through partnerships with more experienced companies (mentors); mentors and protégés may compete together for joint ventures and other set-asides.	$2.2 million[i]	$2.2 million[i]	$2.1 million[j]	$2.2 million[j]	$1.7 million[k]	$2.2 million[k]
APEX Accelerators Program (formerly Procurement Technical Assistance Program) (DOD)	1984 (PTAP)	APEX Accelerators help small businesses that are interested in government contracting, including helping to determine if a business is ready for government contracting, registering in the proper databases, and finding and bidding on contracts. There are 90 APEX Accelerators across the US.						
T.H.R.I.V.E. Emerging Leaders Reimagined (formerly	2014	This seven-month leadership education series focuses on the next stage of a business's growth. It offers high-growth small businesses in underserved communities specialized training and	$9.3 million	$5.9 million	$3.5 million	$1.8 million	$3.3 million	$3.0 million

Entrepreneurship Education) (SBA)		networking, with the goal of producing a three-year strategic growth plan.						
Growth Accelerators (SBA)	2014	Growth Accelerators are organizations, usually run by experienced entrepreneurs, that are aimed at providing guidance on how to start and grow businesses, as well as help to access seed capital and other mentors. The SBA provides $50,000 in matching grants to accelerators. Each year, the SBA administers the Growth Accelerator Fund Competition (GAFC) to support accelerators that are supporting STEM– and R&D–focused businesses. Since 2014, the GAFC has supported 284 unique winners.	$1.0 million	$2.7 million	$604,000	$4.1 million	$297,000	$12.0 million
Regional Innovation Clusters (SBA)	2009	Place-based local collaborations focused on developing and growing the supply chain of specific industries that are relevant to a specific geography. Services offered through the initiative include one-on-one counseling, matchmaking and networking events, and information dissemination.	$2.9 million	$5.5 million	$3.5 million	$4.8 million	$5.7 million	$10.0 million
Minority Business Development Agency (Department of Commerce)		Through a network of business centers, the MBDA provides technical assistance and training to minority-owned businesses to help them secure contracts and capital awards to provide services/supplies to the federal government and private corporations.	$39.0 million	$40.0 million	$52.0 million	$73.0 million	$55.0 million[l]	$70.0 million
EDA Trade Adjustment Assistance for Firms (TAAF)		Administered through EDA, TAAF provides funding to support a network of 11 regional Trade Adjustment Assistance Centers (TAACs) that provide technical assistance to trade-impacted firms. Universities, state or local governments, and nonprofit organizations can operate a TAAC, which allows them to receive	$13.0 million[m]	$13.0 million	$13.0 million	$13.5 million[n]	$13.0 million	$13.0 million[o]

		funding to operate and staff the center. No direct funds are provided to firms.						
Community Development Block Grant (CDBG) Economic Development budget (HUD)[p]		CDBG is a flexible source of funding for a wide variety of economic and community development activities. Under the Economic Development budget, funds may be used for acquiring and redeveloping existing structures, providing direct financing and technical assistance to businesses, and providing other economic development services.	$52.2 million	$54.2 million	$72.2 million	$132.9 million	$95.8 million	Not yet available
USDA Technical Assistance Programs		USDA offers a vast range of technical assistance programs. Comprising 15 agencies spanning farming support, plant and animal health, forestry and conservation, and more, there are numerous technical assistance opportunities within each agency. Notable programs include the Conservation Technical Assistance program, the Rural Cooperative Development Grant program, and the Community Facilities Technical Assistance and Training Grant.						
US Export Assistance Centers (Department of Commerce)		These business support centers are aimed at US exporters. They offer technical assistance for establishing or expanding export activities. USEACs can support businesses in tapping into new foreign markets by facilitating meetings and travel and closing deals. They also offer access to financial services, such as connecting businesses with specialists at the Export–Import Bank of the United States, which offers financial products to expand US export activities.						
State Small Business Credit Initiative (Treasury)	2021	SSBCI, funded through the 2021 American Rescue Plan Act, allocates funds to be disbursed over five years to				$500 million (of which $100		

	multiple types of business technical assistance providers.		million goes to MBDA)
Small Business Transportation Resource Centers (Department of Transportation)	These centers are regional grantees (501 (c)(3) and (6)) that offer technical assistance and other support programming to small, disadvantaged transportation businesses. The focus of the services offered is to assist businesses in accessing federal contracting opportunities.		

Sources: Congressional Budget Justification reports from 2017 to 2023 and Congressional Research Services reports from 2017 to 2023 (details in notes); Urdapilleta et al. (2021).

[a] FY22 Congressional Budget Justification, SBA, updated March 2022.

[b] FY23 Congressional Budget Justification, SBA, pdated March 2023.

[c] "Budget of the US Government, Fiscal Year 2024," The White House, March 2023.

[d] Figures for these programs are total federal expenditures, not funding for technical assistance services alone.

[e] "SBA Awards Grants to 24 State and Local Economic Development Entities, SBTDCs, and Universities to Support Small Business Innovation and R&D Commercialization," SBA, August 29, 2018.

[f] "SBA Awards Grants to 24 Organizations to Support Small Business Innovation and R&D Commercialization," SBA, August 27, 2019.

[g] "SBA Awards Up to $3 Million in Grants to Organizations Supporting Small Business Innovation and R&D Commercialization," SBA, September 18, 2020.

[h] "SBA Awards Grants to 33 Organizations to Help Underserved Communities Succeed with the Small Business Innovation Research Program," SBA, August 11, 2021.

[i] FY20 Congressional Budget Justification, SBA.

[j] FY22 Congressional Budget Justification, SBA.

[k] FY23 Congressional Budget Justification, SBA

[l] "The Minority Business Development Agency: An Overview of Its History and Programs," Congressional Research Service, August 31, 2022.

[m] "Trade Adjustment Assistance for Firms," Congressional Research Service, October 13, 2020.

[n] "Fiscal Year 2022 Congressional Budget Request," US Department of Commerce Economic Development Administration, May 28, 2021.

[o] "Fiscal Year 2024 Congressional Budget Request," US Department of Commerce Economic Development Administration, March 13, 2023.

[p] CDBG estimates taken from grantee reporting to HUD for activity codes 18b and 18c. For more, see "CDBG Activity Expenditure Reports," HUD Exchange, 2023.

What’s Working

While small business owners, lenders, and stakeholders we spoke with were more often critical of challenges and gaps in technical assistance programs, service providers and industry groups were generally positive, while recognizing constraints and areas for improvement.

Interviewees highlighted six strengths to the small business development services ecosystem. Firstly, there is an abundance federal business support program offices and sites across the country, with at least one type of business support center in every state. In many jurisdictions, there are networks of local federal support centers, such as SBDCs, WBCs, or other types of centers, making the availability and coverage of small business support services geographically wide-spread.

Secondly, federal small business development services provide assistance to a high volume of small businesses. For example, an SBDC in Cleveland services over 1000 clients per year, and offers programming in English and Spanish.

Third, the services provided by the business support centers are wide-ranging, and cover many of the business fundamentals that are critical to successfully running a business, as well as offering more specialized training opportunities. In addition, the services offered are typically free for business owners, which makes them particularly accessible to businesses that are just starting out, or small businesses with low revenue generation. Referring to an SBDC, one business owner said, “They have been really instrumental in the groundwork, learning the bookkeeping, helping me navigate the state register, getting jobs, helping me do my finances—anything I need. It was like I finally had someone that knew the things I needed and how to help me get it, and grow it—that was the greatest.” Our interviewees highlighted that there are stand-out examples of technical assistance providers going “above and beyond”, including examples of providers implementing federal programs particularly well. WBCs and contracting technical assistance programs such as DOT’s Small Business Transportation Resource Centers (SBTRC) and DOD’s Apex Accelerators were highlighted as providing a particularly valuable service to small businesses. One interviewee referenced a survey they did of SBTRC clients, noting that almost 40 percent of businesses that participated in this program received a contract within a year.

Fourth, in addition to being an important service for small businesses, federal small business support centers are an important contribution to local small business ecosystems. For example, SBDCs can serve as a connection point for a variety of services offered throughout an ecosystem, such as connecting small businesses to lenders, philanthropic support, other technical assistance providers, and government procurement.

Fifth, organizations that operate SBDCs or WBCs have expressed that being part of a formalized program provides a framework that helps in their program design, as well as allowing for flexibility to provide programming that is specific to local needs. Lastly, organizations operating business support centers receive robust and consistent funding support, and appropriations for business support services has seen consistent bi-partisan support for many decades.

I appreciate being part of an SBDC because it gives me a framework and it gives me the ability to measure our work and the quality of our work and it gives me resources to help our entrepreneurs.
—Business support organization

What's Not Working

Below we discuss what interviewees report is not adequately working with respect to federal technical assistance programs, focusing on six main areas: (1) accessibility and geographic coverage of providers; (2) marketing, awareness, and outreach; (3) coordination and integration challenges; (4) content, expertise, relevance, and relatability; (5) alignment between technical assistance and lending; and (6) measuring outcomes in technical assistance.

Accessibility and Geographic Coverage of Providers

It is not known how many businesses receive assistance annually through federal support, but a rough count indicates at least 300,000 to 800,000 businesses served each year through leading SBA technical assistance programs, with additional businesses served through other federal programs.[i] This is a sizable number, but also a fraction of the roughly 6 million employer firms in the US (SBA 2023). Thus, despite a significant amount of technical assistance funding via a number of programs, the vast majority of small businesses do not access federally supported technical assistance. How well does the supply of business development services match the demand for help? While "ecosystem mapping" is a technique used to answer this question in specific geographies or industries, to our knowledge, there has not been a rigorous demand analysis at the national scale of the potential market for assistance.

Some metropolitan regions appear to have a sufficient number of technical assistance providers, in part because nonfederal providers were adequately filling any gaps in the federally supported programs. For example, in a recent study of the Kansas City small business support ecosystem, we found a thriving and sufficient number of technical assistance providers (Theodos, González-Hermoso, and Hariharan 2022). In another study that measured the business support ecosystem in western New York, research revealed that there was a high volume of business support organizations (BSOs), but highlighted important features of a business ecosystem that go beyond just having a sufficient number of BSOs (Theodos, Su, and Nunna 2023). And another assessment found 138 BSOs serving the Buffalo and Rochester regions in western New York, with little specialization and most BSOs acting as a one-stop shop and offering technical assistance mainly related to core business services (Next Street 2018). Collectively, research highlights that while there are many BSOs available to businesses, there is duplication between them, and missed opportunities to provide more specialized support.

