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An Update on Small Businesses

Rosa Maria Moller, Ph.D.

Prepared at the Request of
Assemblyman Richard Alarcon

MARCH 2007

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C A L I F O R N I A R E S E A R C H B U R E A U

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EXECUTIVE SUMMARY

This paper responds to a request of Assemblyman (then Senator) Richard Alarcón to the California Research Bureau for an overview of issues related to small businesses in California, including recent data on the number of firms, employment, employment growth, and financial conditions within this sector.

The Office of Advocacy of the Small Business Administration (SBA) defines a small business as an independent business having less than 500 employees. In 2004, California had 3.2 million small businesses; most of them (78 percent) were nonemployer firms'.[1] Since more than 99 percent of the employer firms in California had less than 500 employees, this analysis also looks at firms with less than 100 employees and those with less than five employees.

Small businesses are important because they employ a significant proportion of the work force. According to data from the SBA, businesses with less than 500 employees employ half of the work force and produce about half of private sector output in the United States. Small businesses spur competition in free markets and have historically made a critical contribution to innovation. Firms of very modest size have made large contributions to a large share of innovative breakthroughs. Furthermore, small businesses provide employment to individuals and demographic groups who might otherwise be shut out of the labor market.[2]

The number of small businesses has been growing at a faster rate in California compared to the United States as a whole. From 1999 until 2004, California experienced an 8.5 percent growth rate of small businesses compared to the national growth rate of 5.5 percent.

Small business as a group held well in the economic downturn of 2001, as shown by the relatively stable number of firms and self-employed individuals. The number of small firms (including the number of nonemployer firms) and small business employment grew between 2001 and 2004, while the number of larger firms and employment in those firms decreased. This trend was more pronounced in California than in the U.S. as a whole. Under poorer economic conditions, self-employment generally increases because the opportunity cost of being self-employed decreases significantly as job opportunities reduce. With increases in self-employment and as firms reduce their operations, average business size declines and the small business share of the economy increases. Some of this increase is due to the reclassification of larger firms to the small-businesses category, as they had to reduce employment in the economic contraction of 2001.

Compared to the nation, California has a larger proportion of very small businesses (under five employees) in the Information; Arts, Entertainment, and Recreation; Professional, Scientific and Technical Services; and Health Care and Social Assistance industrial groups. These businesses have an average payroll per employee almost as high as the largest firms. Self-employment and nonemployers have increased significantly in California since 1998, a result from the economic boom by the end of 1990s when new business formation accelerated.

Recent National Federation for Independent Business (NFIB) surveys have found that small businesses top concerns are taxes and costs, particularly health insurance costs, and that concerns on credit availability and access to capital are lower on the list. This is an interesting finding since lack of financing is one of the most common reasons for small businesses failure and ranked high on the list during the early 1990s.

The lower emphasis on credit problems can be explained by favorable credit conditions since the late 1990s, the use of credit scoring to reach increasingly riskier borrowers, and a proliferation of credit cards.[i] However, a closer analysis of the surveys indicates that vulnerable entrepreneurs (young, minorities and those with very small ventures) still consider credit availability a problem.

Credit availability has increased significantly since the late 1990s, and it was only slightly affected by the 2001 economic slowdown. Interest rates paid by small business owners have been low thanks to the low interest rate levels of the period. Furthermore, the use of credit scoring has allowed financial institutions to lend to riskier borrowers that traditionally would have been left out.

Credit scoring assigns scores to borrowers according to their probability to repay loans, which is based on statistical analysis of borrower's characteristics that are considered related to creditworthiness. Since credit scoring has proven to be effective in predicting repayment probability, it has become the primary criterion used by lending institutions for determining who is approved for credit or a small business loan.

Banks continue being the primary lenders of small loans and have increased their presence since deregulation. Providers of small commercial loans are aggressively expanding their market by using credit cards as the primary product and credit scoring as the decision-making methodology.

Entrepreneur's equity, resources of family and friends, and angel investors (high net worth individuals that invest for their own benefit) continue being the main source of early stage capital financing. According to the University of New Hampshire Center for Venture Research, in 2005 angel investment in the U.S. was about $23 billion, an increase of 2.7 percent over 2004. Studies from this center also indicate that although angels continue being the largest source of seed and start-up capital, they are shifting capital investment toward later-stage investments and hence, proportionally reducing the amount of seed and start-up capital. As angel investors become more organized and sophisticated, there is a danger that their investment decisions will mirror those taken by venture capitalists. This could be a serious problem for small businesses since traditionally angel investors have filled a gap too large to be met by traditional sources and too small to be of interest to venture capitalists.[3]

The California share of U.S. venture capital investment has been fairly stable, but the amount of venture capital investment in the United States declined by 78 percent, from $104 billion in 2000 to $22 billion in 2005. In California, the decline was 75 percent. Venture capital generally does

[i] Credit score is a number, generally between 300-850, assigned to borrowers to represent an estimate of the borrower's future loan performance.

not fund basic innovation or start-ups. Only about three percent of the $22 billion venture capitalists invested in 2005 went to firms in early stages of development. In California, only 2.2 percent of venture investments funded start ups, with more than three quarters of all capital invested in Silicon Valley firms, mainly in software, telecommunications, networking and equipment, and medical devices and technology.

The paper also describes federal and California credit programs for small businesses. As more and more borrowers are served by lending institutions due to the refinement of credit scoring methods, government programs may have to address the credit needs of those left out of these markets (those with higher levels of risks or lower credit scores). This will require more equity in the government programs' capital structure and the provision of technical assistance to support potential losses associated with higher levels of risk.

Several states have built capital venture programs to fill the gap of start up capital or because venture capital is scarce. In California, the amount of capital available appears to be relatively significant, but capital is more abundant in certain geographic areas (Silicon Valley, for example) and for certain more "trendy" industrial activities. To the extent that traditional capital sources do not reach all sectors, the state may want implement a program to help redirect capital resources to these "neglected" areas or industries. A review of the literature on the various programs currently available in other states indicates that the programs analyzed in the 1998 California Research Bureau report entitled "Business Capital Needs in California: Designing a Program" have not changed significantly and that the issues and elements to be taken into account in the design of state sponsored capital programs discussed in that paper are still valid.

INTRODUCTION

This paper responds to a request of Assemblyman (then Senator) Richard Alarcón to the California Research Bureau. The original intent was to provide an update of the California Research Bureau 1998 report on small business capital needs and state sponsored capital programs. However, a review of the literature indicates that most of it is still current because 1) there is no new available data in most statistic profiles presented in that paper, and 2) there have not been major changes in the operations of state sponsored programs described in that report.

This document complements our previous publication by including recent data on small businesses, such as the number of firms, employment and trends by business size of employment. This report also describes an overview of the recent financial conditions and a description of the federal and state programs currently available for the small business sector.

In 2004, California had 3.2 million small businesses under 500 employees; most of them (almost 78 percent) were nonemployer firms. Since more than 99 percent of the employer firms in California had less than 500 employees, this analysis also looks at firms with less than 100 employees and those with less than five employees.

Small businesses are important because they employ a significant proportion of the work force. Nationwide, businesses with less than 500 employees employ half of the work force and produce about half of the private sector output. Small businesses typically spur competition, have historically made a critical contribution to innovation, and are a source of employment and income opportunities to individuals and demographic groups who may have difficulties in integrating into the labor market.[4]

Section I of this report provides a profile of small businesses, comparing the number of firms, employment and growth rates over time in the U.S. and California. The analysis distinguishes between employer and nonemployers firms (businesses without paid employees). Section II describes the demographic characteristics of the small business owners. Section III describes the main problems affecting small businesses according to responses that this community provided through surveys. Section IV provides an overview on Small Business Financing, including sources of credit available, sources of capital financing, and government programs available for credit and capital financing.

I. PROFILE OF CALIFORNIA'S SMALL BUSINESSES

Small businesses include businesses with (known as an "employer" firm) and without employees (a "nonemployer" firm). There is data on self-employment and on nonemployer businesses. These data are similar, but not perfectly comparable. Self-employment data tracks an occupation and an owner while nonemployers are businesses without employees and payroll. Because most business ventures are one-person operations, data on self-employment and nonemployers overlap significantly, but differ because businesses can have more than one owner, and an owner can have more than one business.

The U.S. Census Bureau [Statistics of U.S. Business (SUSB)] reports data on employer firms. A firm is defined as the aggregation of all establishments owned by a parent company within a geographic location and/or industry that have some annual payroll. These statistics fall short of the total number of firms because it excludes farms and businesses without employees. Employer firms account for roughly 97 percent of business activity (sales or receipts). However, nonemployers are more numerous, accounting for nearly three quarters of all businesses.

EMPLOYER FIRMS

Table 1 shows the distribution of California and U.S. employer firms by employment size in 1998, 2001 and 2004. Table 2 contains employment data for California and the nation by the size of the firm for the same years.

