THIRD WAY

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Starting and Owning a Small Business

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Starting and owning a business is a dream and a risk. Most ventures don't succeed beyond five years. And the individual cost of starting a business, both in time and money, can be enormous. But the reward can be enormous as well. Many of the flagship companies in the United States started in a home office, garage or kitchen. However, in today's economy—with tight credit, diminished savings, and skittish investors—starting a business has become more difficult.

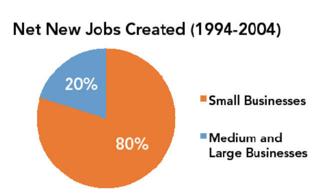
THE PROBLEM

Starting and Operating a Small Business is More Difficult than Ever.

Small businesses are a key driver of American innovation and economic growth.

Small businesses are the driving force behind American innovation. Transformational products such as the personal computer and the search engine were invented by small groups of people working out of cramped offices, dorm rooms, and their homes and garages. Today, innovative products are being created and sold every day from homes and small store fronts on the main streets of America.

Not only are small businesses a key source of American innovation, they are also critical to America's future economic growth. Small businesses employ slightly more than half of the American workforce and create half of the nation's gross domestic product. In fact, as the chart below shows, small businesses were responsible for creating as many as 80% of net new jobs from 1994 to 2004. [1]



Source: Small Business Administration, "The Small Business Economy 2008: A Report to the President," December 2007, available at http://www.sba.gov/advo/research/sb_econ2008.pdf.

Additionally, as many as 7% of Americans are actively in the process of starting a business, one in ten Americans are self-employed, and many more aspire to own their own business. [2]

Small business start-up costs are substantial.

Though small businesses are a significant part of America's economy and job base, it is harder than ever to start one and keep it operational. Not only do small businesses face competitive pressures from larger businesses, start-up and operating costs are substantial. On average, new firms inject a total of $80,000 into their businesses during their first full year of operation and the vast majority of small business owners—between 80% and 90%—also invest significant amounts of their own money into their businesses. [3]

Obtaining a loan is more difficult than ever.

For small business owners, outside debt financing, such as bank loans or credit cards, make up 40% of injected capital in their first year and 62% three years later. [4] However, the recent credit crisis has made obtaining such debt financing nearly impossible. During the 4th quarter of 2008, 70% of banks reported tightening their lending standards for small businesses. [5] As a result, fewer than half of the small businesses that tried to get a loan in the 4th quarter of 2008 were able to get one. [6] Of small businesses seeking a new line of credit in 2009, only three in ten succeeded in doing so. [7] By November 2009, the 22 banks that had received the most help from the Treasury Department's bail-out program cut their small business loan balances by approximately $10.5 billion. [8]

In light of the contributions that small businesses make to state and local economies, governors need an expansive portfolio of policies designed to help citizens create such businesses, keep them operating, and spur their growth. We have identified 17 ideas for governors to help their citizens start and operate a small business.

THE SOLUTIONS

Helping small business owners succeed.

1. Create a cabinet level position for small business.

Small business is an important driver for state economies and a significant source of jobs for state residents. It is imperative that states make a concerted effort to create policies that foster small business growth. To ensure that states make a substantial commitment to small businesses, governors could create a cabinet level position focused entirely on small business growth and development.

2. Create a State Jobs Director or Cabinet

During these turbulent times, many residents of many states have lost their jobs and many businesses are finding it increasingly more difficult to operate. Governors can create a Jobs Director or Jobs Cabinet to focus on ways to make it easier for small businesses to operate and look for opportunities to help small businesses add jobs to communities. For example, this Czar or Cabinet could review the regulations imposed on businesses and look for ways to eliminate unduly burdensome red tape. Similarly, the Czar or Cabinet could conduct economic development studies and identify sectors for further development.