In less connected and integrated regions, interviewees noted the geographic and institutional location of BSOs constrains the ability of federally funded technical assistance to be relevant and accessible to small businesses. For example, in more rural areas, there is likely to be one Small Business Development Center (SBDC) serving a vast geography, making it infeasible for many businesses to rely on the center for support. As one interviewee said, "For rural business owners, in particular, it's challenging to access that local, in-person support." We also heard that the hours that BSOs operate pose challenges for owners who need to operate their business during those times.

What [the federal government is] doing is way, way underproportioned to, first, the scale of the challenge and, second, to the amount of debt capital that we're providing. The technical assistance programs are the poor distant cousins of the capital programs. I would argue that there's a huge amount of value in technical assistance that we're not really delivering.
—Lender

Marketing, Awareness, and Outreach

In areas with BSOs, interviewees still observe challenges to accessing services. Respondents stated that many BSOs are not integrated into existing institutions or networks, and that business owners have challenges navigating service providers. This confusion often remained even after a business had received assistance from a BSO.

Technical assistance providers agreed that they struggle with raising the visibility and awareness of their offerings. As one BSO representative said, “People don’t find us by foot traffic, that’s for sure. They don’t come by us by just driving by us on Main Street and saying, ‘Oh, there’s a Women’s Business Center. I should walk in and check out what that’s all about.’” Under SBA rules, SBDCs are not funded for marketing, and must rely on building local relationships, such as with banks, who will refer clients to them. As one interviewee recounted, “We’re not allowed to pay for advertising. That is one of our biggest challenges, as far as being able to push ourselves out there to actively engage.”

Business owners expressed frustration that federally funded technical assistance programs often work passively, rather than proactively identifying businesses to serve. Interviewees serving small businesses noted that outreach to small businesses across groups is “personality driven,” which makes outreach inconsistent. In some cases, BSOs will make efforts to reach out to businesses. In most instances, we heard that outreach efforts are lackluster and aren’t leveraging relationships or connecting businesses to experts and opportunities. In general, interviewees, including those working within BSOs, said that marketing and outreach to small businesses is insufficient, especially outreach to businesses that are run by entrepreneurs outside of traditional businesses circles.

While the widespread use of the Paycheck Protection Program led to greater visibility for the SBA, we were told there is limited awareness among business owners of the agency and its offerings, and even less familiarity with other federal agencies’ small business supports. Against this background, many interviewees reflected that SBA or EDA or HUD district or regional offices are not a meaningful referral or marketing source for BSOs. As one stakeholder observed, “If you ask business owners how they get in touch with their local district office, or how effectively their district office is helping them in terms of that technical assistance or that connection to a local system, a role that SBA should ostensibly be filling, prior to the pandemic, they probably didn’t do a good job.” It is worth noting that past or present district or regional federal staff we interviewed felt differently, believing that they were making meaningful connections between small businesses and support providers on a frequent and ongoing basis.

Coordination and Integration Challenges

While many geographies are not adequately served by BSOs, others are home to multiple federally and nonfederally supported BSOs. In those environments, we heard about challenges with coordination and integration. Business owners, lenders, and even BSO operators reported not always being familiar with other groups and their areas of specialty, especially as the technical assistance provided can evolve from year to year. We heard from several business owners that they didn't understand the array of programs, how they differ, or which is the best fit in which context.

Respondents said that federally funded technical assistance (as well as nonfederal technical assistance programs) are not well coordinated, creating an uneven patchwork of programs. As one respondent stated, it is unclear "how all of the organizations that are pushing to help small businesses fit together to create a robust network that ensures that small businesses are getting driven into the programs that help them."

As a result of this ineffective coordination, entrepreneurs sometimes feel the need to seek help from multiple providers, starting over each time they seek support. As one owner reflected, "There's no one-stop shop, like our medical system where doctors can really catch up on where you're at, so people can start from there instead of starting from scratch…It can be repetitive…You're doing a full intake or assessment every time you approach [a BSO]…If I were seeking paid support, instead of something that's grant funded, I don't think that I would be experiencing that."

A lack of coordination is not equally a concern in every market. In some markets, we heard of nonprofits and other intermediaries acting as referral partners. In others, there is an umbrella organization that can draw from a wide range of experts and technical assistance offerings across a vast geography (multiple states), as well as link businesses to lending or other capital resources. In general, however, there is a sense that coordination is not adequate. As one observer reflected about federal technical assistance programs and centers, "A lot of them are siloed and would be more impactful if people can figure out how to connect better."

In other markets, where SBDCs are better integrated with other federal technical assistance offerings, colocation seems to play a role. Additionally, when a BSO offers technical assistance that is distinct from another BSO, it is easier for them to complement one another. This may only be possible when a clear relationship has been established and there is an understanding of the specific distinctions between roles. As one interviewee noted, "Well, actually, our function is pretty separate. … So many times, we're housed within the same programs within a university. There's a synergy there. I refer clients to the SBDC that need help with growth. They may come to me, and they're a start-up. Then they may refer a client that has growth, and they want to increase their markets. We get a lot of referrals back and forth. We have to make a judgment at that point if they're more suited to a program with the SBDC first or second."

Content, Expertise, Relevance, and Relatability

We heard mixed views on the content, expertise, relevance, and relatability of federally supported small business advising. Respondents acknowledged that providing effective technical assistance is no easy feat—the range of business sizes, industries, ages, and contexts means that the needs of businesses are vastly diverse and ever changing, as is their capacity to participate in technical assistance programs. This means that technical assistance programs face the challenge of being general enough to be relevant to most businesses, while also focusing on areas where there is a clear need, such as pre- or post-loan technical assistance and capital readiness.

We heard several areas of criticism where small business owners or stakeholders sought improvements in the content and delivery of federal small business development services.

- **Not sufficiently advanced.** Many interviewees said the quality and effectiveness of the available technical assistance programs needs improvement. This was often linked to the curriculum or content not meeting the needs of businesses beyond just providing information on how to start a business, and that some programs can be "too basic." A prevailing overall sentiment on content and curriculum offered through the various technical assistance programs is that the programs do not match the nuanced needs of entrepreneurs and businesses and are especially falling short in providing "contextually responsive" solutions for businesses. One interviewee suggested that "organizations that get all or most of their funding from one government source, and don't need to hustle for money or demonstrate meaningful results, are not very likely to become high performers."
- **Insufficient technical expertise and emphasis.** We heard from service providers, business owners, and observers that technical assistance staff tend to have more general knowledge rather than specific expertise and that staff emphasize (some said overemphasize) basic business knowledge as a core part of the curriculum. For example, one respondent made the point that the curriculum is too focused on how to start a business and isn't effectively assisting small businesses in other aspects of business management: "I don't think those centers are delivering. I think they help certain businesses, if you want to start a business. I think that there is missing in the curriculum anything about how to financially manage your business." There is a sense that business-specific information and training is difficult to come by because technical assistance providers are too general and broad in their approach. As one respondent noted, technical assistance providers tend to be generalists rather than experts, stating, "Everyone who works in the technical assistance space with small businesses is a generalist. There may be a few people who have had an affinity toward a certain industry or sector, but most people

working with small businesses have worked with a gamut of all different kinds of small businesses." As one business owner shared, "'How much inventory can you stock next month, or how much inventory do you need for your biggest season?' They're not going to be able to answer questions like that."

- **Uneven quality and lack of consistency.** Other shortcomings of the overall technical assistance offering were related to a lack of consistency of technical assistance in the quality of services that providers offer. Especially for pre-loan technical assistance, we heard serval concerns that the quality of programs is uneven, and there is no guarantee that a business will be qualified to receive a loan after completing a program. One lender noted that their model to outsource pre-loan technical assistance "really has not worked as well as [we] hoped because of the lack of standardization of technical assistance across just a wide swath of places that are doing it; it's pretty bad."
- **Relevance and cultural competence.** Another common critique of federally funded technical assistance relates to the relevance and cultural competency of the content offered to small businesses. For example, one respondent noted that locating SBDCs at universities, rather than their being embedded in communities, is a "huge mismatch" for small businesses: "The fact that SBDCs were largely focused on institutions of higher learning automatically creates a barrier for certain kinds of folks to walk into those organizations…They don't have any kind of cultural competence or understanding of the life circumstances of where these business owners are. There's a huge mismatch. The product is wrong, and the setting is wrong. Maybe they work for other kinds of businesses, but for the target populations we've been focused on, they have not."
- **Underemphasis of networks.** Interviewees called for more assistance and effort to be made for technical assistance providers to act as a connecter and convener to help small businesses build relationships within their specific industries. As one respondent noted, "Small businesses need more than just learning how to write a business plan. They need the networking, the connections to industry…That kind of connection can only be facilitated at gatherings, meetings, conferences."
- **Lack of modernization.** Too little federal technical assistance programming is available online or in an automated format. SBDCs are operated as decentralized offices, hindering their ability to offer services online in standardized way. Only recently has there been an effort to offer agencywide digital learning options, such as the SBA's digital learning platform called Ascent, launched in 2021. However, there is little documentation related to how much uptake there has been, and what the related outcomes are. Further, based on SBDC funding allocations by state,

SBDCs' budgets are dedicated to direct services, which makes local transition to digital or technology-based offerings difficult unless centers can coordinate and leverage considerable private support. Given that their business model depends on in-person engagement, centers are not adequately incentivized to develop online resources.

Alignment between Technical Assistance and Lending

A common purpose of technical assistance is to help a business prepare for and access a loan. Lenders also sometimes offer or require post-loan technical assistance. However, respondents expressed the view that the rationale and mechanisms for linking technical assistance to lending needs to be scrutinized and validated. Many interviewees said that there are long-held assumptions about borrower readiness, technical assistance, and organizational capacity that are either inaccurate or unproven. The challenges we heard related to lending and technical assistance include these:

- **Disconnects between federal programs**, which translates into disconnects for providers and services. An important area of improvement highlighted by respondents is the disconnect between federally funded capital delivery programs and technical assistance programs, which often means that businesses needing technical assistance to access capital are not receiving the guidance they need. As one interviewee noted, "SBA has not effectively connected its technical assistance business advising to its capital delivery programs. They're run separately. They're not connected. Therefore, it's an incredibly inefficient use of resources in that regard. I mean, so much so that we set up our own business advising because we couldn't really rely on SBA's infrastructure to provide the kind of assistance and the kind of customer acquisition that [we] could provide." Another respondent noted, "It never seemed like what they were providing was moving the needle for the small business owners. If anything, they maybe stumbled across an SBDC and got some ancillary support, but it wasn't like [the SBDC] was guiding them through the process."
- **Not a clear continuum of services between pre-loan technical assistance and lending.** Contributing to the mismatch between lending and technical assistance is the lack of services that create a direct pathway from technical assistance to a loan, as well as an understanding of how complex the borrowing process can be for early-stage businesses. Part of the misalignment between technical assistance and lending is that there is often no follow-up process for borrowers that have received pre-loan training or assistance. One business owner reflected on

feeling left alone to navigate the journey: "It just felt really clunky…'Yeah, just put your business plan together and then submit that'—like people write business plans all day, every day."