In 2004, California had 696,301 employer firms and more than 99 percent had fewer than 500 employees. About 97 percent of the businesses (677,903) were small businesses under 100 employees (Table 1). Small businesses with less than 100 employees provided employment to 38 percent of the labor force (almost five million people).

About 60 percent of the California employer firms have less than five employees. These firms provide five percent of the state's employment.

Between 1998 and 2004, 44 percent of California employment growth took place in firms under 500 employees. Small businesses with less than 100 employees created more than 300,000 jobs, 28 percent of the total employment growth. Very small businesses (less than five employees) accounted for 4.5 percent of the state employment growth.

Table 1: California and U.S. Employer Firms and Growth in the Number of Firms by Size of Employment, 1998-2004.

Employer Firms						
			Percentages			
	Year	**All firms (100 Percent)**	**Less Than Five Employees**	**Less Than 100 Employees**	**Less Than 500 Employees**	**More Than 500 Employees**
California	**1998**	642,156	59.4%	97.3%	99.2%	0.8%
U.S.		5,579,177	60.5%	98.3%	99.7%	0.3%
California	**2001**	668,068	58.7%	97.2%	99.1%	0.9%
U.S.		5,657,774	60.1%	98.2%	99.7%	0.3%
California	**2004**	696,301	60.1%	97.4%	99.2%	0.8%
U.S.		5,885,784	60.8%	98.2%	99.7%	0.3%
Firm Growth (Percentages)						
California	**1998-2001**	4.0%	2.8%	3.9%	4.0%	6.0%
U.S.		1.4%	0.8%	1.3%	1.4%	6.0%
California	**2001-2004**	4.2%	6.7%	4.4%	4.3%	-5.1%
U.S.		4.0%	5.2%	4.1%	4.0%	-1.8%
California	**1998-2004**	8.4%	9.7%	8.5%	8.5%	0.6%
U.S.		5.5%	6.0%	5.5%	5.5%	4.1%

Source: U.S. Census Bureau. Statistics of U.S. Businesses.[5]

Compared to the nation, in 2004 California had relatively fewer small businesses. The contribution of California's small business with less than 100 employees to 1998-2004 employment growth was four percent lower than the contribution of U.S. small businesses in the same size range. However, the contribution of very small businesses to employment growth in California was higher (4.5 percent) than the contribution of very small businesses to U.S. employment growth (3.7 percent).

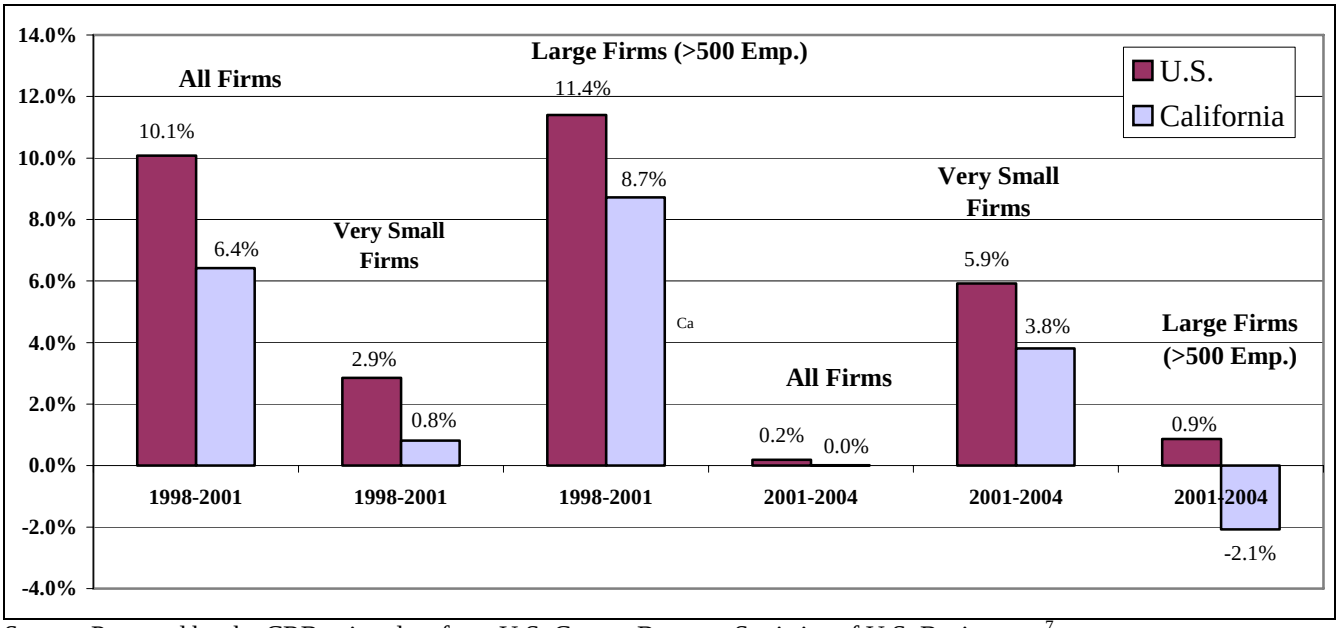
Business and employment growth between 1998 and 2004 was not steady. Employment growth between 1998 and 2001 was significant in the United States and California. In 2001, California employment was 10.1 percent higher than in 1998 while the U.S. was 6.4 percent higher. The economic contraction that started in 2001 reversed this trend. In 2003, employment in California was 1.9 percent lower than in 2001 while in the U.S. it was 1.4 percent lower. In 2004, the levels of employment were comparable to the 2001 in both California and the nation as a whole. Employment in firms with more than 500 employees increased slightly in California but decreased by 2.1 percent in the U.S. during 2001-2004, but employment in the very small businesses increased in both California (by 5.9 percent) and the nation (by 3.8 percent) (see Figure 1).

Table 2: California and U.S. Employment and Employment Growth by Size of the Firm, 1998-2004.

	Year	Employment in All Firms	Less Than Five Employees	Less Than 100 Employees	Less Than 500 Employees	More Than 500 Employees
California	**1998**	12,026,989	617,727	4,629,800	6,420,943	5,606,046
U.S.		108,117,731	5,584,470	39,653,019	55,064,409	53,053,322
California	**2001**	13,239,616	635,376	4,967,239	6,994,468	6,245,148
U.S.		115,061,184	5,630,017	40,973,082	57,383,449	57,677,735
California	**2004**	13,264,918	672,990	4,969,649	6,965,332	6,299,586
U.S.		115,074,924	5,844,637	41,839,701	58,597,452	56,477,472
Employment Growth						
California	**1998-2001**	10.1%	2.9%	7.3%	8.9%	11.4%
U.S.		6.4%	0.8%	3.3%	4.2%	8.7%
California	**2001-2004**	0.2%	5.9%	0.0%	-0.4%	0.9%
U.S.		0.0%	3.8%	2.1%	2.1%	-2.1%
California	**1998-2004**	10.3%	8.9%	7.3%	8.5%	12.4%
U.S.		6.4%	4.7%	5.5%	6.4%	6.5%
California National Share of Employment						
	1998	11.12%	11.06%	11.68%	11.66%	10.57%
	2001	11.51%	11.29%	12.12%	12.19%	10.83%
	2004	11.53%	11.51%	11.88%	11.89%	11.15%

Source: U.S. Census Bureau. Statistics of U.S. Businesses.[6]

Figure 1. Growth Rate in Employment by Business Size 1998-2001 and 2001-2004.



Source: Prepared by the CRB using data from U.S. Census Bureau. Statistics of U.S. Businesses.[7]

Because individual small businesses and industrial groups are usually at different stages of development, it is difficult to compare how small businesses were affected by the latest economic slow down. Under poorer economic conditions, self-employment usually increases as the opportunity costs of being self-employed decreases with the reduction of employment opportunities. With increases in self-employment and as firms reduce their operations, average business size declines and the small business share of the economy increases. The SBA Office of Advocacy in a contract with the Census Bureau publishes data comparing employment at the start and end of each year for firms classified by employment size. Their analyses show that in economic downturns small businesses increase employment and lose relatively less jobs than larger firms. However, it is important to note that this effect could be magnified by the reclassification of larger firms to smaller employment size categories as they adjust to lower demand.[8]

Table 3 compares the average annual payroll per employee by size of the firm in California and the U.S. in 2004. With the exception of micro-businesses, the average annual payroll per employee increases with the size of the firm. Employees in firms with more than 500 employees had the highest average payroll. It is interesting to note that in California very small businesses (less than five employees) had nearly the same average annual payroll as the large U.S. firms.

Table 3: Average Annual Payroll (In Thousands of Dollars) per Employee by Size of the Firm in California and the U.S., 2004.