Best Practices

- In Los Angeles, the Mayor appointed an economy chief to focus on economic development. Almost half of the city departments will report to this new economy chief, and he will focus on identifying development opportunities and reducing red tape for businesses. [9]

- In Virginia, Governor McDonnell, shortly after being sworn in, signed an executive order to create a chief job creation officer and an economic development and job creation commission. [10]

- Colorado created a jobs cabinet that issued a report with a series of recommendations to better align education, workforce, and economic development to provide Colorado businesses the workers, information, and resources to grow. These recommendations included: 1) implementing local collaboration forums; 2) engaging employers in workplace assessements to ensure local education and training needs are targeted; and 3) developing a coordinating web portal, among others. [11]

3. Create a new small business property tax break.

Several states such as New Jersey and Illinois already have programs in place that freeze property taxes for senior citizens and encourage the rehabilitation of older homes. [12] States could create similar programs for small businesses. This would allow new and expanding businesses to purchase and renovate vacant and foreclosed storefront properties without paying additional property taxes for up to five years. Under this proposed idea, the assessed value of the property would be frozen at its vacant or foreclosed level no matter how extensive or expensive the improvements the new operator makes. At the end of a specified period of time (for example, five years) the property would be reassessed at the new, higher value. This property tax break would provide economic incentives for new start-ups and expansions. It would create jobs, not only by helping people start new businesses, but by encouraging renovations and new construction. It would have a minimal impact on state and local budgets since these properties currently lie fallow. The proposal is scalable and could be expanded to include vacant factories and offices.

4. Convert vacant commercial and government real estate properties into

small business office space.

In addition to equipment, many start-up businesses also need access to inexpensive office space. To help small businesses obtain affordable office space, state governments should partner with local communities, commercial real estate owners, and universities to provide small businesses access to vacant office space at reduced rents. By providing small businesses access to affordable office space, proprietors of these businesses can focus on growing their business rather than paying their rent. [13]

Best Practices

- A similar program has already yielded results in New York City, where the city partnered with academic institutions, property management companies, and commercial landlords to create "incubators," which provide ready-to-use offices to small businesses at reduced rents. [14]

5. Hold regional summits with banks to encourage small business lending.

It has never been harder to obtain credit than it is today, and it is nearly impossible to start or expand a business without obtaining a loan. Governors could hold summits with banks throughout the state in an effort to free up credit and to get banks lending again. They could hear from the banks to learn why they are holding capital so tightly, and they could hear from small business about the troubles they've had securing loans. Governors could set a goal of increasing small business lending by 20% over the next three years and ask banks to help the state achieve that goal.

Best Practices

Maryland held its first Small Business Summit in December 2009, where over 120 small business owners were brought together with banking, healthcare, technology, and energy experts. Discussions focused on those issues most pertinent to small businesses today, including access to credit and healthcare. This summit was a part of the Governor's strategy to strengthen small businesses and their access to capital. [15]

6. Provide interest-free or interest-reduced loans to small businesses.

Not only do small business owners use their own money to fund their businesses, many rely on outside debt financing such as bank loans or credit cards. During the financial crisis many sources of credit dried up and small businesses were unable to obtain the financing and credit they need to operate their businesses. To ensure that small businesses are able to obtain reliable and steady sources of credit, states could establish programs to provide interest-free or interest-reduced loans to small businesses.

Best Practices

- Ohio has instituted such a program already, called "GrowNOW," which provides interest-reduced loans of up to $400,000 to small businesses located in Ohio that employ fewer than 150 people and create/retain jobs in the state. [16]

- Delaware established the LIFT (Limited Investment for Financial Transaction) program that covers the interest on small-business loans for two years. [17] In less than one year of existence, the program has helped 37 Delaware businesses save or create 440 jobs. [18]

- Iowa also recently instituted a Targeted Small Business loan program to provide low interest financing for small businesses majority-owned by women, minorities, or persons with disabilities. [19]

7. Establish a small business loan loss reserve program.

To help small businesses obtain access to capital and reduce risk to financial institutions, states can establish a loan loss reserve program. Under such a program, borrowers would have to pay a registration fee of one or two percent of any loan of up to a maximum amount and such fees would be deposited in an account for the lender that is owned and managed by the state. In the event of defaults, the lender's losses would be paid out of such an account.