- **Gaps in operationally focused technical assistance.** We heard about a need for more specialized technical assistance, such as how to become a government contractor, how to leverage social media and marketing, and legal advice. Respondents expressed that it is important to provide businesses with the training and support to effectively use capital, and without doing this, as one interviewee shared, "you're not really building or helping build an ecosystem that will help those businesses be sustainable."

Measuring and Evaluating Outcomes in Technical Assistance

A cross-cutting problem identified by respondents is the lack of knowledge of the extent to which technical assistance is producing positive outcomes in small businesses—a critique we heard much more prominently about technical assistance than about lending programs. Respondents noted that the federal agencies collect a substantial amount of data for the various programs, but the focus tends to be on whether organizations are complying with program parameters, and not on how the programs are benefiting businesses and owners. There is a significant need for improved measurement, evaluation, and learning of technical assistance programs.

There have been few attempts to evaluate the impact of federally funded technical assistance programs, and these have been limited and lacking in rigor. In 2010 the SBA surveyed small businesses participating in various programs, but the response rate was very low (between 16 and 23 percent) and the respondents not particularly diverse demographically (Dwight et al. 2011). A recent survey of SBA Microloan Program borrowers had just a 13 percent response rate—too low to support reliable conclusions about the program (Urdapilleta et al. 2021). One interviewee attributed this to a general lack of outcome-driven focus within federally funded technical assistance programs, and an overemphasis on outputs over outcomes. Where evaluations have been conducted, their methods do not adequately measure outcomes. One example is an evaluation of Historically Underutilized Business Zones (HUBZones) that used only an input/output method and was limited in the outcomes it measured, focusing mainly on dollars invested and new jobs created, but didn't include analysis on business outcomes, such as firm success and financial health (Optimal Solutions Group 2021b).

One respondent pointed out that while the SBA collects plenty of data, there isn't a practice of using these data to better understand the performance of its programs, and BSOs are not rewarded for good outcomes, nor are funds withheld from those that provide services for—but do not truly benefit—businesses.

What do you guys [the federal government] do with this data? Is there even any internal report that you put together to say, 'This is what's working; this is what's not working.' It was crickets. It's like, collect the data, but then do something with it. How does that data inform looking at more outcome driven results?
—Former government employee

Interviewees indicated that there has not been a meaningful practice of inquiry and experimentation associated with technical assistance to determine what models work best, for whom, and under what conditions. As a result, there is little known about the best pairing of program designs and businesses. Agencies may track their outputs as a requirement for funding, but little is required in demonstrating positive outcomes. To date, there have been few independent evaluations of these programs, compared to other federal programs that come out of HUD, the US Department of Health and Human Services, or the US Department of Labor. Researchers and scholars in adjacent fields have demonstrated that it is possible to do rigorous research on financial coaching (Theodos, Stacy, and Daniels 2018), financial counseling (Roll and Moulton 2019), and homeownership counseling (Moulton et al. 2015; Quercia and Wachter 1996; Peck et al. 2021), and demonstrate outcomes associated with various interventions.

Recommendations

After more than 150 interviews with policymakers, BSOs, lenders, business owners, and others, it is clear that there is no easy fix to solving the shortcomings of federally funded technical assistance services. The effectiveness and efficiency of technical assistance programs administered by the SBA have been under scrutiny under multiple administrations, yet few, if any, significant programmatic changes have been made. In some ways, the challenges raised are systemic, requiring systems-level change that will take many years to fully realize. The issues highlighted are deeply embedded and intersect with other aspects of the small business landscape, such as lending. Many of the challenges identified cut across agencies and programs rather than being unique to just one or a few. Overall, the sense expressed is that there is a patchwork of efforts, with some services that are very specific and others that are more general, but no coherent continuum. And we heard that the quality of services provided is variable. As one respondent noted, “Any kind of educational program is idiosyncratic as to who’s providing that education. … It’s hit or miss.” All this is compounded by the lack of evaluative research and outcome data, making it virtually impossible to know what is working and why.

Some we interviewed did express a belief that personalized technical assistance and more focused one-on-one coaching can be effective in increasing capacity for entrepreneurs to improve and grow their business. And we heard from some interviewees that business development support is most effective when it is sector- or outcome-specific, such as providing training focused on the needs of the food industry or offering a federal contractor readiness program.

To meaningfully advance and reform the business support landscape, we offer the following recommendations.

- **Establish a high-quality national virtual resource center.** There is a need to reimagine and repurpose the existing structure of location-based business support services, such as those available through SBDCs, Veterans Business Outreach Centers, Women’s Business Centers (WBCs), Minority Business Development Centers, APEX Accelerators, US Export Assistance Centers, and others. A common solution we heard was to provide a mechanism to businesses that provides more agency in deciding which technical assistance provider they feel best meets their needs, rather than being limited by geography, or by referral networks. One solution would be to bring all federal and nonfederal technical assistance programs together into a national virtual resource center. Especially after the pandemic, as virtual interactions have grown more popular than in-person training and service delivery, business support centers need to adapt their approach to serving businesses and business owners. This could be achieved by establishing a national virtual resource center in which all services offered by federal centers are accessible online, and that also features an extensive selection of high-quality and specialized training materials, as well as options for real-time virtual coaching sessions. The services offered and content covered must go beyond basic business training to be more targeted and relevant for the diverse operational and industry-specific needs of businesses. For more difficult and complex demands, online coaching with industry experts could allow for a more tailored suite of services. As one respondent within the SBA put it, there is a need for “a human counselor—a very experienced human—learning about you, and giving you expertise and wisdom-based advice that’s inherently a lot less data-driven but also a lot more personalized to you." It may be helpful for buy-in and quality assurance feedback loops for small business owners to pay a portion of the cost of personalized services, even if a modest amount.

- **Repurpose place-based business centers to be focused on outreach; expand outreach and support to community-oriented and -embedded organizations.** In-person outreach still remains valuable, especially in rural or urban communities that have not been well connected to resources. Such outreach can work in tandem with a national center. And yet, federal government business development services are insufficiently targeted toward community-oriented organizations that are able to reach a broad set of small businesses with a goal of increasing not only the number of new entrants into government contracting but also their ability to succeed and the size of their contracting awards. Similar to the Community Advantage program, but more comprehensive in coverage, existing federally supported centers should be repurposed to focus on outreach to businesses. These centers could act as referral agents, connecting businesses to the virtual materials, learning tracks, and experts appropriate for their specific needs. Especially in areas where broadband access may be a barrier, outreach staff should be focused less on programming, and more on engaging with businesses to connect them to service providers that meet the businesses specific need.
- **Create better linkages between lending and technical assistance via improvements in content, processes, and staff expertise.** One of the most significant gaps identified was the disconnect between technical assistance and lending. Lenders we spoke with feel that most out-of-house pre-loan counseling is inadequate in preparing businesses to get a loan. Conversely, many technical assistance specialists we spoke with felt that lenders change their criteria without notice and can be unclear or inconsistent in what they expect businesses to provide and demonstrate. This divide has to be bridged; here are some suggestions:
- **Better facilitate, incentivize, and track how lenders work with technical assistance programs and providers to support borrower readiness.** For those seeking loans, federal technical assistance programs should have a focus on enabling a business to manage a loan well or a focus on borrower preparedness if a business is not yet ready to borrow capital. Technical assistance needs to be closely linked to lender-specific standards.
- **Tailor post-loan assistance more specifically to borrower needs.** Post-loan technical assistance should be treated as case management for borrowers, through one-on-one counseling and regular follow-ups. Both pre- and post-loan support can be tasks of the national virtual resource center and its experts.

- **Establish measurement and evaluation practices that focus on outcomes rather than outputs and compliance reporting.** While there is a practice of collecting data on technical assistance programs, this is focused on outputs and compliance, rather than for the purpose of program evaluation. There is a sense from interviewees, including federal officials, that even the data currently collected by staff are not used to understand the performance of their programs or allocate resources across providers. The suite of federal programs must reorient their data collection to focus on programmatic outcomes—which are linked to concrete goals and a standard set of programmatic expectations—and conduct regular program evaluations. This could be done in partnership with and with guidance from organizations with experience and expertise in measuring impact and evaluating government programs. And the federal government must embrace experimentation and learning to refine and adapt its service offerings to maximize their efficacy.

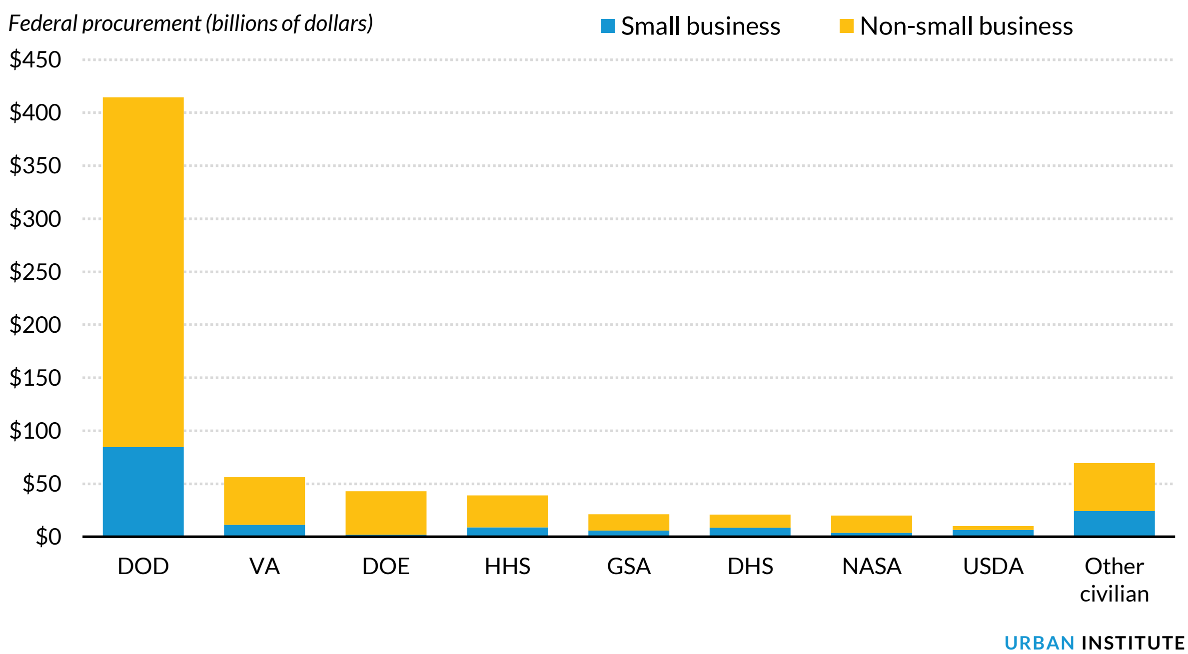
Federal Procurement

Background

The role of the federal government as a purchaser of goods and services is an extremely important part of the government's support for small business. The purchasing power of the federal government is enormous: in FY 2022 it spent approximately $414.5 billion through the Department of Defense (DOD) alone, of which approximately $84.4 billion, or 24.86 percent of the small business–eligible amount, was awarded to small businesses.[76] Governmentwide, $162.9 billion, or 26.5 percent of small business–eligible contracts, were awarded to small businesses, of which $69.9 billion went to small disadvantaged businesses.[77] Figure 36 shows the total dollars spent on federal procurement by agency in FY 2022.