	All Firms 100%	Less than Five Employees	Less than 100 Employees	Less than 500 Employees	More than 500 Employees
California	42	46	36	37	47
U.S.	37	35	32	33	41

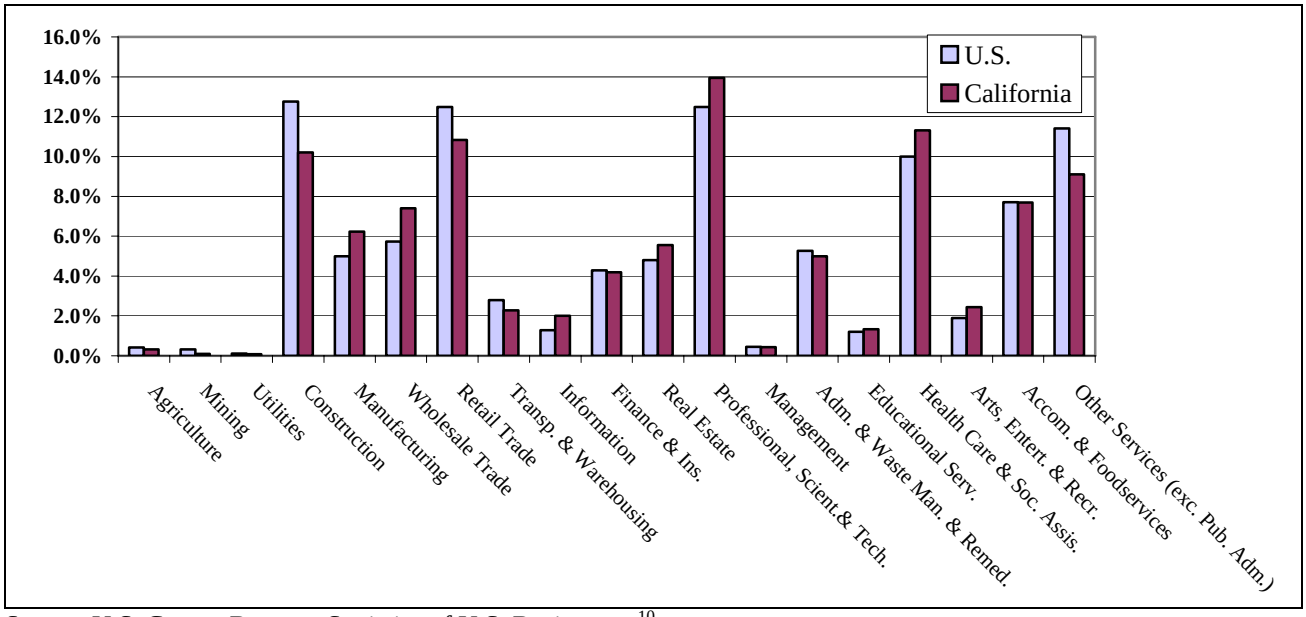
Source: U.S. Census Bureau. Statistics of U.S. Businesses.[9]

Distribution of Employer Firms by Industry

The largest proportion of firms in California is in the following industrial classifications: Professional, Scientific, and Technical Services; Health Care and Social Assistance; Retail Trade; Construction; and Other Services (which include services such as automotive repair, pet services, beauty services; and electronic and precision equipment repair and maintenance).

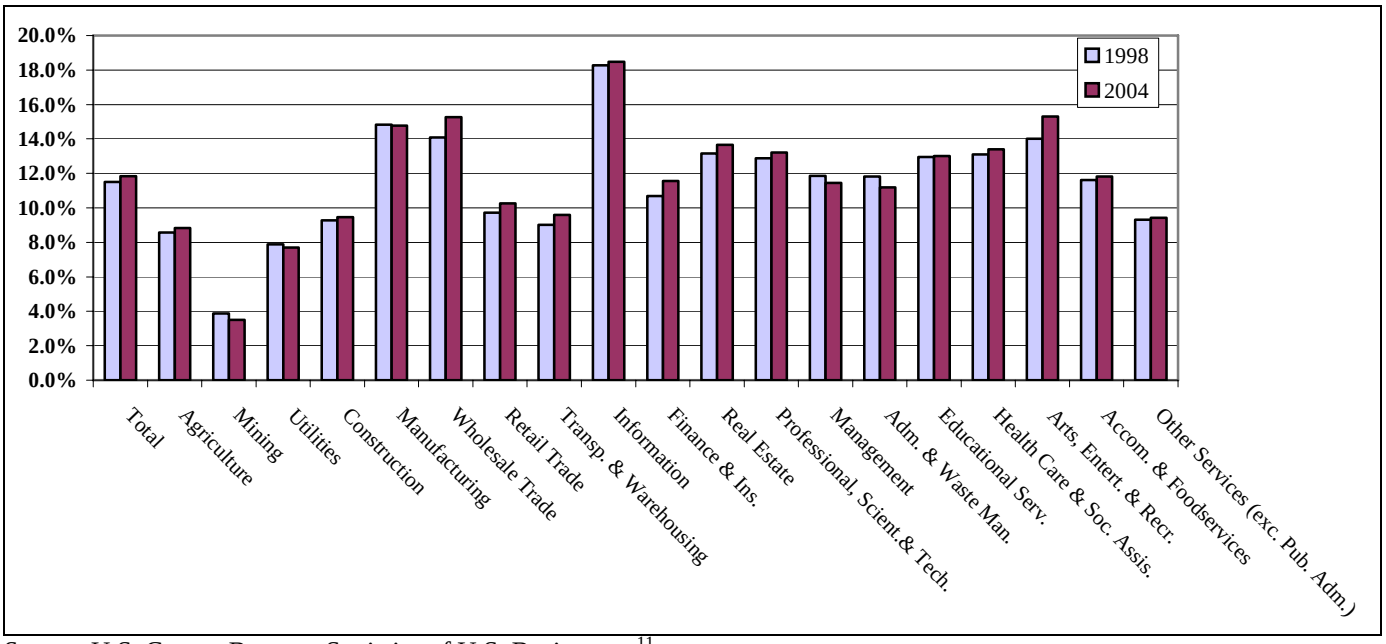
Figure 2 compares the distribution of California firms by industrial groups to the national distribution. California has a relatively larger percentage of firms in Information; Wholesale Trade; Manufacturing; Arts, Entertainment and Recreation; Real Estate; Professional, Scientific and Technical Services; Educational Services; and Health Care and Social Assistance industries. Figure 3 shows that the national share of California firms in these industries has increased since 1998.

Figure 2: Distribution of U.S. and California Firms by Industry, 2004.



Source: U.S. Census Bureau. Statistics of U.S. Businesses.[10]

Figure 3: Share of California Firms in National Industries, 1998 and 2004.