Best Practices

- Colorado has instituted the "Colorado Credit Reserve" (CCR) program to increase small business lending. Under this program, borrowers pay a 1.5% origination fee for any loan up to a maximum amount of $500,000 that is deposited in an account designated for the bank but owned by the CCR program. Losses from loans eligible for the program that are incurred by lenders are paid out of this account. [20]

8. Issue innovation bonds.

A state's residents can also have a stake in assisting small businesses. To assist small businesses in obtaining the financing they need, states can issue "innovation bonds" to finance fledgling businesses developing products that, in the state's estimation, have commercial viability. Under this proposal, the state would issue municipal revenue bonds to companies and individuals that reside in the state, the proceeds of which would be used to fund small businesses that create products that have commercial viability. Because some products may not come to market until years after the business is started, the state can subsidize the payment of the interest on the bond until the small business is able to repay the state's outlay with product revenues.

Best Practices

- Ohio's Enterprise Bond Fund program allows large and small credit-worthy, but unrated, businesses access to the national capital markets through the issuance of bonds. The proceeds of which are provided to these businesses for eligible projects in the form of loans. [21] The program has completely financed 91 projects at a total cost of $425 million. [22]

9. Provide a generous small business start-up deduction.

Small business start-up costs can be significant. Even before their doors open for business, small businesses face a substantial number of expenses—everything from legal and accounting fees, advertising expenses, supplies and equipment, tools, licensing, permits, rent, and utilities. Though the federal tax code provides a start-up deduction of $5000, this benefit pales in comparison to the costs, on average $80,000, that entrepreneurs face in starting a business. [23] To encourage entrepreneurs to start new small businesses, states could complement the federal government's efforts and provide their own small business start-up deduction.

10. Provide small businesses with "Seed Money" grants.

While tax credits are great ways to incentivize small business start-ups, the financial benefits are not felt until after a full year has passed and what many small businesses need to jump-start their operation is money today. In establishing a small business seed money program, states can direct money to small businesses with new innovative ideas or products that meet public policy goals and spur further economic development. For example, a state such as Michigan, which, despite its high unemployment and reliance on the automobile industry, ranked third in clean energy technology patents as of June 2009 and attracted $55 million in venture capital from 2006 to 2008, could provide money to entrepreneurs interested in starting businesses to facilitate the transition from carbon-intensive to clean energy industries. [24] In addition to businesses focused on clean energy, states can also focus their funding on businesses that complement other public policy priorities such as encouraging the growth of minority or female-owned businesses.

Best Practices

- Connecticut recently announced the Connecticut Small Business Innovation and Diversification Program to help Connecticut's small businesses develop, produce, and commercialize products. Under this program, Connecticut will make $250,000 available for strategic grants of up to $25,000 to companies with 500 or fewer employees and have ongoing business and sales derived from Connecticut-based activities. [25]

- New York's Small Business Task Force recently called for the creation of a Seed Capital fund that would leverage private capital sources and support the development of start-up companies. Under this proposal, funds would be allocated based on a competitive process that rewards high performance, and matching funds would be made available from the state's 64 venture capital firms. [26]

11. Provide individuals investing in small businesses a 100% capital gains tax exclusion.

Another source of capital for small businesses is direct investors. By attracting investors, small business owners can preserve their own personal funds and limit their lending from banks and credit cards, making it more likely for their businesses to succeed. The federal government provided a 75% capital gain tax exclusion for investing in small businesses in the stimulus package and the President recently announced an initiative to increase that exclusion to 100% of capital gains. States could do the same by excluding from taxation income earned on investments in small business.

Best Practices

- Wisconsin, as part of its "Accelerate Wisconsin Program," provides a limited 100% capital gains tax exclusion up to $10 million when reinvesting in Wisconsin businesses. [27]

12. Provide a standard home office deduction for small businesses.

Many small business owners—nearly 9 million—work out of their homes. [28] The federal tax code provides these home-based small businesses a tax break, but the federal home office deduction is too complex and too time consuming. As a result, fewer than one in three home-based small business owners take the trouble to figure out the federal deduction, [29] and the complexity of the deduction is the top tax complaint among self-employed workers. To make it easier for home-based small businesses to operate, states could provide a generous standard home-office deduction. This would simplify the process for small businesses and make it easier for them to take advantage of the deduction that they sorely need during these turbulent times. [30]

13. Create a "Power for Small Business" program.

Increasingly, electricity costs have become a larger portion of a small business' operating expenses. Not only can electricity be expensive, but its costs can be somewhat unpredictable, and small businesses need a predictable bottom-line in order to plan for future growth and create new jobs. To help small businesses offset these costs and maintain predictable expenses, states could provide small businesses with discounted, fixed-price, electricity from state-owned electrical utilities.