FIGURE 17

Federal Procurement by Agency and Contractor Type FY 2022



Source: "A Snapshot of Government-wide Contracting for FY 2022," GAO, August 15, 2023.
Notes: DOD = US Department of Defense; VA = US Department of Veterans Affairs; DOE = US Department of Energy; HHS = US Department of Health and Human Services; GSA = General Services Administration; DHS = US Department of Homeland Security; NASA = National Aeronautics and Space Administration; USDA = US Department of Agriculture.

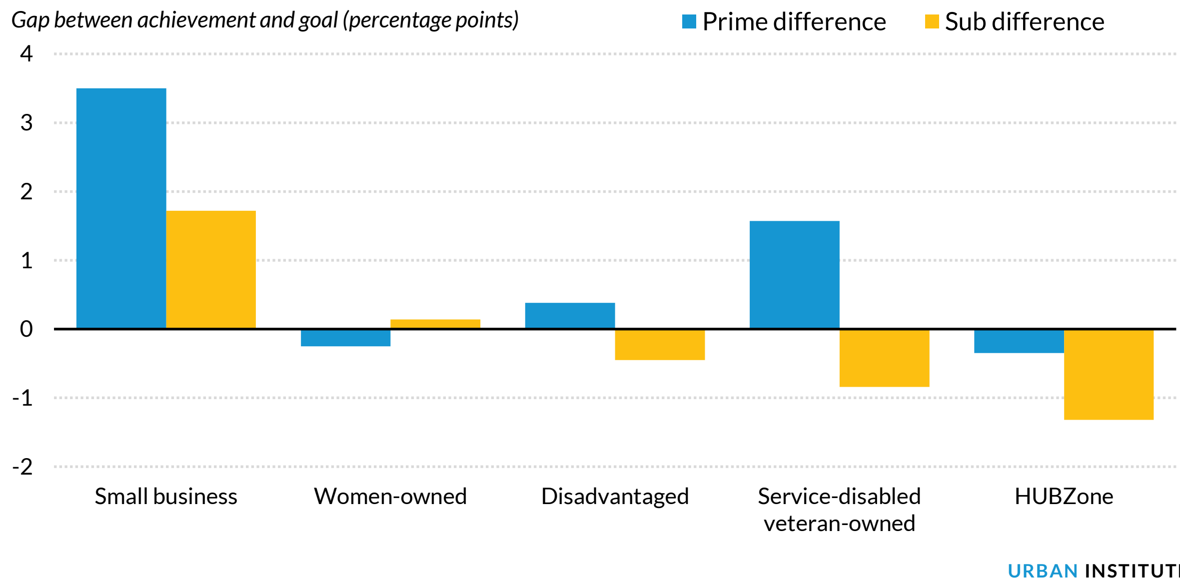
The federal Small Business Act of 1958 as amended in 1988 requires that 23 percent of small business–eligible prime contracts governmentwide go to small businesses (CRS 2022a). Each government agency also has a specific small business goal, established by the SBA in consultation with the department or agency. The government has met the overall target each year since FY 2013.[78] For FY 2022, small business prime contracting reached $162.9 billion (26.5 percent against a goal of 23.0 percent).[79] Small businesses won a further $79.1 billion in subcontracted work (31.08 percent against a goal of 29.36 percent) in FY 2022.[80] While the amount awarded to small businesses in FY 2022 increased by about $9 billion from FY 2021, the percentage awarded declined by about 0.7 percentage points.

In addition to overall small business procurement goals, there are governmentwide subgoals for specific groups and types of small businesses. The federal government has goals for how much it contracts to small disadvantaged businesses[81] (increased for FY 2022 to 11 percent for prime contracts, while remaining at 5 percent for subcontracted work), women-owned small businesses (5 percent for prime and for subcontracted work), service-disabled veteran-owned small businesses (3 percent for prime and for subcontracted work), and businesses located in HUBZones (3 percent for prime and for subcontracted work). In October 2023, the Biden administration asked agencies to increase the goal for small disadvantaged businesses to 13 percent for FY 2024, working toward 15 percent by FY 2025.[82]

In FY 2022, the federal government met its prime contracting goals for small disadvantaged businesses (11.38 percent against an 11.00 percent goal) and service-disabled veteran-owned small businesses (4.47 percent against a 3.00 percent goal).[83] However, the federal government as a whole again fell short of its goals for women-owned small businesses (4.57 percent against a 5.00 percent goal) and HUBZone businesses (2.65 percent against a 3.00 percent goal) (Figure 18).[84] Since FY 2013, the HUBZone target has never been met, and the women-owned business target has been met only twice.[85] For subcontracting (for which the data are not as reliable), only the overall small business and women-owned business goals were met (Figure 19). It is important to recognize that these calculations can double count businesses that fall into more than one category. With respect to individual departments, four (including the largest, DOD), did not meet their overall goals for prime contracting. Performance under the subgoals was highly variable.[86]

FIGURE 18

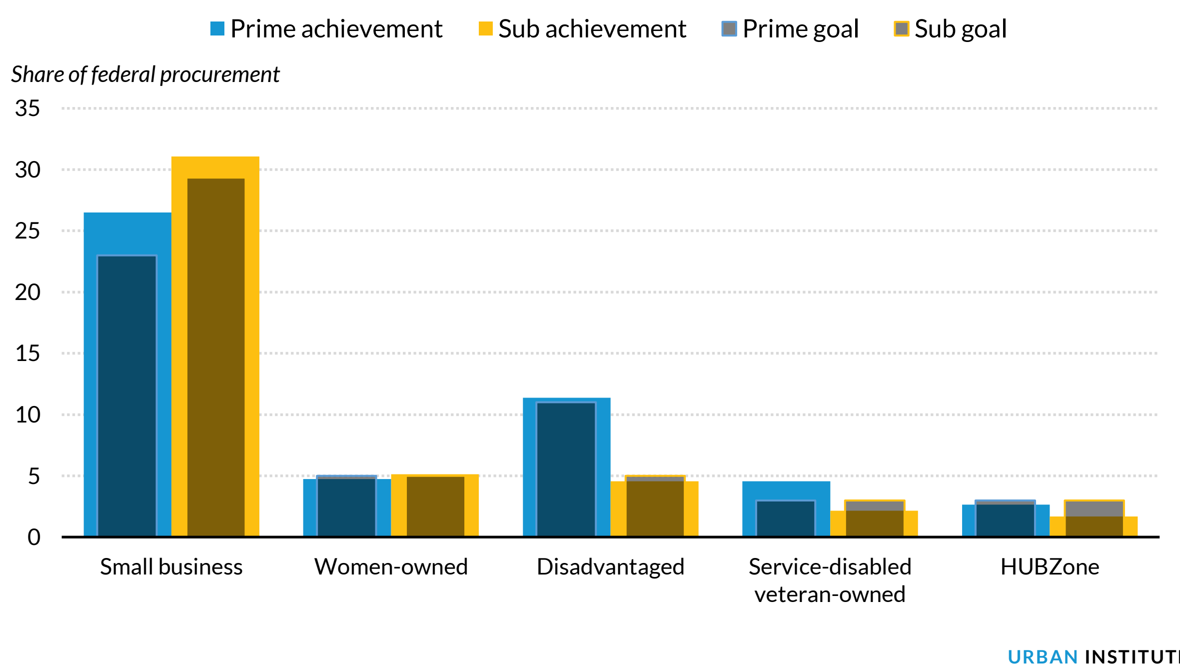
2022 Federal Small Business Procurement Achievement and Goal Difference



Source: "Government-Wide Performance: FY2022 Small Business Procurement Scorecard," US Small Business Administration, accessed August 29, 2023.

FIGURE 19

2022 Federal Small Business Procurement Achievement and Goal Amounts



Source: "Government-wide Performance: FY2022 Small Business Procurement Scorecard," US Small Business Administration, accessed August 29, 2023.

Although the federal government is meeting many of its small business procurement goals, we observe some concerning trends. From 2010 to 2019, the number of small businesses contracting with the government declined by 38 percent (Hunter et al. 2018), and between 2005 and 2019, there was a 79 percent decline in the number of new small businesses entering the federal contracting system (Bipartisan Policy Center 2021). According to the SBA, these trends continued in FY 2022, with a 4.22 percent decline in the number of small business contractors from FY 2021 to 62,670 governmentwide. There is a similar trajectory at the government's major contracting agency, the DOD: the number of small businesses receiving contract awards declined by 43 percent from FY 2011 to 2020 (from 42,723 to 24,296), and the number of new entrants declined from 7,083 in FY 2016 to 5,526 in 2020 (GAO 2021). In FY 2022, only 29,991 small businesses received DOD contracts, a decrease of 6.11 percent from FY 2021.[87]

Expanding overall small business participation is especially important because federal procurement has shown some success in breaking down barriers to participation and reducing disparities. Businesses owned by people of color achieved a meaningful share of small business procurements that helped reduce disparities evident in other small business markets. For example, in FY 2020, almost 40 percent of government small business procurement dollars went to minority contractors.[88] Asian American and Pacific Islander people represent 10.0 percent of employer businesses but received 11.1 percent of government small business procurement spending.[89] Black people represent 2.0 percent of employer businesses and 6.7 percent of government procurement spending; Latino people 5.8 and 7.1 percent; and American Indian and Alaska Native people 0.3 and 10.8 percent.