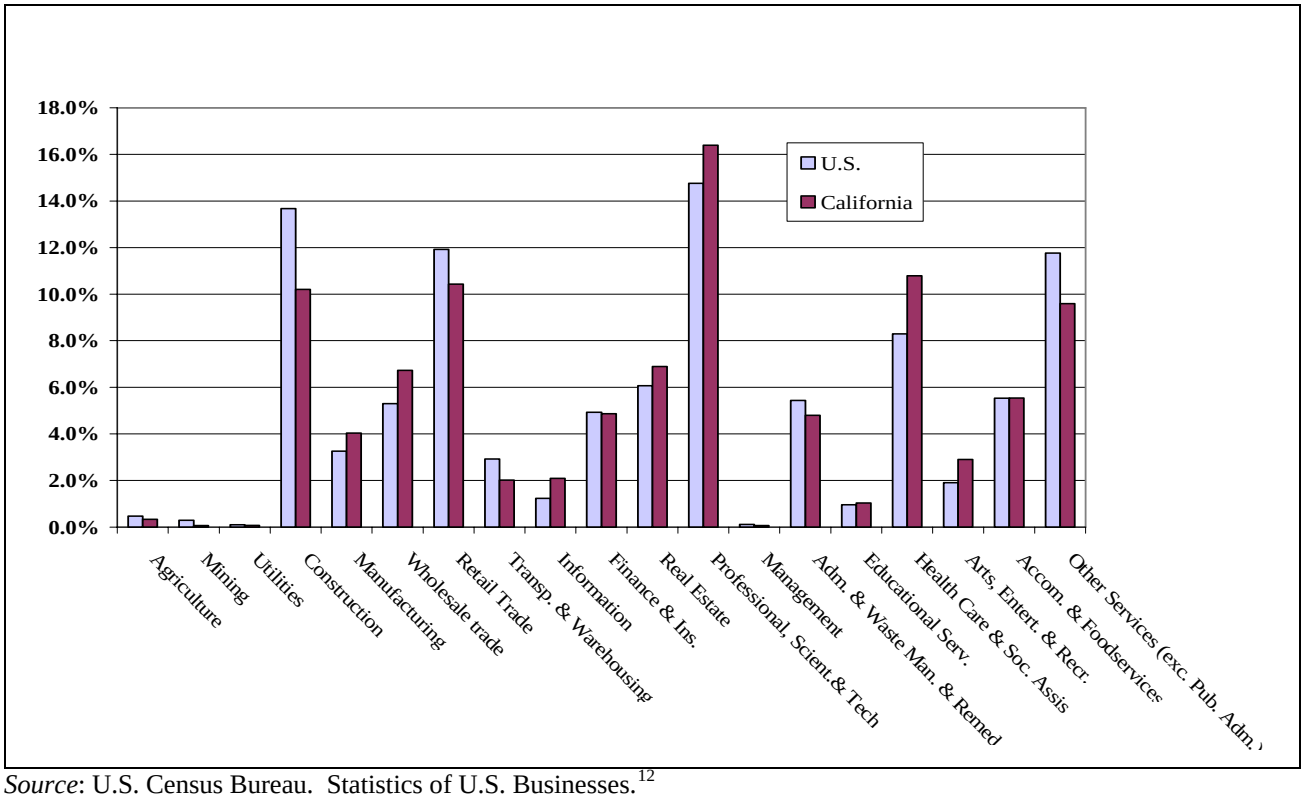


Source: U.S. Census Bureau. Statistics of U.S. Businesses.[11]

Generally, the distribution of small business by industry is similar to the distribution of all firms for both, California and the United States. However, compared to the nation, California has a larger proportion of very small businesses (less than five employees) in the Information; Arts,

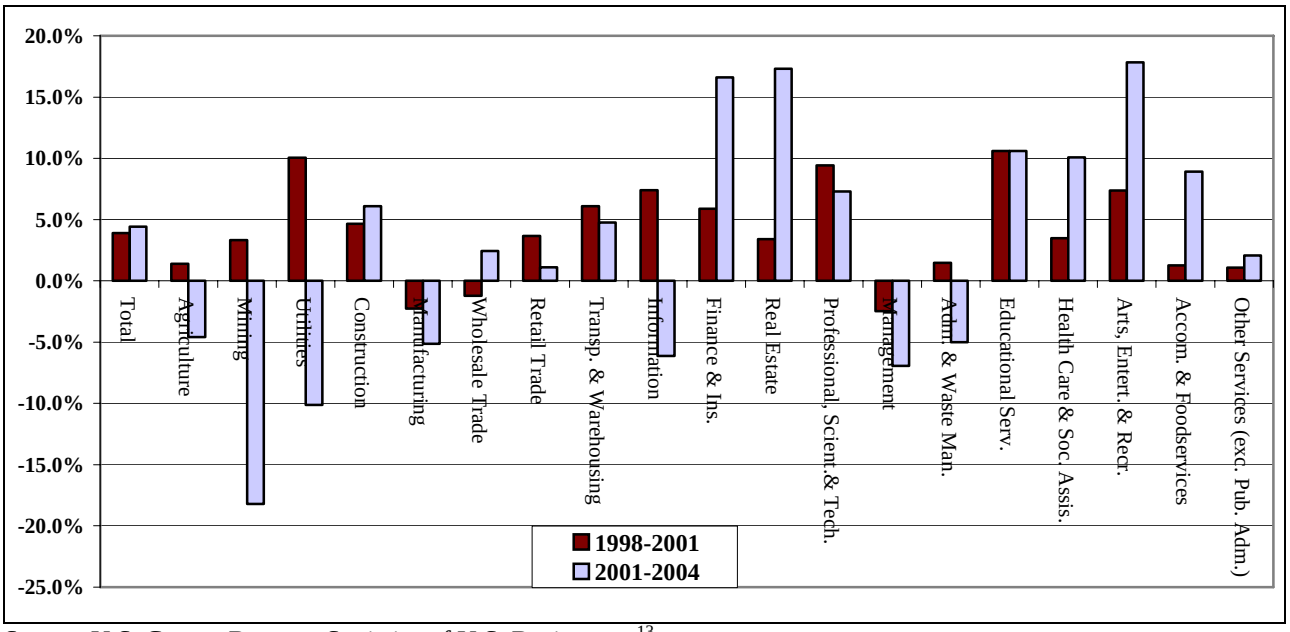
Entertainment and Recreation; Professional, Scientific and Technical Services; and Health Care and Social Assistance industrial groups (see Figure 4).

Figure 4: Distribution of U.S. and California Firms with Less than Five Employees, by Industry, 2004.



Source: U.S. Census Bureau. Statistics of U.S. Businesses.[12]

Figure 5: Growth of Small Businesses With Less Than 100 Employees, by Industrial Sector in California (1998-2001 and 2001-2004).



Source: U.S. Census Bureau. Statistics of U.S. Businesses.[13]

Between 1998 and 2001 small businesses with less than 100 employees grew significantly in California, particularly those in Educational Services; Professional, Scientific and Technical Services; Utilities; Information; and the Arts, Entertainment and Recreation Sector. The number of small businesses in Manufacturing, Wholesale Trade, and Management Sectors decreased during that period and continued falling after the downturn of 2001, while the number of businesses in Management; Real Estate; Finance and Insurance; Health Care and Social Assistance; and Arts, Entertainment and Recreation groups increased rapidly (see Figure 5).

Table 4: California Employer Firms by Employment Size and Metropolitan Region, 1998 and 2002.

	1998		2002		% Change 1998-2002	% Change 1998-2002
	<500	**500+**	**<500**	**500+**	**<500**	**500+**
Los Angeles--Long Beach	187,949	3,102	197,131	3,070	4.9%	-1.0%
Orange County	63,218	2,182	68,252	2,193	8.0%	0.5%
San Diego	53,044	1,788	58,020	1,894	9.4%	5.9%
San Francisco	51,951	1,634	49,946	1,606	-3.9%	-1.7%
Oakland	46,722	1,801	48,047	1,839	2.8%	2.1%
Riverside--San Bernardino	41,306	1,591	46,450	1,710	12.5%	7.5%
San Jose	36,989	1,568	36,377	1,569	-1.7%	0.1%
Sacramento	28,796	1,313	31,386	1,447	9.0%	10.2%
Fresno	13,930	798	15,025	832	7.9%	4.3%
Ventura	13,917	794	14,240	856	2.3%	7.8%
Santa Rosa	11,396	513	11,866	586	4.1%	14.2%

Source: U.S. Census Bureau. Statistics of U.S. Businesses.[14]

Table 4 shows that in 2002 the number of businesses with less than 500 employees was higher than in 1998 in most regions and grew relatively faster than large firms with 500 or more employees. In San Francisco and in San Jose, the number of smaller businesses in 2002 was lower than in 1998. This could be largely explained by the end of the "internet boom" and the economic contraction of 2001, and partly by the increase in size of some firms. The total number of firms in both San Francisco and San Jose was lower in 2002 than in 1998 by 3.8 and 1.6 percent respectively.

Table 5: California Employers with Less Than 100 employees, by Main Metropolitan Regions, 1998-2002.

Firms With Less Than 100 Employees					
	Total 1998	**Total 2001**	**% Change 1998-2001**	**Total 2002**	**% Change 1998-2002**
Los Angeles--Long Beach	183,438	190,112	3.6%	192,622	5.0%
Orange County	61,175	64,972	6.2%	66,064	8.0%
San Diego	51,546	54,847	6.4%	56,306	9.2%
San Francisco	50,382	49,915	-0.9%	48,388	-4.0%
Oakland	45,333	46,367	2.3%	46,478	2.5%
Riverside--San Bernardino	40,063	42,670	6.5%	44,899	12.1%
San Jose	35,748	35,848	0.3%	35,081	-1.9%
Sacramento	27,974	29,432	5.2%	30,392	8.6%
Fresno	13,536	13,679	1.1%	13,788	1.9%
Ventura	13,496	14,295	5.9%	14,582	8.0%
Santa Rosa	11,155	11,489	3.0%	11,567	3.7%

Source: U.S. Census Bureau. Statistics of U.S. Businesses.[15]

Table 5 shows that the number of small businesses with less than 100 employees has been increasing in all metropolitan regions with the exception of San Francisco and San Jose. The number of firms with less than 100 employees in San Francisco was slightly lower in 2001 than in 1998, and in 2002 it was four percent lower. Small businesses in San Jose followed a similar, but less pronounced pattern.

Table 6 shows the number of very small firms (under five employees) by metropolitan region. The pattern is similar to the small firms under 100 employees.

Table 6: Very Small Firms (Under Five Employees) by Metropolitan Region, 1998-2002.