Best Practices

- In New York, where electricity is higher than the national average, a similar program, "Power for Jobs" has been in place since 1997 and currently supports nearly 240,000 jobs at approximately 475 businesses and not-for-profit organizations throughout the state. [31]

14. Provide subsidies to small businesses to help their employees purchase health care policies (updated April 2010).

One of the largest costs to small business owners is the cost of providing health care coverage to their employees. In 2009, 41% of businesses with less than 200 workers did not offer health insurance to their employees and 62% of those businesses cited cost as "the most important reason" for not doing so. [32] While the recently enacted health care reform law provides subsidies beginning in 2010, the tax credit is limited to 35% of the employer's contribution to health care premiums. [33] To help small businesses weather the storm of the ongoing recession, states can provide additional subsidies to small businesses to help them purchase health insurance for their employees.

Best Practices

- Arizona's Health Insurance Premium Tax Credit program allows small businesses that have been in existence for at least a year and have not offered insurance for six months to apply for a tax credit on a first come, first served basis. [34]

- Kansas's Employer Health Insurance Contribution Credit provides a refundable tax credit to qualifying small businesses that begin offering health insurance to their employees. [35]

- "Insure Montana" provides a tax credit to small business employers that already provide health insurance, and for those who do not offer coverage, it offers premium assistance through an insurance purchasing pool. This program is paid for with tobacco tax funds. [36]

15. Start a program to refurbish recycled office equipment and provide the equipment at a discount to small business owners.

Today, many people are looking for ways to recycle aging office and computer equipment in safe ways to protect their confidential information. At the same time, many small businesses just starting out need access to quality, cheap office equipment and technology. While several states and private businesses have implemented programs to recycle computer and other electronic equipment, few if any have implemented programs to resell such equipment to small businesses. States could partner with local communities and recycling businesses to establish programs that would enable individuals and businesses to recycle old computers and other office technology, refurbish them, and then resell them to local businesses. Information on this program could be provided at the state's "Start a Small Business Day" or on the dedicated website (see below). A program such as this would enable individuals and businesses to recycle their old computers while providing small businesses access to the equipment they need to jump-start their endeavors.

Best Practices

- New York City's WasteMatch program was created in 1997 and has since diverted over 25,000 tons of materials from landfills and helped participants realize $4 million in savings and revenues. WasteMatch provides a free service funded by the NYC Department of Sanitation which facilitates the exchange of used and surplus equipment from organizations that do not need them to businesses that do. Organizations that donate or sell materials reduce waste disposal costs and generate revenue while clients that obtain free or low-cost materials face lower purchasing costs and reduce their environmental impact. [37]

16. Sponsor "Start A Small Business Day" throughout the state.

Establishing a small business even when you have the funding can be difficult because of myriad legal, administrative, and technical hurdles that need to be overcome. Small business owners need to obtain licenses, permits, establish a partnership or corporation, locate office space, and purchase supplies and equipment. To help them navigate this complicated process, governors could establish "Start a Small Business Day" in local communities around the state to provide potential and existing small business owners a "one-stop shop" to obtain information about what they need to do to establish a new small business, to obtain answers to questions they may have, to meet professionals and consultants to assist them in getting started, and to assist them in filling out the necessary forms and license applications.

17. Establish a dedicated small business website.

Along the same lines, states can make establishing a small business easier and more accessible by providing a one-stop shop online by creating a website dedicated to information on running and setting up a small business. The website can provide on-line articles and other resources explaining the steps an entrepreneur needs to take to establish a small business, instructions for filling out the necessary forms and applying for necessary licenses, and on-line permitting and licensing tools. In addition, lawyers, accountants, and other professionals that can help small businesses could advertise on the site and pay a fee to the state to do so.

Best Practices

- Virginia has an online business One-Stop that was launched in May 2008 to consolidate business licensing, registration and permitting into a single online system. It has already been used by 15,000 entrepreneurs, including 8,587 new businesses. [38]

- New York's Small Business Task Force recently proposed developing an online permitting and licensing process for small business. New York estimates that this process would cost approximately $10 million to implement, but that it would likely create other cost-savings in terms of current data-entry and processing costs. [39]

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