Women-owned and rural businesses lag on these metrics. While 19.9 percent of employer firms are women owned, these firms receive just 18.6 percent of small business procurement. Similarly, 7.3 percent of employer firms are rural, but such firms receive only 2.5 percent of federal small business procurement.[90]

Programmatic Supports: 8(a), 7(j), Mentor-Protégé, and SBIR/STTR

An important element in achieving overall small business goals, especially for smaller and disadvantaged businesses, is Section 8(a) of the Small Business Act. This section established a business development program that offers small disadvantaged businesses training and technical assistance to enhance their ability to obtain government contracts, with the goal of graduating to regular procurement as well as private sector contracts after nine years in the program. Participation in the 8(a) program has generally been limited to small businesses unconditionally owned and controlled by, as well as managed by, socially and economically disadvantaged individuals, an economically disadvantaged American Indian tribe, or an economically disadvantaged Native Hawaiian organization.[91]

Of the $154.2 billion of prime government contracts awarded to small businesses in FY 2021, a sizable share—22 percent ($34.4 billion)—went to 8(a) firms (CRS 2022b). This means that 8(a) contracts constituted 5.4 percent of the volume of all federal procurement, which counts toward governmentwide and departmental small business goals. The $34.4 billion in 8(a) contracts included $8.7 billion in 8(a) set-asides and $11.3 billion of sole-source contracts (CRS 2022b).

The 8(a) program historically included a rebuttable presumption that members of certain minority groups are "socially disadvantaged" for purposes of participation, while individuals who do not belong to these groups must demonstrate by a preponderance of evidence that they are socially and economically disadvantaged according to criteria set by the SBA to qualify. The minority groups that previously received a presumption of social disadvantage include Black Americans, Hispanic Americans, Native Americans, Asian-Pacific Americans, and subcontinent Asian Americans. The rebuttable presumption was based on Congress's recognition that individuals in certain groups are socially disadvantaged "because of their identification as members of certain groups that suffered the effects of discriminatory practices or similar invidious circumstances over which they have no control."[92]

In response to a federal court ruling, SBA has recently announced changes to the 8(a) program that could have significant implications for the small businesses the program reaches. In July 2023, a federal district court in Tennessee decided that the SBA could not presume individuals to be socially disadvantaged based on their membership in one of the identified groups, and required the agency to immediately cease use of the rebuttable presumption to administer the 8(a) program.[93] In August 2023, SBA issued guidance to federal agencies concerning implementation of the court's decision.[94] And in September 2023, the SBA issued detailed guidance to existing and potential program participants about how to establish or reestablish eligibility to participate in the 8(a) program.[95] Further changes may be forthcoming as the courts continue to examine the 8(a) and similar government programs. In particular, in June 2023, a federal district court in Texas granted a preliminary injunction against the Minority Business Development Agency's use of a presumption very similar to that under 8(a) "or otherwise considering or using Plaintiffs' race or ethnicity in determining whether they can receive access to the Center's services and benefits"—suggesting the possibility of even broader vulnerability of not only 8(a) but all racially based procurement preferences.[96]

Although the loss of the rebuttable presumption presents a serious challenge, it is not the only issue facing the program. The Congressional Research Service, for example, has cited concerns about the continued eligibility of firms that have grown beyond the program's limits for procurement dollars received or otherwise violated program guidelines, as well as lack of well-defined measures of individual firm and program success (CRS 2022a).

An important part of federal procurement supports is the training opportunities under the 7(j) Management and Technical Assistance program and the All Small Mentor-Protégé Program. The training program covers training in areas such as finance, management, and accounting and assistance in finding and pursuing new business opportunities. The Mentor-Protégé Program enables small businesses to team up with more established businesses to receive both technical and financial assistance in obtaining and performing government contracts. Mentor firms can qualify for small business set-aside contracts for which their protégés are eligible. While both programs were initially limited to 8(a) firms, the 7(j) program is now open to small disadvantaged businesses and businesses operating in low-income areas or owned by people with low incomes; the Mentor-Protégé Program is open to all small businesses (CRS 2022b).

In FY 2022, the government awarded about $4.3 billion for grants, contracts, and cooperative agreements under the Small Business Innovation Research program (SBIR) and the Small Business Technology Transfer program (STTR), with DOD, the Department of Health and Human Services, and the Department of Energy accounting for approximately 90 percent of obligations.[97] The programs are funded through a set-aside of a portion of the research and development budgets of major government agencies (16 under SBIR, of which 5 also participate in STTR) and have been reauthorized through 2025. They are designed to enable the federal government—and the broader economy—to benefit from innovative research from businesses with fewer than 500 employees. The programs also have a special focus on participation by socially and economically disadvantaged small businesses and those owned and controlled by women. In FY 2019 (latest data available), women-owned firms received about 12 percent of SBIR awards and 13 percent of STTR awards and dollars—higher than the 4.6 of all federal small business procurement going to women-owned firms (SBA 2020). Socially and economically disadvantaged businesses received about 5 percent of SBIR and STIR dollars (SBA 2020). Commercialization is also a goal of these programs. A special benefit of these programs is that participants receive no-strings-attached grant funding while retaining full rights to all intellectual property produced—essentially equity funding. STTR also supports R&D for commercialization through partnerships between small businesses and universities or federally funded research and development centers.

A similar pathway into the system is the DOD's Defense Innovation Unit's transaction agreements. According to the US Government Accountability Office (GAO), as of 2020, 77 percent of the awardees under this program were small businesses, in part because the requirements to work with the program are "not burdensome" (GAO 2021). DOD components, especially the Air Force, have recently increased outreach and support activities to bring new participants into federal procurement and support their development—as well as better meet the needs of the service—through programs such as AFWERX and SpaceWERX.[98]

What's Working and What's Not Working

Contracting with the federal government can be appealing, in part because government contracts are relatively large and many are renewed. Some items or services, such as those with military or security uses, are purchased significantly more by the government than by the private sector. However, becoming a certified government contractor and then winning a government contract is a difficult and often costly process; only approximately 1.2 percent of all employer businesses (those with at least one employee) take advantage of this source of business in a given year.[99]

Barriers to participation in federal procurement are obviously disadvantageous to the businesses involved. However, limited participation also negatively affects other major goals of the small business procurement programs, namely increased competition and development, preservation of a vibrant base for innovation and economic growth, and resilient supply chains. As the DOD wrote in its *Small Business Strategy*, "It is imperative for the Department of Defense to focus on small business. These innovative companies account for 43 percent of all high-tech jobs in the US and generate 16 times more patents than large firms. Small businesses spur innovation [and] represent most new entrants into the Defense Industrial Base…[They] are agile and often can implement change more quickly than larger firms" (DOD 2023).

What are the reasons for this current state of affairs? Our interviews with business owners, technical assistance providers, federal agency staff, and others highlight nine challenges.

- **Complex processes.** Becoming a certified government contractor (i.e., getting on the General Services Administration schedule) is difficult, time-consuming, confusing, and expensive, sometimes requiring irrelevant certifications, clearances, and bonding requirements. Becoming 8(a) qualified—supposedly a door-opening process for new and disadvantaged business—is particularly confusing, difficult, and subject to changing rules and regulations. Similar problems exist in the HUBZone program, which is meant to bring government contracts to locations that have not historically benefited from government contracting. And annual recertification requirements can limit or delay opportunities.

- **Discovery challenges.** Learning about contracting opportunities can be difficult, especially for businesses that may not have networks of existing contractors to tap into.

- **Limited support.** Beyond learning about contracting opportunities and how to qualify for them, small businesses, both at the start of their contracting experience and as they grow, need more relevant, affordable, and accessible technical assistance on all aspects of contract performance and reporting, and future business development. Many businesses also need encouragement, from mentors and others, not to give up if the first several attempts to get a contract are not successful.

- **Payment delays.** Government contracts and subcontracts can create serious cash flow problems, especially for businesses at the start of their government contracting careers. This is a special challenge for new and microbusinesses. As one interviewee said, "It takes too long to get paid, and some businesses actually have gone out of business because of a lack of prompt payment." Prime contractors' compliance with prompt payment regulations concerning subcontractors is not effectively monitored or enforced.

- **Difficult graduations.** Interviewees reported that the training and other skills-building provided to 8(a) contractors is insufficient to enable them to move on to regular contracting. This is exacerbated by the nine-year limit on 8(a) certification, which runs from the time of certification rather than when a business receives its initial contract. A 2021 study conducted for the SBA found that the median time from certification to first federal contract was approximately 22 months, and in general, federal contracting revenues declined after graduation from the 8(a) program (Optimal Solutions Group 2021a).

- **Subcontracting challenges.** For many new and smaller government contractors, direct contracts within their capabilities are not available and they must access the procurement system through subcontracting. However, subcontracts may not be issued through formal processes, making it difficult for new firms to become aware of opportunities and compete for them. Even after a successful award, some interviewees reported challenges getting actual work under their subcontract. Moreover, we heard that federal agencies focus on the share of a prime award going to small business subcontractors at the proposal stage but not on how work is actually allocated during the project. This can result not only in inflated goal statistics but also underutilization of the businesses the goals are intended to support.

- **Tight time and budget constraints.** Overly constrained timelines and budgets lead contracting officers to favor contractors with whom they have previously done business. This means that while some small businesses will get repeat business, others, especially new entrants, will be discouraged and shut out.
- **Short-term cost emphasis.** Individual government contracts are often short term, conventional, and price or budget driven. The pressure for efficiency and cost savings—exemplified by the category management system of the US Office of Management and Budget (OMB), especially its best-in-class contract designation, which converts individual departmental procurements for many standard items into far larger, governmentwide contracts—has had the effect of reducing contracting opportunities, especially prime contracting opportunities, for small businesses. This concern has been recognized by both the SBA and OMB; OMB has now issued revised guidelines to encourage greater participation by small businesses in contracts covered by category management.[100]
- **Competing goals.** Some small business programs have goals that are in tension with one another. A clear example is the SBIR and STTR programs. One objective is to contract with firms that understand agency missions and can reliably produce effective R&D, which can lead to making multiple awards to the same set of small businesses. Conversely, the programs are also tasked with strengthening the commercial small business sector and cultivating new entrants into federal contracting—goals that favor granting awards to a greater number of individual businesses.

Recommendations

We provide several recommendations for federal action to make better use of federal procurement to support and advance small businesses.