Very Small Businesses	**Total 1998**	**Total 2001**	**% Change 1998-2001**	**Total 2002**	**% Change 1998-2002**
Los Angeles--Long Beach	113,392	117,467	3.6%	120,987	6.7%
Orange County	36,138	38,449	6.4%	39,579	9.5%
San Diego	31,575	33,324	5.5%	34,621	9.6%
San Francisco	30,697	29,852	-2.8%	29,309	-4.5%
Oakland	27,064	27,411	1.3%	27,608	2.0%
Riverside--San Bernardino	23,458	24,636	5.0%	26,128	11.4%
San Jose	20,770	20,420	-1.7%	20,634	-0.7%
Sacramento	16,749	17,473	4.3%	18,114	8.1%
Fresno	7,944	7,914	-0.4%	7,972	0.4%
Ventura	8,165	8,584	5.1%	8,869	8.6%
Santa Rosa	6,835	6,872	0.5%	6,981	2.1%

Source: U.S. Census Bureau. Statistics of U.S. Businesses.[16]

A comparable analysis on employment rather than firms yields similar results, with the conclusion that smaller businesses experienced less employment losses compared to the largest firms. Tables 7, 8 and 9 illustrate this point.

Table 7: Employment by Size of the Firm, by Metropolitan Region 1998-2002.

Employment by Firm Size	**1998**		**2002**		**%Change 1998-2002**	**%Change 1998-2002**
	<500	**500+**	**<500**	**500+**	**<500**	**+500**
Los Angeles--Long Beach	1,908,407	1,785,130	1,948,169	1,843,193	2.1%	3.3%
Orange County	668,031	606,043	713,495	669,808	6.8%	10.5%
San Francisco	505,689	456,348	495,418	444,003	-2.0%	-2.7%
San Diego	524,135	436,879	576,143	506,904	9.9%	16.0%
San Jose	425,172	521,191	408,465	486,740	-3.9%	-6.6%
Oakland	461,380	425,587	496,208	476,546	7.5%	12.0%
Riverside--San Bernardino	418,331	348,622	501,447	413,390	19.9%	18.6%
Sacramento	260,950	243,477	303,927	291,073	16.5%	19.5%
Fresno	128,188	99,813	140,446	103,343	9.6%	3.5%
Ventura	130,358	87,379	141,582	110,243	8.6%	26.2%
Santa Rosa	98,338	55,849	104,765	61,592	6.5%	10.3%

Source: U.S. Census Bureau. Statistics of U.S. Businesses.[17]

Table 8: Employment Provided by Businesses With Less Than 100 Employees, by Metropolitan Region, 1998-2002.

Small Businesses	**Total 1998**	**Total 2001**	**%Change 1998-2001**	**Total 2002**	**% Change 1998-2002**
Los Angeles--Long Beach	1,348,832	1,414,844	4.9%	1,381,535	2.4%
Orange County	470,978	510,375	8.4%	500,409	6.2%
San Francisco	358,894	382,780	6.7%	352,610	-1.8%
San Diego	370,835	407,172	9.8%	402,662	8.6%
San Jose	289,529	308,222	6.5%	278,961	-3.7%
Oakland	337,146	361,019	7.1%	351,773	4.3%
Riverside--San Bernardino	303,077	335,509	10.7%	350,544	15.7%
Sacramento	196,547	216,373	10.1%	221,308	12.6%
Fresno	99,280	104,505	5.3%	106,447	7.2%
Ventura	98,435	106,189	7.9%	104,667	6.3%
Santa Rosa	77,340	82,279	6.4%	80,180	3.7%

Source: U.S. Census Bureau. Statistics of U.S. Businesses[18]

Table 9: Employment Provided by Very Small Businesses (Under Five Employees), by Metropolitan Region, 1998-2002.

Very Small Businesses	**Total 1998**	**Total 2001**	**% Change 1998-2001**	**Total 2002**	**% Change 1998-2002**
Los Angeles--Long Beach	176,686	182,224	3.1%	187,308	6.0%
Orange County	58,132	61,513	5.8%	62,955	8.3%
San Francisco	50,581	49,779	-1.6%	48,786	-3.5%
San Diego	50,748	53,165	4.8%	55,064	8.5%
San Jose	33,983	34,172	0.6%	33,973	0.0%
Oakland	44,354	45,184	1.9%	45,619	2.9%
Riverside--San Bernardino	38,637	40,985	6.1%	43,500	12.6%
Sacramento	27,386	28,566	4.3%	29,460	7.6%
Fresno	13,623	13,295	-2.4%	13,663	0.3%
Ventura	13,454	13,707	1.9%	14,353	6.7%
Santa Rosa	11,219	11,445	2.0%	11,703	4.3%

Source: U.S. Census Bureau. Statistics of U.S. Businesses.[19]

NONEMPLOYERS AND SELF EMPLOYED

Data on the number of nonemployer firms and the self-employed are commonly used to assess the number of microenterprises or smallest business ventures.[i] Nonemployer figures are useful for determining the number of businesses in an industry or area, and can be added to the employer firms to assess the total number of small businesses.

NONEMPLOYER FIRMS

A nonemployer firm is defined as one that has no paid employees, has annual business receipts of $1,000 or more ($1 or more in the constructing industries) and is subject to federal income taxes. The Census Bureau provides nonemployer business data. Most nonemployer businesses are very small and many do not provide the primary source of income for their owners.

Table 10: Number of Nonemployers in California and the U.S., 1998-2004.

	Nonemployers			% Change		
	1998	**2001**	**2004**	**1998-2001**	**2001-2004**	**1998-2004**
California	1,971,388	2,149,145	2,508,801	9.0%	16.7%	27.3%
U.S.	15,708,727	16,979,498	19,523,741	8.1%	15.0%	24.3%
California's Share	12.5%	12.7%	12.9%			

Source: U.S. Census Bureau. Statistics of U.S. Businesses.[20]

Table 10 shows that the number of nonemployers has increased faster in California relative to the nation. Since 1998, the number of California nonemployers increased by 27.3 percent.

Table 11: Self-Employment in California and the U.S., 2001 and 2003.

	Self Employment		% Change
	2001	**2003**	**2001-2003**
California	2,002,507	2,113,517	5.5%
U.S.	14,950,000	15,600,000	4.3%
California's Share	13.4%	13.5%	

Source: U.S. Census Bureau. Statistics of U.S. Businesses.[21]

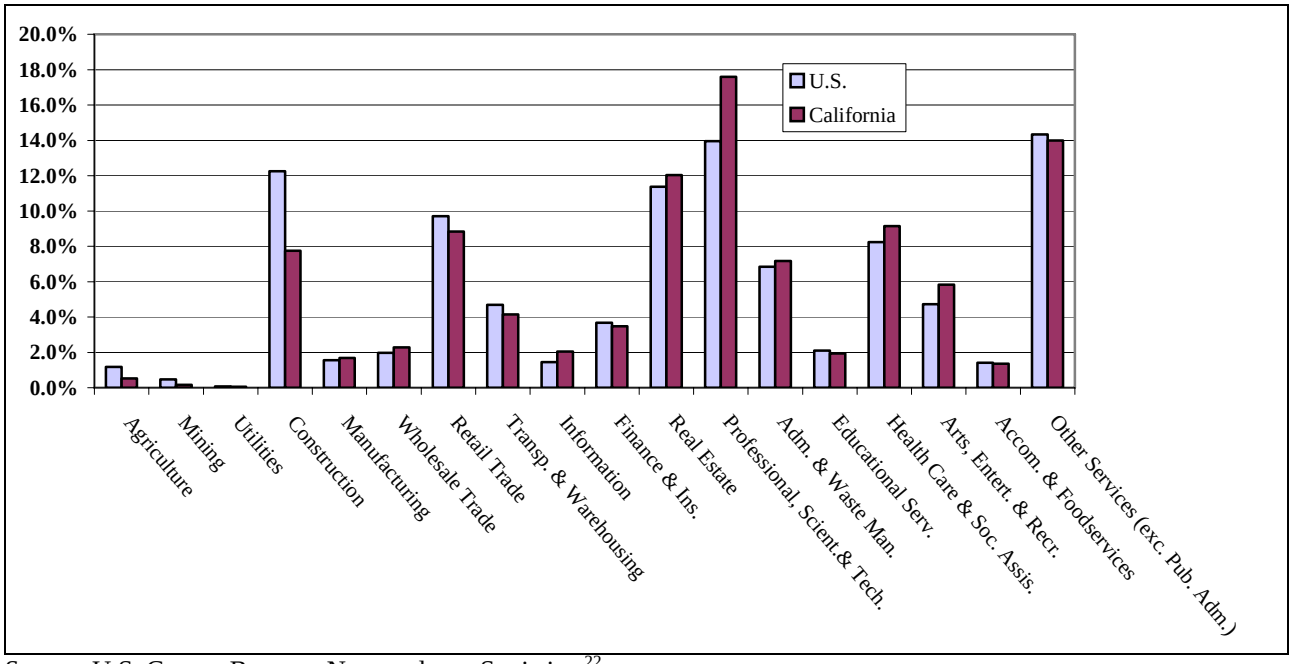
Table 11 shows that the number of self-employed in California has been increasing faster than in the U.S. as a whole.

