ALLIANCE FOR ENTREPRENEURIAL EQUITY

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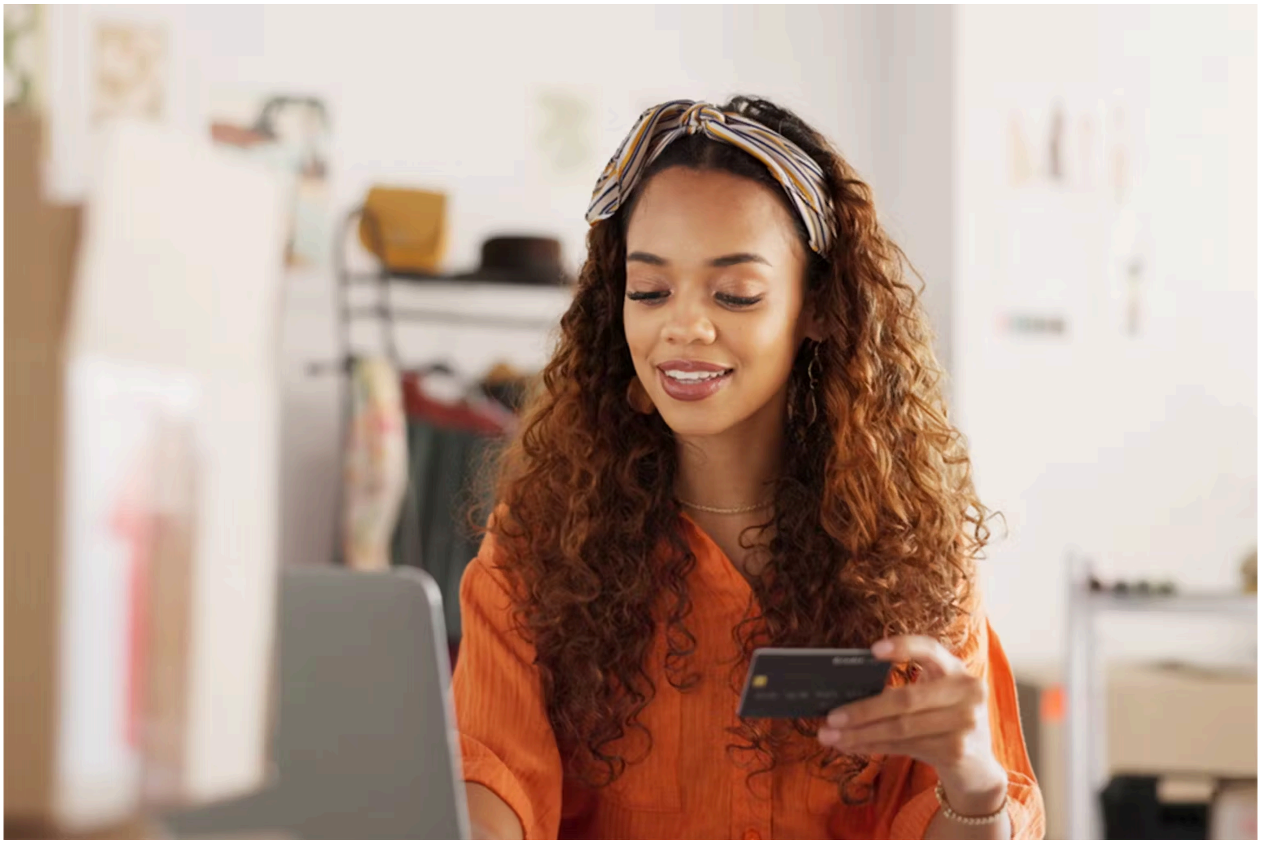
Unlocking Capital for America's Underserved Businesses



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Takeaways

Small businesses need affordable and accessible capital—and they need the system that delivers it needs to be fair. In this paper, we explore solutions to unlock capital for America's underserved businesses, including:

- Invest $1 billion in microlending to small businesses over the next decade.
- Reform the financial system with fair asset valuations and increased incentives for lending to rural and disadvantaged communities.
- Help small businesses keep more of what they earn by modernizing the tax code.

Unaffordable and inaccessible capital is what keeps firms—particularly those owned by people of color—small, stagnant, and starved for opportunity. Just think, half of Black-owned businesses applied for a loan, but four-in-ten were completely denied. Only 32% were fully approved.[1] There are a litany of reasons for these capital constraints: poor or no credit history and insufficient collateral, stricter underwriting rules for younger businesses, expensive interest rates, branch closures in certain neighborhoods, and more.[2] But the result is the same: less opportunity to start and grow businesses.