- **Make the discovery process easier for potential contractors, government buyers, and acquisition officers.** More contractors can be brought into the system, and the government can potentially more easily and cheaply meet its needs if potential contractors have easier ways of finding out about opportunities and buyers of contractor services as well as acquisition officers know about potential contractors who can meet their needs. The General Services

Administration's commercial marketplace (where agency officials can purchase items from several commercial e-commerce platforms) is a step in this direction (West 2023). In addition, expanded use of Industry Days, expos, programs such as AFWERX, and similar opportunities can help businesses demonstrate their prowess and value outside of a formal contracting process and make connections. As one observer said, "Where a small business can interact directly with specific departments within the federal government, who are looking for procurement vendors to add to their supply chain—those [events] have been pretty good." Similarly, greater incentives, connections, and training are needed for small business support centers such as SBDCs, WBCs, and Minority Business Development Centers, to better connect their clients with procurement on-ramps, pathways, resources, and supports, making use of existing resources, programs, and procurement centers. Other centers should be tracked against their success in referring for and ultimately receiving contracts.

- **Simplify eligibility, application, certification, and recertification processes.** Federal procurement processes are often needlessly complicated and expansive, resulting in the creation of an excessively narrow and specialized class of contractors. As reflected by one interviewee, "It is a difficult task…There are lots of hoops and hurdles you have to overcome…a lot of paperwork, a lot of red tape, a lot of work." As the government's largest contractor, this is especially important at the DOD, and mitigating the problem is part of the first strategic objective of the department's new *Small Business Strategy* (DOD 2023).

- **Enforce prompt payment requirements at both the contractor and subcontractor levels.** Late payment can be deadly for small businesses that contract directly with the government. But late payments to larger businesses can also harm smaller businesses, as primes delay payment to subs because the prime itself has not been paid and has a cash crunch. The effect is not only hurting those who have business relationships with the government but also discouraging others from participating.

- **Raise the simplified acquisition threshold and create an additional tier of government contracts and set-asides.** To target more contracting to small businesses, the federal government should raise the simplified acquisition threshold, currently $250,000, and the sole-source nonjustification thresholds. In addition, federal agencies could better reach truly *small*-small businesses if they created an additional tier of contract awards. Currently, many of the firms awarded contracts can better be understood as midsize businesses. We recommend maintaining some preference for those firms but setting aside awards for firms with 50 and fewer employees and corresponding revenue levels. A corollary is that smaller contracts and contracts with more modular components are needed to help small businesses effectively compete for work, giving smaller companies a better chance of obtaining initial and follow-up contracts. Both the Office of Management and Budget and SBA are focused on this issue.[101]

- **Strengthen subcontracting plans**. We heard repeated concerns about small business subcontracting and encourage greater attention by federal agencies to reporting and enforcement. As reflected above, performance for subcontracting generally lagged prime performance (SBA 2021), especially for women-owned small businesses and firms in HUBZones. Subcontracting is often the first step to becoming a direct government contractor, and thus critical to the goal of increasing new entrants into government contracting. Additional completeness, timeliness, and accuracy of subcontracting data could substantially assist in this process.
- **Embed the small business goals and subgoals into the performance plans of both government buyers and acquisition officials.** What gets measured and incentivized gets done. The small business goal has been part of the performance plans of many senior government procurement officials for about 10 years (and has coincided with a period of meeting that goal). In December 2021, the Biden administration issued guidance requiring inclusion of the subgoals "as evaluation criteria in all performance plans for SES [Senior Executive Service] managers that oversee the acquisition workforce or agency programs supported by contractors."[102] As one interviewee said, "Unless every department—and we've met with all of them, DOD, HUD, Education, I could go on and on—unless they have a plan to get to the 15 percent and a good-faith effort and champions within those departments, and unless they break up contracts to sizes that are realistic for small businesses to capture, we will never achieve those goals of 15 percent."
- **Couple strategies for improved performance with increases in the subgoals.** While simply increasing the goals could have marginal effects, coupling strategies (e.g., pushing goals closer to the relevant share of employer businesses) can provide additional incentives to better serve all small business communities. This is especially important with respect to the goals that have consistently lagged, namely the government's targets for women-owned businesses and HUBZones.
- **Expand training and mentoring.** Training under the 8(a) program should be improved, including measuring the extent to which businesses taking advantage of the training are able to obtain government contracts after they lose 8(a) status. In addition, although training under section

7(j) and mentor-protégé programs can be valuable, these programs need to be broadened and mentors given more incentives to participate.

- **Improve the 8(a) program.** Several interviewees stated that the 8(a) program continues to be difficult to access. The recent court decision ordering SBA to stop using the rebuttable presumption of social disadvantage, and SBA's response, may make access even more difficult. Moreover, many of those who become eligible for 8(a) are unable to move into contract opportunities quickly. One strategy to bolster the program would be to start the nine-year eligibility period from the time of award of the first contract.
- **Improve data and reporting.** Without good data to understand what is happening and where gaps and problems exist, it is hard to improve processes or see the results of improvement. Data on subcontracting, as well as on the number and dollar amount of awards made to targeted business groups, are especially weak. Data also need to be more timely, which will require better coordination between the SBA—which produces much of the public data, including the annual goal scorecards—and the procuring agencies.

Factors Influencing Federal Small Business Policymaking

This report focuses on federal financial support for small businesses, primarily through guarantees, loans, and grants, as well as technical assistance and procurement. These activities are largely the purview of agencies within the executive branch of the government that have substantive responsibility to support small business and that are appropriated funds to effectuate their support. However, the federal government also affects small businesses through its regulatory policies, implemented by the Treasury Department, banking supervisors, the IRS, the Consumer Financial Protection Bureau (CFPB), the Securities and Exchange Commission, and others. In this section, we briefly cover tax policy affecting small business; the Community Reinvestment Act (CRA); data and reporting, including under Section 1071 of the Dodd-Frank Act; and the missing policy—the lack of truth-in-lending protections for small business finance.

Tax Policy

While a detailed review of tax policies affecting small businesses is beyond the scope of this report, it is important to note that several provisions of the tax code provide support to small businesses. Congress's Joint Committee on Taxation estimated that federal revenue forgone through 18 of the most generally applicable small business tax benefits may cost around $12 billion in FY 2023.[103] These tax benefits affect one or more categories of small business activities:

- the amount of money available to the firm, such as by allowing firms to deduct expenses that would otherwise have to be capitalized, thus reducing (currently or permanently) the tax payable—an example is limited expensing under Section 179
- the timing of tax payments, such as by deferring taxes or by allowing a firm greater flexibility in choosing when income is taxable—examples are deduction and amortization of business start-up expenses under Section 195 and allowing cash-basis accounting under Section 446
- the cost of capital, by special treatment of investor gains or losses, including allowing deduction from ordinary income (not capital gains) of losses from the sale (e.g., Sections 1202, 1244), exchange, or worthlessness of SBIC stock (Section 1242)

- the cost of employee accommodations, such as those pursuant to the Americans with Disabilities Act (Section 44), or benefits such as pensions (Sections 45E and 45T) or health insurance (Section 45R) by special tax deductions or credits
- administrative costs, for example, by allowing simplified accounting methods for inventory and depreciation (Sections 446, 474, 263A)

Unlike many of the other programs discussed in this report, the SBA definition of "small business" does not govern the availability of the tax benefits. Almost every tax benefit has its own definition of eligible businesses, which may be based on receipts, assets, number of employees, time in business, or some combination of these. In addition to generally available small business tax benefits, tax benefits are available for small businesses in specific industries, such as life insurance, banking, and energy production or distribution. Finally, business forms such as the S corporation and the partnership—which allow pass-through taxation rather than taxation at both the corporate and shareholder level and generally result in an overall lower tax burden—are used disproportionately by small businesses. For example, according to the IRS, S corporations with $1 million or less of total receipts filed 80.8 percent of S corporation returns for the 2017 tax year, even though they accounted for only 10.2 percent of total S corporation business receipts.[104]

As is the case with many small business programs, there has been limited research on the effectiveness of these provisions in either supporting small businesses in general or incentivizing specific actions by small businesses (such as encouraging small businesses to offer or maintain employee health benefits), and the research is not consistently encouraging. One study that did explore this, a 2016 GAO report, found that fewer than one-tenth of small businesses eligible to claim the credit for employee health benefits had done so (although the total amount claimed was about one-fourth of that predicted), concluding the credit was too small, too complex, and too short term to be attractive.[105]

The Community Reinvestment Act

The CRA, enacted in 1977 to combat redlining, requires that each bank[106] help meet the "credit needs of its entire community, including low- and moderate-income neighborhoods." Since 1995, regulators have evaluated all banks engaged in small business lending on how their performance helps meet their community's credit needs. For CRA purposes, bank regulators count a small business loan as one that goes to a firm with less than $1 million in annual revenues. In addition, small business loans also count for CRA if they are in a low- or moderate-income community and the loan is under $1 million, even if the business has annual revenues of more than $1 million. A bank's CRA evaluation plays a role in its ability to smoothly consummate a merger or acquisition; a negative evaluation can also generate community concerns and negative publicity.

As described in the introduction, banks subject to CRA do a significant amount of small business lending. Yet community complaints and experiences under the Paycheck Protection Program, where many small businesses had difficulty accessing assistance—especially new and very small businesses and those owned by people of color, women, and other traditionally underrepresented communities (Glancy 2023)—combined with a lack of good data, have generated pressure to improve incentives for banks to do more lending to these groups.

In May 2022, the bank regulators proposed revisions to the regulations under CRA to accomplish this and other goals.[107] A final regulation was adopted in October 2023 and will be implemented starting in 2026.[108] This extended implementation period is designed to give all parties—banks, regulators, and the community—time to develop and implement tools and guidance, including examiner guidance, to make the transition as smooth as possible. In addition to concerns related specifically to implementation of the new CRA regulation, bankers and regulators also need to consider the interaction of these regulations with new bank capital regulations proposed in July 2023.[109] These proposed regulations would generally require banks with more than $100 billion in assets to hold significantly more capital against many of the types of loans the CRA regulations are intended to incent. While the concerns are most pronounced with respect to mortgages, the higher capital requirements have the potential to negatively affect all loans with relatively low margins.[110]

The new CRA regulations focus largely on the approximately 400 retail banks with assets of more than $2 billion. These banks will be evaluated on their retail lending (40 percent) and retail products and services (10 percent weight), community development financing (40 percent weight), and community development services (10 percent). Small business loans will largely be counted as part of the retail lending test, which will focus on the relative amount of lending a bank does in low- and moderate-income communities and to businesses with annual gross revenues of $250,000 or less and $1 million or less. The analysis based on business revenues rather than loan size largely will be delayed until implementation of the CFPB's recently adopted regulations pursuant to Section 1071 of the Dodd-Frank Act (discussed below).

