Are Small Businesses *Concerned* about Credit?

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Small businesses[1] are vital to New England's economy. They employ 60 percent of the region's workers and are responsible for more than half of New England's payrolls and economic output. But running a successful small business is not easy. Aside from their large investments in long days and sweat equity, small business owners confront a host of challenges that threaten to unravel their livelihoods. According to the U.S. Small Business Administration (SBA), 50 percent of small businesses fail within their first year, and only 5 percent make it for more than five years.[2]

[1] The Small Business Administration's Office of Advocacy defines a small business as an independent business with fewer than 500 employees.

[2] http://www.sba.gov/starting_business/startup/areyouready.html

What are these challenges and how daunting are they? In February, the National Federation for Independent Business (NFIB) Research Foundation conducted the sixth *Small Business Problems and Priorities* study. NFIB surveyed 4,603 small business owners and asked them to rate the severity of 70 problems faced by today's small businesses. For respondents, cost concerns and taxes topped the list of pressing problems (see table on page 23).

The high cost of health care was the number one concern of small business owners in 2004, and over 65 percent of respondents called it a critical problem. The price tag on liability insurance was the second biggest worry; workers compensation costs were number three, while rising fuel prices made energy costs a fourth major concern. With the nation just coming off the tail of an economic recession, it is not surprising that cost pressures were the greatest concerns of small business owners. With little room to expand revenues, businesses have had to control spending to stay out of the red.

What is striking about the NFIB's survey results, however, is the relatively low level of concern related to the availability of financing and credit. Obtaining business loans was the least important concern for small business owners in the survey, and aside from anxiety over cash flow, businesses were relatively unconcerned about financing matters in general. Given that inadequate financing has been shown to be one of the most common reasons why small businesses fail, why so little concern?

A Greater Concern for Younger Businesses

The lack of concern over credit availability may be a function of who answered the NFIB's survey. When compared with U.S. Census data on small businesses, respondents to the survey had, on average, more employees and were more likely to have been in business for over 10 years. The high percentage of larger, more-established small businesses in the sample may have resulted in greater emphasis on the problems associated with running a more complex organization and less on the problems faced by businesses trying to get off the ground—including a lack of credit. Unlike newer entrepreneurs, longtime business owners probably have established relationships with lenders and adequate revenue and assets to finance growth and capital improvements. In general, these businesses have fewer worries about obtaining credit than younger firms.

A closer look at the NFIB data reveals that owners of small businesses that have been in operation for less than four years were more concerned about financing than survey respondents as a whole. Cash flow was deemed a "critical" problem for 33 percent of young businesses—making it the second largest concern for this group behind the cost of health care. Moreover, obtaining loans was considered a critical problem by more than 15 percent of these business owners. Immigrant business owners were also more likely to be concerned with the financial health of their businesses. Cash flow was cited as a critical problem by nearly one-third of immigrant-owned businesses, and immigrants were more likely than natives to worry about obtaining business loans and to have concerns about their credit ratings.

Economic Impacts

While credit remains a major source of anxiety for many younger, smaller, and immigrant-owned businesses, recent economic conditions likely reduced small business financing concerns overall. Economic weakness in the early part of the decade decreased the demand for credit among small business owners. New loans were not on the radar screen, as many small businesses were preoccupied with keeping costs in line and riding out the economic downturn. As in past recessionary periods, many small business owners put their plans for expansion, growth, and improvements on the back burner, awaiting a rebound in sales, revenues, and profits. In fact, in 2002, total business loans declined for the first time in years, and growth in the number of small business loans significantly slowed.

At the same time that demand stagnated, the cost of credit became cheaper. Beginning in January 2001, the Federal Reserve steadily marched interest rates down to all-time lows in an effort to promote economic growth and stability. Between January 2001 and June 2003, the federal funds rate dropped 500 basis points, moving from 6 percent to 1 percent, where it remained at this historic low for almost a year. Banks and other lenders also reduced their interest rates, creating an accommodating credit market that likely lessened small businesses' concerns about obtaining affordably priced business loans.