[i] The U.S. government defines "microenterprise" as a firm of ten or fewer employees (including unpaid family workers) that is owned and operated by someone who is economically disadvantaged. However, others define microenterprises differently. For example the Utah Loan Fund defines a microenterprise business as a small business with five or fewer employees that requires less than $35,000 to start, and is too small to qualify for commercial banking services.

Distribution of Nonemployers by Industry

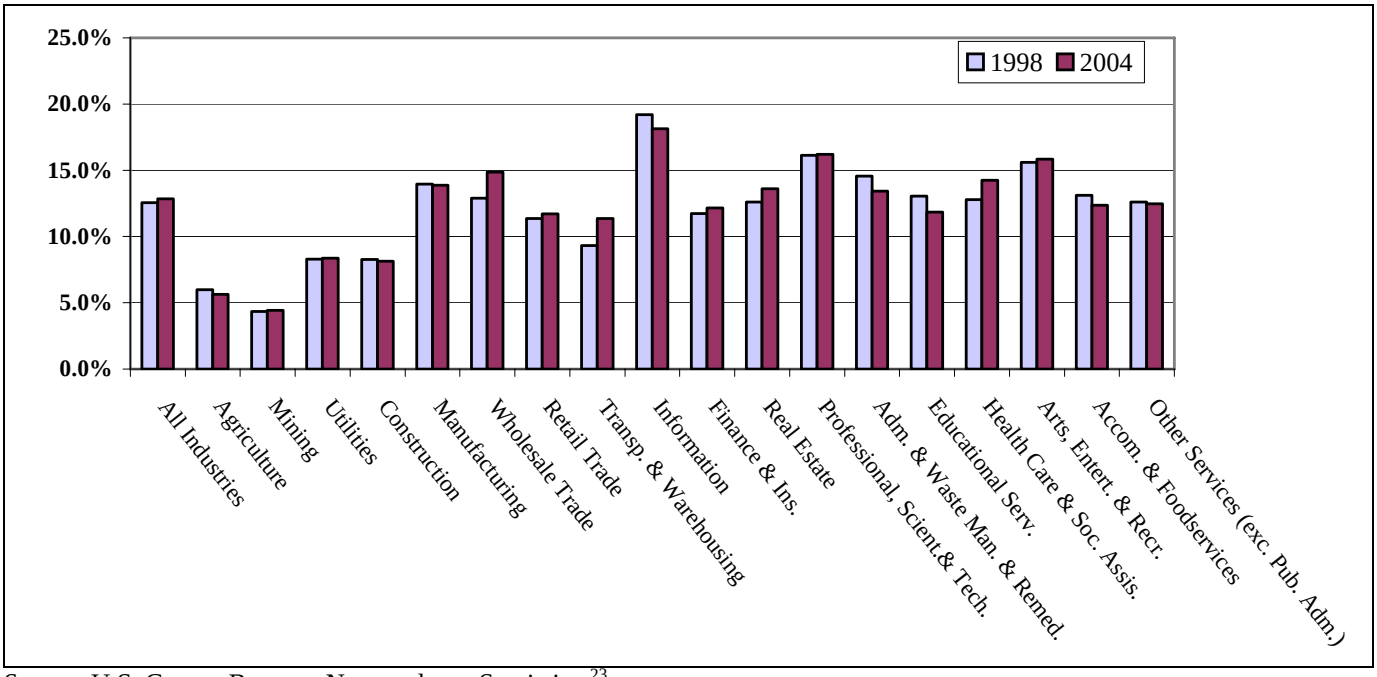
Figure 6 describes the distribution of nonemployer firms by industry for the U.S. and California. Most of these firms are in services such as Professional, Scientific, and Technical Services; Real Estate; Health Care and Social Assistance; Retail Trade; and Construction. Figure 7 shows California's share of nonemployer firms by industry. California has relatively more nonemployer firms in the following industries: Information; Professional, Scientific and Technical Services; Arts, Entertainment and Recreation; Wholesale Trade; Health Care and Social Assistance; Manufacturing; Administration and Waste Management and Remediation; and Real Estate. California's share of nonemployer firms by industry has remained fairly stable since 1998 with some increase in the proportion of Transportation and Warehousing; Wholesale Trade; and Health Care and Social Assistance sectors and decreases in Educational Services and the Information industry (Figure 7).

Figure 6: Distribution of Nonemployer Firms by Industry in the U.S. and California, 2004.



Source: U.S. Census Bureau. Nonemployer Statistics.[22]

Figure 7: California Share of U.S. Nonemployer Firms, 1998 and 2004.

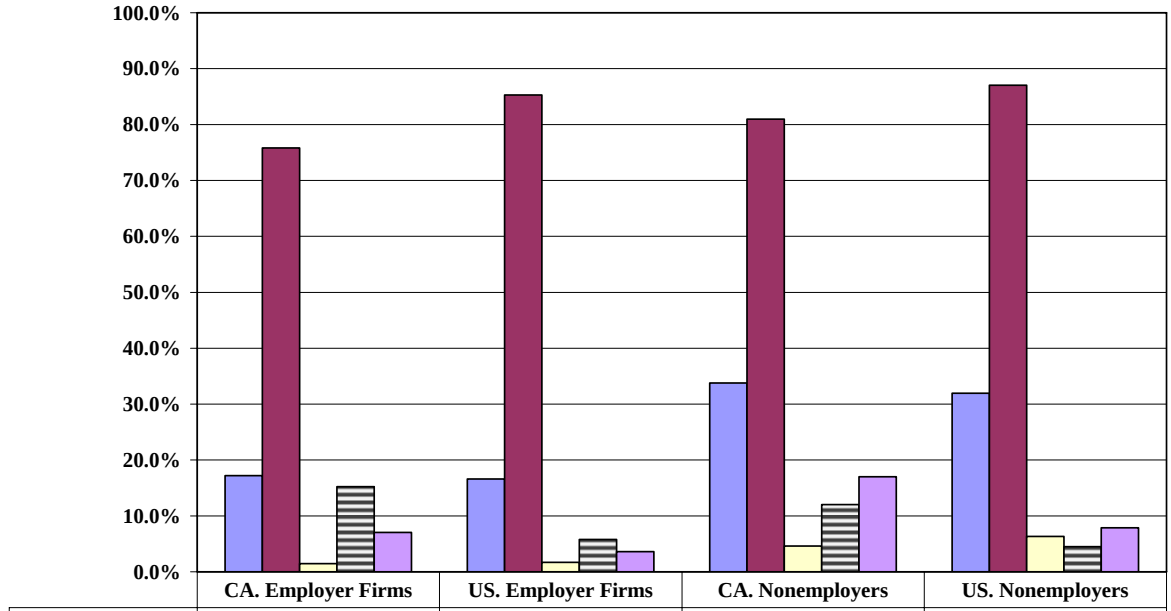


Source: U.S. Census Bureau. Nonemployer Stat istics.[23]

II. DEMOGRAPHIC CHARACTERISTICS OF THE SMALL BUSINESS OWNERS

Figure 8 compares the distribution of firms according to characteristics of the owners. Data from the 2002 Economic Census indicates that most employer firms are White non-Hispanic and Asians. In comparison with the nation, California has a higher proportion of businesses owned by Asians and Hispanics, while it has a lower proportion of businesses owned by African Americans. This reflects in part the demographic composition of the state.[i]

Figure 8: Distribution of Firms by Demographic Characteristics of the Business Owners in the U.S. and California, 2002.



	CA. Employer Firms	US. Employer Firms	CA. Nonemployers	US. Nonemployers
Female Owners	17.2%	16.6%	33.8%	31.9%
White Owners	75.8%	85.3%	80.9%	87.0%
Afr. Am. Owners	1.5%	1.7%	4.6%	6.3%
Asian Owners	15.2%	5.8%	12.0%	4.5%
Hispanic Owners	7.1%	3.6%	17.0%	7.9%

Source: U.S. Census Bureau, 2002 Survey of Business Owners.[24]

Nationwide and in California, most firms are owned by Whites. However, the proportion of nonemployer firms owned by women, African Americans and Hispanics is significantly larger than the proportion of employer firms owned by these groups. Consistently, these groups have also a significantly higher percentage of self-employed; an alternative indicator to assess the number of smallest business ventures (microenterprises). Table 12 shows the distribution of self-

[i] Detail on employer and nonemployer firms may not add to totals because a Hispanic or Latino firm may be of any race. Moreover, each owner had the option of selecting more than one race and therefore is included in each race selected. The U.S. totals are based on the 2002 Economic Census, whereas the gender, Hispanic or Latino origin, and race estimates are based on the 2002 Survey of Business Owners.

employed according to Current Population Survey (CPS) data from the March Supplement, 2002.[i]

Table 12: Distribution of Self-employed by Race/Ethnicity, 2002.