An important innovation of the new regulation is that many banks will be evaluated on their lending not only in areas around their branches but also in places where they do not have a physical presence—the new retail lending assessment areas and outside retail lending areas. More than one-third (36 percent) of bank small business lending is done outside banks' assessment areas (the areas around branches and other deposit-taking facilities, now called facility-based assessment areas), and the percentage grows as the bank size decreases. This relationship may be affected by inclusion of credit card loans in the analysis, a problem that is not addressed by the final regulations (Goodman, Seidman, and Zhu 2022). Moreover, the percentage of bank small business loans that "count" for CRA purposes is greater inside than it is outside assessment areas, suggesting that adding retail lending assessment areas to CRA analysis might increase the incentives to make small business loans that "count."

Under the new regulation, large retail banks that do 20 percent or more of their retail lending outside their facility-based assessment areas will also be evaluated on their retail lending in places (generally metropolitan statistical areas) where they make at least 400 small business loans in each of two consecutive calendar years. Moreover, both these large retail banks and the more facility-oriented large retail banks (as well as some smaller banks) will be evaluated on their retail lending outside all assessment areas. The regulators state that the purpose of these changes is, among other things, to "increase the share of retail lending by large banks that is considered in CRA evaluations."[111]

In addition to counting under the retail lending test, some bank loans to small businesses will also count under the community development financing test. Current CRA regulations do not define a "small business," although a "small business loan" is defined (by reference) as a loan of less than $1 million. The new rule would define a small business as a business (other than a farm) "that had gross revenues for its preceding fiscal year of $5 million or less."[112] Until the implementation of the CFPB's Section 1071 regulations, when standards based on business rather than loan size will come into effect for the retail lending test, the new small business definition is mainly relevant in connection with indirect bank lending "in conjunction or in syndication with" government-related "plans, programs or initiatives that support small businesses," explicitly including SBICs, CDCs, RBICs and New Markets Venture Capital Companies.[113] In general, for these loans and investments to count, the businesses affected must meet either the program's size standards or, if the program does not have a size standard, serve businesses with annual gross revenues of $5 million or less (an increase from $1 million).

In a change from the proposed regulation, banks will also be able to receive economic development credit (as well as credit under the retail lending test) for direct loans to small businesses that are "in conjunction or syndication with" a government plan, program, or initiative that supports economic development and "have the purpose of promoting permanent job creation or retention for low- or moderate-income individuals or in low- or moderate-income census tracts." These direct loans to small businesses must meet the business size eligibility standards of the SBIC or SBDC programs they work with or, if not made in conjunction with an SBIC or SBDC, have annual gross revenues of under $5 million (up from $1 million under current CRA rules).[114] In contrast to the current regulations, banks will receive credit for community development activities nationwide, although the amount of credit will be weighted by the location of a bank's deposits.[115]

Banks will also receive credit under the community development tests for investments in and other support of intermediaries that support small businesses, including nonfinancial intermediaries such as incubators (an expansion beyond current regulations) as well as direct bank noncredit support to small businesses, such as counseling, shared space, and technology. Banks will also receive community development credit for loans, investments or services in cooperation with a CDFI, a minority depository institution, a women's depository institution, or a low-income credit union, without regard to the geographic area served by either the CRA bank, CDFI, or other entity it is working with.[116]

Finally, banks can receive positive credit under the responsive credit products section of the retail products and services test for credit products and programs that meet the needs of small businesses. The commentary to this section says that such responsive products include microloans and patient capital to entrepreneurs through longer term loans.

Data and Reporting

The data currently available on small business lending are not nearly as detailed as those available with respect to home mortgage lending pursuant to the Home Mortgage Disclosure Act (Goodman, Zhu, and Walsh 2019).[117] In particular, CRA data only cover bank lenders—no data are available on the gender or race/ethnicity of the small business owner, credit card lending is conflated with more traditional types of small business lending, and no data are available about the terms of the loan. Although the new CRA regulations discussed above would add additional reporting requirements under CRA, relating mainly to the location and size of the business to which a loan is made, more detailed information will need to await the implementation of regulations under Section 1071 of the Dodd-Frank Act.

Section 1071 of the Dodd-Frank Act required the CFPB to adopt regulations to establish a reporting regime similar to that of the Home Mortgage Disclosure Act for small business lending. On March 30, 2023, the CFPB adopted a final regulation to put the system in place.[118] The largest lenders will need to begin collecting data starting October 1, 2024, and all covered lenders will be collecting data by January 1, 2026. The data will be made available to the CFPB annually starting on June 1, 2025, and all covered lenders must be reporting by June 1, 2027.[119] The CFPB has stated that subject to privacy concerns, it intends to make most of the data publicly available. Thus, public data from the largest lenders should first become available after October 1, 2025. In October 2023, a federal district court in Texas issued an injunction staying implementation of the regulation nationwide,[120] pending resolution of a case before the Supreme Court challenging the CFPB's funding structure.[121]

Small business loans are defined as loans to businesses with annual gross revenues of $5 million or less in the preceding fiscal year, thus focusing on the size of the business rather than the size of the loan. (Loans to nonprofits and government entities are not covered.) The regulation covers a wide swath of bank and nonbank lenders that make at least 100 "covered loans" a year, including fintechs, merchant cash advance providers, and nonprofit lenders such as CDFIs. Covered loans, including applications for a loan, are defined broadly although trade credit, leases, and factoring, and most loans by auto dealers are excluded.

The data that must be reported include critical information about the loan, including denial reason if the loan is denied, amount of the loan, type of credit (e.g., credit card, closed-end loan) and guarantee if any, purpose of the loan, term if applicable, and interest rate and other pricing data such as fees. In addition, the data to be reported include the business's census tract, annual gross revenue, NAICS code, number of employees, and time in business. Finally (on a self-reported basis), the lender must report on owner demographics (e.g., race/ethnicity and gender).

The public, financial regulators, and lenders would benefit from a consistent and comprehensive Section 1071 dataset, both to conduct fair lending analyses and to identify business and community development needs and opportunities. Both the collection and the public availability of these data should advance our understanding of small business lending in this country—who is and is not getting loans, from whom, and on what terms. The data will be useful not only to the bank regulators as they implement CRA, but also to the broader community of borrowers, lenders, policymakers, advocates, and the media.

Limited Public Data Sources on Small Businesses

Beyond Section 1071 data on small business credit originations, quality, timely, and publicly accessible data about the small businesses themselves are necessary to understand the challenges facing these businesses and to devise appropriate policy solutions. While multiple data sources currently exist, many of which have been utilized in this report, there are significant gaps in accessible data that describe the state of small businesses in the economy, their finances, ownership details, and the programs that support them.

What information do researchers and policymakers need to understand small businesses? Broadly speaking, data should be publicly accessible, nationally representative, well documented, and made available in a timely manner. Certain data are useful in real time—hiring and firm starts and closures, for instance—while others can be released less frequently. Sample sizes are important, especially when collecting data by subgroups such as industry, firm size, race, gender, and geography. Geographic granularity is also important—for example, metropolitan statistical area–level data are not useful for understanding small business activity at the neighborhood level. Finally, longitudinal and panel data are essential for understanding the effects of policies on small businesses over time.

The federal government provides at least 39 different series of small business data, as counted by researchers at Drexel and Yale universities (Bassine et al. 2020). These range from reports on employment and revenues using census and IRS data, such as the Business Dynamics Statistics, to surveys and loan records. They are hosted across a range of agencies, though primarily the US Census Bureau, US Bureau of Labor Statistics, and Federal Reserve.

Data availability and quality vary widely between agencies. The SBA provides regular updates on its loan portfolio and loan-level data for its 7(a) and 504 programs, enabling the general public to scrutinize the federal government's flagship loan guarantee programs. The USDA, a larger agency overall and one with a substantial portfolio of small business programs, has little publicly accessible data on its development programs. The data that are is available are typically stored in PDF files and are not sufficiently granular to be useful. Other agencies, such as the Minority Business Development Agency, have no publicly accessible data that we were able to find.

Information on how businesses finance their operations and make decisions is sorely lacking. For instance, the Federal Reserve Board Survey of Small Business Finances historically collected detailed information on firms' finances and credit history, using a stratified sample. However, the survey was last conducted in 2003. While the current Small Business Credit Survey sheds some light on these characteristics of businesses, few sources have been able to replicate the detail and statistical strength offered by the Survey of Small Business Finances.

The IRS collects valuable information through business tax returns. Some tax data are used in aggregated series, such as the Census Bureau's Business Formation Statistics; however, individual-level data are not accessible. Anonymized or synthetic tax data could be very valuable in advancing research on small businesses, although many businesses do not file tax returns or have limited tax histories—especially start-ups and informal businesses.

Research relies on understanding outcomes, not just program funding and user counts. Unfortunately, while there are some quality sources that enable researchers to understand what services the federal government provides, there are few that enable rigorous program evaluation. Many technical assistance programs across multiple agencies report the number of businesses with which they interact. However, the quality of those interactions or the businesses that utilize them are almost never reported, leaving researchers and policymakers in the dark about whether technical assistance programs are delivering their intended results.

The Missing Policy: Small Business Protection from Irresponsible Lending Practices

On the heels of the Great Recession, a new breed of "alternative" lenders emerged to offer small businesses much-needed access to credit. These new lenders helped fill a void created after banks cut back on lending to small businesses. Compared with traditional lenders, these alternative lenders—some of whom have access to business cash flow data—are often able to offer small businesses credit more quickly, with little or no collateral required, and with a much simpler application and underwriting process. Online small business financing has become mainstream, a trend that is unlikely to reverse course. By 2019, 30 percent of small businesses were seeking financing from online lenders. Although that share declined to 17 percent in 2020, in part because of pandemic relief programs, it has steadily climbed since and reached 22 percent in 2022 (Corcoran et al. 2023). While some of these new lenders are responsible companies that use new technologies to lower costs and deliver affordable and fair credit, others offer loans that carry rates ranging from 36 to 350 percent APR or higher, are not always transparent about those high rates, and often do not underwrite businesses' ability to repay.[122]

Federal regulations governing disclosure, terms, and interest rates and fees that cover consumer loan products such as credit cards and mortgages protect small business lending to a far more limited degree, even in cases where the business is a sole proprietorship and the owner has no greater financial sophistication than the average American. This has enabled some of the newer forms of financing to create debt traps that bear a striking resemblance to the cycle of payday lending. Research by the CDFI Accion Opportunity Fund analyzed 104 financing contracts small businesses had taken out with alternative financing companies and found that the average payment amount represented 178 percent of the small businesses borrower's net income (Weaver, Brown, and McShane 2016). In other words, the average financing contract was pushing the small business into unprofitability, charging well beyond what the business could afford to pay.