Problems Cited by Small Business Owners

Rank	Problem
1	Cost of Health Insurance
2	Cost and Availability of Liability Insurance
3	Workers Compensation Costs
4	Cost of Natural Gas, Propane, Gasoline, Diesel, Fuel Oil
5	Federal Taxes on Business Income
6	Property Taxes
7	Cash Flow
8	State Taxes on Business Income
9	Unreasonable Government Regulations
10	Electricity Costs
58	Interest Rates
64	Credit Rating
68	Obtaining Long-Term Business Loans
70	Obtaining Short-Term Business Loans

Source: *Small Business Problems and Priorities.* National Federation of Independent Business Research Foundation. 2004.

Changing Supply

While macroeconomic conditions have affected the demand for small business financing, lenders have arguably increased the supply in recent years. First, credit cards have made capital dramatically more accessible for many entrepreneurs. For small-sized loans, credit cards offer less rigorous application requirements in exchange for higher interest rates on balances. Since the late 1990s, the use of credit cards for business financing has greatly expanded. The 1998 Federal Reserve Survey of Small Business Finance found that 45 percent of small business owners used a personal credit card for business purposes, and 33 percent had a designated business credit card. Likewise, the 2001 NFIB Research Foundation's report *Credit, Banks, and Small Business*, found that 82 percent of small business owners used a credit card to finance their businesses, and for 15 percent of owners, credit cards were the primary source of working capital. Credit card usage is more prevalent in younger and smaller firms, which are less likely to have an established credit history or banking relationship. The 2001 NFIB credit survey showed that 34 percent of firms in business for less than 4 years relied on credit cards for working capital, compared with only 16 percent of those in business for over 35 years.

Despite the growing popularity of credit cards, banks remain the primary source of funding for small businesses. Fifty-five percent of small businesses surveyed by the Federal Reserve in 1998 had at least one outstanding loan, lease, or line of credit from a banking institution, and banks accounted for 84 percent of the loans held by small businesses in the NFIB's 2001 survey. In the last decade, bankers' appetite for small business loans has improved, in part because the focus of the Community Reinvestment Act (CRA) was shifted toward small business lending in the mid 1990s.

Originally passed in 1977 to stop the practice of "redlining" in home mortgage lending, CRA seeks to ensure that banks meet the credit needs of their entire communities. In 1995, changes to the law put greater emphasis on small business lending as a way for banks to accomplish this goal. This new focus eased the availability of capital for small business owners, and researcher Jonathan Zinman found that the changes induced a 12 percent increase in overall small business lending.

The growing use of credit scoring in small business lending has also apparently increased the credit supply for entrepreneurs. Credit scoring uses computer-generated models to determine the probability of default on a specific loan application based on the applicant's prior credit history. The automated process is replacing traditional relationship-based small business lending. Some worry that as banks know less about their clients, the number of loans to small businesses, especially those in traditionally underserved markets, will decline. Researchers at the Federal Reserve Bank of Atlanta have found just the opposite. Credit scoring has increased small business lending both overall and in low- and moderate-income neighborhoods by increasing competition, reducing discrimination, and improving the quality of information. Moreover, the standardized use of credit scoring by the banking industry has even greater potential to increase small business lending. According to researchers at a recent SBA conference, credit scoring could eventually be used to securitize small business loans, allowing them to be packaged and sold on the secondary market and thereby increasing the overall profitability of small business lending.

Potential Threats Remain

While innovations in small business lending have increased the supply of credit and reduced some owners' concern about financing, potential threats remain. For instance, the banking industry of the past decade has been characterized by mergers and acquisitions, with at least 300 bank mergers taking place every year in the 1990s. Traditionally, smaller community banks have been the largest source of small business loans, and the industry's shift toward larger institutions may be negatively impacting small business lending. A recent research paper by the SBA found that credit is less available to small businesses in markets that are dominated by large banks. However, the evidence is mixed. Researchers have shown that mergers between small banks may actually increase small business lending and that new sources of credit, both bank and nonbank, often move into consolidated markets to help meet demand. Nevertheless, concerns remain that the continued consolidation of the industry may limit some small business owners' access to credit. In sum, although small business owners may be less concerned about credit today, changing economic and industry conditions may heighten their anxiety about this problem in the future.

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