	California Self-Employment	U.S. Self-Employment
Female	40.6%	38.7%
White	59.9%	80.9%
African American	3.5%	6.0%
Asian	13.0%	4.0%
Hispanic	22.0%	8.3%

Source: Current Population Survey, March 2002.

As stated earlier, data for nonemployers and the self employed are similar but not the same mainly because these data measure different concepts. The nonemployer database is the universe of businesses without employees, composed primarily of sole proprietors. Self-employment data track an occupation and an owner and most self-employment data exclude people working for incorporated businesses. Other reasons for the differences in the figures include:

- Some self-employed have employees.
- A large number of self-employed ventures are recorded as secondary occupations rather than as main occupation.
- Some persons in occupations such as sales and real estate file taxes as sole proprietors so they are classified as nonemployers, but respond yes to wage work and no to self-employment when they are asked about their occupation.[25]

Research indicates that, in addition to lower rates of business ownership, African-American and Latino firms have lower sales, hire fewer employees, and have smaller payrolls than White-owned businesses. African-American-owned firms also have lower profits and higher closure rates than White-owned firms.[26]

Studies on the causes for lower rates of business ownership and lower business performance among minorities suggest a variety of factors. Among them are the low levels of family assets, limited access to capital and lower levels of education attainment for these groups.

[i] Self-employment data only include non-incorporated self-employed. Due to the sample size, estimates for African American and Asian self-employed are not robust. The Social Security Administration publishes self-employment data, but this agency does not provide data for Hispanics and Asians. Their estimates on female, African American and White self-employed are robust, and are comparable to the CPS estimates reported in the table.

III. MAIN PROBLEMS AFFECTING SMALL BUSINESSES

A recent study found that costs of compliance (as measured by cost per employee) with federal regulations are significantly higher for small businesses, a conclusion consistent with previous research findings.[27] The difference in costs of compliance per employee is particularly large for the smallest firms in the manufacturing sector (with less than 20 employees); while in the service sector, there are no major differences between the regulatory costs of small and larger firms. Environmental and tax compliance regulations appear to be the main drivers in determining the extent of the disproportionate cost for smaller firms. Compliance with environmental regulations costs almost four times more per employee for smaller businesses (with less than 20 employees) compared to large firms (with more than 500 employees), while costs of tax compliance per employee are almost 70 percent higher for the smaller firms. [28] In addition to federal regulations, small businesses in California have to comply with environmental laws that are relatively more stringent than those in other states. On the other hand, compliance with environmental regulations has also provided an opportunity to small businesses since an increasing number of them are providing consulting services to assist other companies to meet the requirements of environmental laws.

In 2004, the National Federation for Independent Business (NFIB) survey found that small businesses' top concerns were taxes and costs. Health care cost was the number one concern. In 2003, small businesses began citing the cost and availability of insurance (mainly health) as their largest problem. A survey by the Kaiser Family Foundation and Health Research and Educational Trust found that insurance rates for small firms rose 15.5 percent in 2003. In response, many small firms no longer offer health benefits or are charging employees a higher share of the cost. The percentage of small firms providing health insurance coverage to their employees fell from 71 percent in 1999 to 65 percent in 2003.[29] The second most pressing issue was the cost of liability insurance while workers' compensation and rising fuel prices were also among the most important.

IV. SMALL BUSINESS FINANCING

What is striking about the results of the 2004 NFIB survey is the relatively low level of concern relating to the availability of financing and credit since inadequate financing has been one of the most common reasons of small businesses failure. This is partly due to the recent favorable conditions for credit financing.

From January 2001 the Federal Reserve has decreased interest rates to all-time lows in order to reactivate the economy. The Federal Reserve Board maintained a steady, but very easy monetary policy throughout most of 2002 after decreasing interest rates ten times in 2001, and lowering the discount rate once in November 2002. Interest rates stabilized throughout most of 2002, then moved downward after the rate cut, falling for most of the first half of 2003, due to continuing weakness in real output growth and expectations for further cuts in the federal funds rate. Interest rates paid by small firms followed the same path. As expected, rates paid by small business owners were lower in 2003 than in 2002. For example, interest rates on small variable-rate loans averaged around 4.25 percent in 2003 compared with about 5 percent in 2002. By the

end of 2004 interest rates increased somewhat, but since 2005 businesses have benefited from the continued recovery in the economy and the relatively abundant supply of credit.

With the favorable financial conditions, lenders are providing more credit. Credit cards have become more accessible and, since 1990, their use for business financing has greatly expanded.

In addition to the growing role of credit cards, banks, the primary source of funding for small businesses, have increased their loans to small businesses in part due to the Community Reinvestment Act.[30] This act seeks to ensure that banks meet the credit needs of their communities and caused a shift, beginning in 1995, from focusing in home mortgage lending to small business lending.[31]

The expansion of credit markets has favored small business in general. However, a closer look at the NFIB data also indicates that credit still remains a major concern for many younger, smaller, and immigrant-owned businesses. The relatively larger proportion of mature businesses in the NFIB sample may have deemphasized the problems associated with businesses at the initial stages. Mature businesses have established relationships with lenders and are more likely to have adequate revenue and assets to finance growth and capital improvements, while younger firms (operating less than four years) are relatively more concerned about financing. According to Marnie Marcuss of the Federal Reserve Bank of Boston, a closer look at the NFIB data reveals that about one third of young businesses mentioned that cash flow was a critical problem while 15 percent of them mentioned obtaining a loan as a critical problem. Similarly, about one third of immigrant business owners cited cash flow as a critical problem and immigrants were more likely than natives to worry about credit.[32]

Another factor that has increased small business credit availability is the use of credit scoring by financial institutions. A credit score is a number, generally between 300-850, assigned to borrowers to represent an estimate of the borrower's future loan performance. Scores are developed by analyzing statistics that are considered indicators of creditworthiness. This tool has allowed financial institutions to provide loans to borrowers that have been considered "high risk" under traditional criteria.[33]

For example, credit scoring allows lenders to underwrite and monitor loans without actually meeting the borrower. With this system, borrowers can obtain unsecured credit from distant lenders through direct marketing channels. Generally, the price of small business loans will decline particularly for high credit score borrowers since their loans will no longer have to bear the cost of extensive underwriting. Increased competition (resulting from small businesses' having access to more lenders) further lowers borrowing costs. Finally, credit scoring increases credit availability for small businesses as better information about the repayment prospects of a small business applicant makes it more likely that a lender will price the loan based on expected risk, rather than charging excessive risk premiums for covering possible losses, or denying the loan.[34]

SOURCES OF CREDIT FOR SMALL BUSINESSES

The most recent comprehensive database on the uses of credit and other financial services by U.S. small firms is the Federal Reserve Board's Survey of Small Business Finances (1998 SSBF).[35]

Data indicate that most small business use credit from depository institutions and credit cards. Compared to larger businesses, smaller firms use less credit from depository institutions (particularly banks) and relatively more credit from credit unions and personal credit cards compared to larger businesses. Other sources of credit are financing companies, leasing, and family friends (see Table 13).

Table 13: Percentage of Small Business in the United States Using Main Sources of Credit.

Number of Employees	Credit Union	Thrift	Commercial Banks	Finance Company	Leasing	Family and Friends	Other Businesses	Other Loans
0	3.0	2.9	17.3	7.1	2.5	3.6	2.6	0.2
1-4	2.2	3.3	31.3	11.5	4.8	5.7	2.4	12.0
5-9	2.3	2.8	53.2	15.8	9.6	5.6	3.4	19.3
10-19	3.3	3.9	59.0	19.7	14.5	9.4	3.4	29.1
20-99	1.0	5.0	70.2	24.3	12.4	10.5	5.6	32.9
100-449	0.1	3.4	77.2	27.5	22.7	6.5	4.3	27.6

Source: Ou, Charles, "Banking and SME Financing in the United States."[36] (1998 SSBF data).

The percentage of firms using any type of credit increases with firm size. Table 14 shows that, in addition to loans from depository institutions, credit cards, credit lines[i] and vehicle loans are among the most common type of credit used by smaller firms.

[i]Credit line is an amount of credit that can be drawn from during a certain period.

Table 14: Percentage of Small Business in the United States Using Credit, by Credit Type.