Researchers have published several reports demonstrating that disclosure practices used in the small business financing market today may misguide small business owners toward more expensive credit (e.g., Lipman and Wiersch 2015, 2018, 2019). Although the impacts of high-cost small business financing practices are widespread, vulnerable communities are affected unequally. Research finds that firms owned by business owners of color were twice as likely to apply to "potentially higher-cost and less transparent forms of credit" (Fed Small Business 2019).

Several bills have been introduced in Congress to expand consumer protections to small businesses. The most prominent of these has been an effort to expand Truth in Lending Act transparency requirements to commercial financing.[123] This bill follows the passage of small business truth-in-lending laws in several states, including California and New York.[124] These state laws were based on the Small Business Borrowers' Bill of Rights, a set of standards for small business financing created by the Responsible Business Lending Coalition, "a network of nonprofit and for-profit lenders, investors, and small business advocates."[125] Several interviewees we spoke with believe small business truth-in-lending legislation will lead to more transparency around price disclosure of APRs, prepayment penalties, and other hidden fees. Their hope is that this will empower small businesses to better compare financing options and create price competition, leading to more affordable and better products.[126] Other proposed federal bills have sought to expand the scope of the Fair Debt Collection Practices Act to small business lending[127] and to ban an abusive collections practices called "confessions of judgment."[128]

The Treasury Department has also integrated responsible lending standards based on the Small Business Borrowers' Bill of Rights into federal regulation on several occasions. In 2022, Treasury released a revised draft CDFI certification application that requires small business financing providers to adhere to certain standards of responsible practice to be eligible to be certified as a CDFI. Requirements include disclosing to small business financing applicants the APR, total loan amount, "periodic" payment due, and total finance charges over the life of the loan.[129] In 2021, Treasury incorporated elements of the Small Business Borrowers' Bill of Rights into the State Small Business Credit Initiative (SSBCI) Policy Guidelines (US Department of the Treasury 2023). SSBCI rules stipulate that SSBCI–supported transactions "may not include any of the following: (1) confessions of judgment or (2) prepayment or 'double-dipping' fees," and incorporate requirements for the transparent disclosure of certain terms (US Department of the Treasury 2023).

These are useful steps, but they are piecemeal. A meaningful advancement would be for the SBA to incorporate responsible lending standards into its licensing process for Small Business Lending Company and SBA 7(a) licenses.[130] More broadly, Congress should amend the Truth in Lending Act to extend its protection to all forms of small business financing—including loans, merchant cash advances, factoring, and leasing—in amounts of less than $250,000 at initiation or outstanding over the course of a year.

Conclusion

Small businesses are a vital part of the US economy and social fabric. At the end of 2020, there were approximately 6 million businesses in the United States with at least 1 but fewer than 500 employees (the standard definition of a "small business"), representing more than 99 percent of all firms.[131] These firms employed almost half the country's employees. Moreover, more than 15 percent of the country's employees were employed by firms with fewer than 20 employees.[132] Although small business owners are primarily older and white, more than 1.2 million firms with employees are owned by women and about 1.1 million by people of color, offering opportunities for economic growth for these diverse business owners and their communities.[133]

The small business sector is also a source of dynamism, entrepreneurial energy, and innovation. Each year, about 1 million new businesses—almost all of them small businesses—are started, while approximately the same number are lost. Between 1995 and 2021, small businesses accounted for almost 63 percent of net new jobs.[134] Although the pandemic was hard on many small businesses, business formation has rebounded to above prepandemic levels.[135]

Nevertheless, small businesses still face many challenges that threaten their survival and ability to contribute to economic prosperity. Credit availability remains tight, fluctuating economic conditions produce unpredictable cashflows, more frequent climate-change-related disasters impose damages to businesses and supply chains and increase insurance costs, and there are virtually no federal protections for small businesses against excessively costly or unfair lending practices. Business owners without preexisting wealth or wealthy personal networks are especially vulnerable.

Because of the ubiquity of small businesses and opportunities created by the sector, the federal government has provided small businesses with a range of benefits over the past 70-plus years, including capital support, government procurement preferences, business development assistance, and favorable tax and regulatory policies. As stated in the Small Business Act, "It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small-business concerns in order to preserve free competitive enterprise." Moreover, the legislation declares that "it is in the national interest to expeditiously ameliorate the conditions of socially and economically disadvantaged groups; [and] that such conditions can be improved by providing the maximum practicable opportunity for the development of small business concerns owned by members of socially disadvantaged groups."

Our research has shown that this system of supports works well for a great many small businesses, especially those that are larger, well-resourced, and have collateral to back up the loans needed for both working capital and growth. We have also found, however, that the system is less effective in supporting new entrepreneurs—especially those who do not have access through business associates, family, or friends to initial capital and business knowledge and advice. This is more often the case for women and people of color, as well as for entrepreneurs in rural areas.

Our findings lead us to the conclusion that the federal support system must be updated in order to effectively promote economic vibrancy and competitiveness through small businesses and to support small businesses of all types in all communities. The multiplicity of programs and agencies—some additive, some overlapping—coupled with the relatively sparse amount of federal subsidy in comparison to the scope of need, adds up to a system that simply is not as robust or effective as it needs to be.

There are five areas in which changes both small and large are most needed: (1) greater focus on the loan capital needs of newer businesses, those in rural areas, and those owned by socially and economically disadvantaged people; (2) increased availability of true equity capital to enable small businesses to grow to their potential; (3) an updated business development support system that makes better use of technology to maximize utility; (4) streamlining of cumbersome administrative processes and increased automation where possible to improve the efficiency of program delivery; and (5) regulatory reforms to provide safeguards to small business borrowers from deceptive and predatory lending practices.

In our research, we have identified numerous opportunities to improve existing or new programs that show promise in enabling the system to better serve the needs of businesses owned by socially and economically disadvantaged people, women, veterans, and people in rural areas. These include the recently reauthorized State Small Business Credit Initiative (SSBCI), Community Advantage program, SBA and other federal microloan programs, support for small businesses through the CDFI Fund, and the federal government's procurement goals. While none of these have reached their full potential and continued innovation is essential, their focus on target groups and their flexibility on multiple dimensions have overall been effective and provide strategies for improvement in other programs. While some of these tools are likely to be challenged judicially over the next several years, we must continue identifying and implementing supports that will not only withstand challenge but also are more effective than programs in their current forms.

More broadly, we need a more modern reassessment of the balance between the goal of limiting government expenditures and the necessity of more risk-taking to respond to the needs of target small businesses. Although the flagship SBA 7(a), 504, and SBIC programs are "unsubsidized" in a budget scoring sense in most years, these programs have inherent subsidies through the government guarantees and low cost of funds. However, the current level of subsidy is insufficient in the face of the challenges we have identified, and it is difficult to imagine current programs reaching much deeper and wider without additional subsidy—especially for the smallest and most disadvantaged businesses. If the federal government is to seriously scale up its support of businesses with the greatest needs, it cannot maintain its current approach to managing risk, which largely precludes serving those businesses.

Even apart from subsidies, there are key questions about whether current expenditures are adequately designed to meet the goal of the Small Business Act to maximize "practicable opportunity for the development of small business concerns owned by members of socially disadvantaged groups." In considering these issues, it will be useful to take into account changes in the financial system that have occurred since the major small business financial support programs were developed, including the securitization of loans not guaranteed by the government (including those made by CDFIs) and the maturation of nonbank small business financing by fintechs and other institutions. Similarly, modern technology can assist in simultaneously reducing the administrative burden on businesses, lenders, and the government, while strengthening appropriate risk controls and programmatic targeting.

Our research found a large unmet need for equity capital. This is especially the case for small businesses that have the opportunity to grow—although at rates more moderate than those sought by venture capital investors—and for businesses outside the few states and sectors, such as technology, where private venture capital is concentrated. Grants that essentially function as equity financing are to some extent available to potential government contractors, and the federal government provides or supports a limited amount of equity financing. But broader attempts to fill this gap have floundered, in part due to the inherent difficulties of equity investing at smaller scale, but also because of a lack of federal appetite for the level of risk that equity financing for new and growing ventures inevitably entails. The venture capital programs funded through this round of SSBCI are promising developments worth watching and potentially expanding. However, guardrails are necessary to ensure that the level of risk being undertaken with public dollars is understood and properly structured.

The business development support system is also sorely in need of rethinking. The plethora of programs, run for multiple purposes by multiple agencies through multiple channels, both local and national, has resulted in a system that is difficult for any small business—but especially start-ups and businesses that are located in remote areas, owned by non-English speakers, have specialized or technical support needs, or show potential for significant growth—to navigate. Past attempts at interagency coordination have had varying degrees of success, but it is important to align, standardize, and even combine efforts to best serve the needs of both businesses and the economy. There are also ripe opportunities to improve the system through modern technology. Local, high-touch strategies and outreach are essential, but so is highly specialized advice and instruction, which can often be provided more efficiently online or through in-person remote channels. The private and nonprofit sectors have developed successful models for remote and specialized learning; the federal government would benefit from coordinating and integrating with these more fully.

A final key area of reform is in expanding protections for small business owners. Many new to small business policy are surprised to learn that there are not equivalent protections for small business owners as there are for consumers around financing terms and conditions. It is a mistake for federal policy to assert, implicitly, that small business owners do not need or deserve such protections. The expansion of the fintech sector has made the need for such protections more acute. While some strides have been made, the SBA and Congress should take action to ensure transparency around price disclosure of APRs, prepayment penalties, and other hidden fees; collect debt fairly; and ban abusive collections practices. Implementation of the data gathering regulations pursuant to Section 1071 of the Dodd-Frank Act—which is long overdue—will help illuminate the dynamics of the small business credit market and the types of protections needed.

In this report, we have provided both overarching and more detailed technical recommendations, as well as raised additional questions and concerns. Our goal is to position policymakers, industry, advocates, and others to better understand the sector's needs and how the federal government can best support it, to the benefit of the country as a whole. The moment is pressing. While maintaining the status quo is often the most comfortable strategy, many federal small business support systems, policies, and programs have remained unchanged for decades, even as the business and finance worlds within which they operate have changed dramatically. Programs and policies have multiplied, often without coordination, and have not kept pace with technological and financial developments. The result is a dizzying and confusing array of programs and tools, few of them sufficient or comprehensive. We can do better; now is the time for reform.

Notes

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Statement of Independence

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