There is no silver bullet that will fix the financial fortunes of small businesses in this country. But there are things lawmakers can and should do now that will start to turn the tide. In this paper, we explore three critical reforms to significantly increase capital for disadvantaged entrepreneurs.

Three Keys for Reform

Capital needs to be accessible and affordable, and the system that delivers it needs to be fair. We can significantly increase capital for disadvantaged entrepreneurs by closing the funding gap for smaller businesses, retooling our financial infrastructure, and helping businesses keep more of what they earn. Here's how:

Close the funding gap for the smallest businesses.

Sources of startup funding are limited, particularly for the average working American and people from disadvantaged backgrounds. When credit is not readily available, entrepreneurs turn to their own funds, loans and gifts from friends and family, or fundraising to get by. [3] However, when businesses do seek financing from financial institutions, it usually isn't for much. In 2023, 41% of employer businesses sought financing for less than $50,000. Almost a quarter had small-dollar financing needs of less than $25,000. [4] And though top banks are increasing their lending to small businesses, microloans of less than $100,000 remain on average 1.6% of their portfolio. [5] Hence, there's a significant gap at the smallest end of the credit market.

SBA's Microloan Program was designed to fill that gap. It provides loans up to $50,000 to help small businesses start up and expand. The problem is, it's just too small. In FY2023, SBA's intermediary microloan lenders mobilized more than $86 million to over 5,500 small businesses. [6] To serve far more entrepreneurs, Congress should magnify the impact of this program by **investing $1 billion in microloan funding to businesses over the next 10 years**. While businesses have used dollars from the Microloan Program as a startup resource, the financing more commonly goes to existing businesses seeking working capital and funds for equipment, supplies, and inventory. [7] A new injection of funding would help SBA surpass the 20,000 jobs the program already supports, increase its outreach to the underserved and underbanked—like rural and minority communities—and expand technical assistance grants to intermediaries who promote business survival skills and mitigate the risk of business failure.

Forty percent of firms with revenues under $500,000 identified interest rates and debt repayment as top financial challenges last year. [8] The high cost of credit can deter businesses from seeking financing and stop them from investing in expansion efforts. Lawmakers can support new and small firms by increasing access to low-interest loans, making borrowing more affordable and allowing owners to invest in things like hiring and new equipment. In a recent announcement, Vice President Kamala Harris proposed **establishing a small business expansion fund**, offering low- or no-interest loans through community banks and CDFIs.

Make equal opportunity central to the financial system.

Since the collapse of the Freedman's Bank 150 years ago, the relationship between financial institutions and disadvantaged communities, particularly Black households, has often been fraught with reticence and mistrust. [9] Black and Hispanic Americans are more than twice as likely as white Americans to be unbanked or underbanked. [10] When applying for credit from financial institutions, only 17% of minority employer firms are fully approved for all the financing they seek. [11] We can restore faith in the financial system by refocusing on equal opportunity lending to businesses with the greatest need.

First, it's time for federal regulators to implement new guardrails and enforcement to **ensure consumer assets, like homes, are fairly appraised**. A study recently found homes in white neighborhoods are appraised at double the value of homes in communities of color, on average $371,000 more. [12] Home equity plays a significant role in household wealth and is often an important source of collateral for borrowers. To ensure small businesses have the best chance at positive credit determinations, federal regulators should provide clear guidance to the appraisal industry, diversify the appraisal workforce, and update appraiser qualification criteria—especially improving training and examination experience requirements. The Biden-Harris Administration has already taken steps to advance valuation equity and should continue to implement its plans. [13]

We also need to reform the incentives guiding financial institutions to better serve underserved borrowers, particularly through the Community Reinvestment Act (CRA). The CRA requires banks to meet the credit needs of the communities they serve, including low- and moderate-income (LMI) neighborhoods. Currently, CRA assesses banks based on the number of home mortgage and small business loans made, treating them equally. However, reforms proposed under a new CRA rule would weigh lending in LMI neighborhoods by both the number and dollar value of loans. This change could devalue small business loans, as they are typically smaller than home mortgages, potentially excluding them from CRA consideration in some areas. **Federal regulators should revise the retail lending test to ensure small business loans remain a key focus under the CRA.** [14]

Finally, we should **expand the use of special purpose credit programs to serve unmet needs in the community**. Under the law, lenders are allowed to design and implement special programs to "extend credit to communities that would otherwise be denied credit or receive it on less favorable terms". [15] For example, a large bank could provide discounted interest rates for applicants in majority-minority neighborhoods who have a lower payment-to-income ratio. Or there could be a business lending program for women-owned firms in which industry experience requirements are relaxed, where it had been a barrier for otherwise qualified entrepreneurs. [16] These programs have been around for 40 years, but very few banks have used them to reach small businesses with the greatest need. The slow uptake is due in part to financial regulators who haven't provided clear guidance around what an allowable credit program would look like.[17] By **establishing an office to review and give prior approval for such programs and by creating rewards to encourage this investment** by financial institutions, regulators could take a large step toward helping firms unlock the capital they need.

Help small businesses keep more of what they earn.

Startups owned by people of color are 10 percentage point less likely than their white-owned counterparts to have annual revenues of more than $100,000.[18] These businesses often start in a much weaker financial position, more frequently operating on thin or no profit margins at all. Needless to say, every dollar counts for today's small business owners. By making a few tax-advantaged strategies permanent, Congress can help businesses keep more money in their pockets.

Small businesses face significant operational expenses when starting out, including costs for insurance, permits, advertising, and payroll. These expenses can total an average of $40,000 in a single year.[19] Currently, when businesses file their taxes, they can only deduct up to $5,000 of these startup costs, which is insufficient for most to recoup their initial investments. A larger startup deduction would allow new businesses to reinvest more into their future success. Vice President Harris recently proposed to **increase the startup cost deduction from $5,000 to $50,000, a tenfold boost aimed at providing stronger support for entrepreneurs**. Under the plan, businesses would be able to use the deduction immediately or down the road to reduce their taxes when they become profitable.

In the past, individuals who received $20,000 or more through a third-party payment app—like PayPal, Venmo, or Zelle—would have to register the money as income on a form known as 1099-K.[20] In 2021, legislation brought that threshold down to $600, capturing far more of the side hustlers and part-timers—and throwing into question which transactions are taxable and which aren't. Later, the IRS announced it would phase-in the $600 threshold and give payment platforms more time to prepare by first implementing a $5,000 threshold for the 2024 tax year. [21] Regardless of when it's implemented, the fact is that $600 is too punitive for far too many small businesses, and the regulatory uncertainty only adds to the confusion. Congress should **establish a new, higher threshold for payments made through third-party platforms** that empowers businesses to hold onto more of what they make. The certainty will help busy entrepreneurs quickly comply with the changes in next tax period and reduce noncompliance.

Innovative businesses drive the economy forward with their research and development of products that have the potential for commercialization. To incentivize this work, the research and development tax credit was designed to help businesses hold onto more revenue and free up cash to reinvest in their work. However, many small businesses miss out on the significant savings of the R&D credit. Less than 30% of business who qualify for the credit actually claim it. [22] The reticence is, in part, because businesses simply don't know about it or don't think they would qualify. Another reason is because businesses were once able to immediately deduct the full value of their R&D investments, but the 2017 tax law required the deduction to be spread out over a five-year period, watering down its effect. [23]

As a result, Congress should **restore full expensing of small business R&D investments.** It can also direct the IRS outreach and taxpayer advocate offices to **increase awareness of the R&D credit among small firms.** A bipartisan bill from Senators Maggie Hassan (D-NH) and Todd Young (R-IN) would do just that, giving businesses a renewed enthusiasm to invest in scientific research, the development of new technologies, and the creation of jobs. [24]

Conclusion

Small businesses are in urgent need of accessible and affordable capital, especially firms owned by disadvantaged entrepreneurs and those in underserved areas. Expanding microloan funding, enhancing tax benefits, and ensuring fairness is central to the financial system are crucial steps to fixing this problem. But more will need to be done. There is a role for government to play, for example, in increasing access to venture capital and equity investments, smartly regulating financial technology, and ensuring all businesses can tap into the full range of financial resources needed for growth and success. There are also areas where government should do no harm. For example, there have been bipartisan concerns over what impact proposed regulations to increase capital requirements on large US banks would have on small business lending. [25]

Overall, however, the size of the problem should not prevent action. Now is the time for lawmakers to act quickly and decisively to boost affordable and accessible capital—and create more opportunity for US entrepreneurs and small business owners.

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