Number of Employees	Loans from Depository Institutions	Line of Credit	Mortgage	Vehicle	Equipment	Lease	Personal Credit Card	Business Credit Card
0	70.2	12.8	6.5	12.3	3.9	3.2	48.2	17.4
1-4	80.3	21.0	12.5	17.9	7.8	7.5	46.7	29.3
5-9	89.6	34.8	15.5	25.1	14.6	14.6	43.2	44.1
10-19	94.1	49.2	19.5	31.3	12.9	22.3	52.2	51.8
20-99	95.0	59.9	21.1	32.9	22.1	23.3	38.8	57.9
100-449	99.6	74.9	18.8	29.8	25.0	28.3	23.7	62.5

Source: Ou, Charles, "Banking and SME Financing in the United States."[37] (1998 SSBF data).

In terms of total debt outstanding for all small firms by credit type, lines of credit and commercial mortgages were the two largest markets in 1998, with a share of more than 60 percent. For businesses without employees, mortgage loans represented 80 percent of the total debt. For employer businesses with less than five employees, this proportion decreased to 37.4 percent.[38]

Bank Credit

Banks are the main source of credit for small businesses through commercial and industrial loans. The Microenterprise Fund for Innovation, Effectiveness, Learning and Dissemination (FIELD) (a project of the Economic Opportunities Program (EOP), housed at the Aspen Institute in Washington, D.C), commissioned a study on trends in the supply of microenterprise loans in the United States. The study, based on a review of existing literature and interviews with key players in the financial industry, found that banks are the primary suppliers to the micro market and have increased their presences since deregulation.

Table 15 shows that small banks tend to grant smaller loans and devote a larger share of their funds to small business lending. In 2004, nationwide, 38 percent of all bank loans were small business loans (loans of less than a $1 million) and 9.1 percent were micro-business loans (loans of less than $100,000), while for small banks with assets under 100 million these proportions were 89 percent for small business loans and 35 percent for micro-business loans.

Table 15: Small Business Bank Lending in the U.S., June 2004.

Banks/Loan Size	**All Bank Loans**		**Loans by Banks with Less Than 100 Million in Assets**	
	Amount In $ Billion	**Percent of Total**	**Amount In $ Billion**	**Percent of Total**
Loans under $100,000	125.3	9.1%	12.1	35.4%
Loans under $250,000	228.3	16.6%	18.0	52.6%
Loans under $1 Million	522.1	38.0%	30.5	89.2%
Loans $100,000 to $1 Million	396.9	28.9%	18.4	53.9%
Total Business Loans	$1,372.9		34.1	

Source: Ou, Charles. "Banking and SME Financing in the United States."[39]

The largest proportion of smaller loans provided by smaller banks is explained by three factors:

- Small banks achieve diversification by making many smaller loans rather than fewer big loans. In this way banks can minimize risks.

- Smaller banks are less able to offer the banking services needed by larger borrowers (such as foreign exchange transactions).

- Small banks may have more flexibility to meet the needs of their customers than larger banks. Large banks with automated and centralized loan approval processes do not provide for a great deal of flexibility to address a variety of small business situations.

Since small banks tend to be the most active lenders to small businesses, many analysts use lending by small banks as a proxy for small businesses loans. Table 16 shows the value of small business bank loans and growth rates between 2000 and 2004 in the U.S. Between 2000 and 2004 small business loans grew by almost 20 percent, while micro-business loans increased by only 3.2 percent. Between 2002 and 2004, after the economic slowdown in 2001, the value of micro-business loans decreased and small business increased by less than between 2000 and 2002.

Table 16: Small Business Bank Loans in the U.S., 2000-2004.

Banks/Loan Size	2000 ($ Billion)	2002 ($ Billion)	% Change 2000/2002	2004 ($ Billion)	% Change 2002/2004	% Change 2000/2004
Loans under $100,000	121.4	128.9	6.2%	125.3	-2.8%	3.2%
Loans under 250,000	209.4	225.0	7.4%	228.4	1.5%	9.1%
Loans under $1 Million	437.0	484.0	10.8%	522.3	7.9%	19.5%
Total Business Loans	1,300.3	1,307.0	0.5%	1,373.3	5.1%	5.6%

Source: Ou, Charles. "Banking and SME Financing in the United States."[40]

Despite bank consolidation, major small business bank loan markets seem to have remained competitive, as shown by the continued presence of many profitable community banks in places where national and regional banks have been consolidating. Competition and continuous declines in the cost of borrowing as a result of a monetary policy that focused on keeping interest rates low in the financial markets explain why most small firms have indicated little concern about credit availability during the last few years.[41]

Government Loan Programs

The 1998 Federal Reserve Board's Survey of Small Business Finances indicates that nationwide small business of more than 10 employees use government programs more frequently as a source of credit. For example, while only one percent of all businesses used government financing, 1.6 percent of business with 10 to 19 employees; 3.2 percent of small businesses with 20 to 99 employees; and 2.6 percent of the businesses with 100 to 500 employees borrowed from government programs. However, less than one percent of the very small businesses (under five employees) obtained credit from government sources. Small business can apply to several federal and state loan programs.

SMALL BUSINESS ADMINISTRATION FEDERAL LOAN PROGRAMS

The Basic 7(a) Loan Guaranty

This program helps qualified small businesses obtain financing when they might not be eligible for business loans through normal lending channels. Loans can be provided to start-ups and existing small businesses as well as commercial lending institutions. Lenders who are called participants provide all 7(a) loans under SBA guidelines. Most American banks and some non-bank lenders are participants in this program.

Basic 7(a) loans are provided by lenders who choose to structure their own loans by SBA's requirements and who apply and receive a guaranty from SBA on a portion of this loan. The SBA does not fully guaranty 7(a) loans. The lender and SBA share the risk that a borrower will not be able to repay the loan in full. The guaranty is a security against payment default.

Under this program, businesses apply to a lender for their financing. The lender decides if they will make the loan internally or if the application requires an SBA guaranty for the loan to be made. The guaranty provided by the SBA assures the lender that in the event the borrower does not repay their obligation and a payment default occurs, the Government will reimburse the lender for its loss, up to the percentage of SBA's guaranty. Under this program, the borrower remains obligated for the full amount due. SBA's 7(a) Loan Program has a maximum loan amount of $2 million dollars with an SBA maximum exposure of $1.5 million.[42]

The scope of this program has not changed very significantly during the last few years. For example, nationwide, in FY 2005-06 this program provided 97,290 loans, totaling $14.5 billion. The total value of the loans was $2.3 billion higher than the amount loaned in FY 2001-2002 and the average loan was less than half the amount of FY 2001-02. In California, in FY 2005-06, the number of loans under this program was also significantly higher than in FY 2001-02 (12,683 compared to 8,044), but the total value of the loans was lower ($2.4 billion compared to $2.5 billion).[43]

Certified Development Companies

The 504 Certified Development Company (CDC) Program provides long-term, fixed-rate financing to small businesses to acquire real estate or machinery or equipment for expansion or modernization. A certified development company is a non profit corporation set up to contribute to the economic development of its community or region. There are about 290 CDCs nationwide operating in specific geographic areas. CDCs work with the SBA and private-sector lenders to provide financing to small businesses.

Typically a 504 project includes a loan secured from a private-sector lender with a senior lien[i] property before other liens (which are called junior liens), a loan secured from a CDC (funded by a 100 percent SBA-guaranteed debenture[ii]) with a junior lien covering up to 40 percent of the total cost; and a contribution of at least 10 percent equity from the borrower. Interest rates are pegged to an increment above the current market rate for five-year and 10-year U.S. Treasury issues. Maturities are 10 and 20 years.[44]

This program has expanded significantly since FY 2001-02. Nationwide, in FY 2005-06 the dollar amount loaned under this program was more than double the amount in FY 2001-02 (it increased from almost $2.5 billion to $5.7 billion). The number of loans provided also almost doubled. In California, this situation was similar, with a more dramatic increase in the total dollar amount loaned (from $656 million to $1.5 billion).[45]

[i] The security interest that has precedence over all other interests in that property is called senior lien. The security interest that can be availed only after senior lien is satisfied is called junior lien.

[ii] Debenture is an unsecured debt backed only by the integrity of the borrower, not by collateral, and documented by an agreement called an indenture. One example is an unsecured bond.

The Microloan, 7(m) Loan Program

This program provides very small loans to start-up, newly established or growing small business concerns. SBA makes funds available to nonprofit community based lenders (intermediaries), which, in turn, make loans to eligible borrowers in amounts up to a maximum of $35,000. The average loan size is about $13,000. Applications are submitted to the local specifically designated intermediary lenders and all credit decisions are made at the local level. Intermediary lenders are nonprofit organizations with experience in lending and in technical assistance, since these organizations are required to provide business-based training and technical assistance to its microborrowers. Individuals and small businesses applying for microloan financing may be required to fulfill training and/or planning requirements before a loan application is considered.

The maximum term allowed for a microloan is six years, with loan terms varying according to the size of the loan, the planned use of funds, the requirements of the intermediary lender, and the needs of the small business borrower. Interest rates vary, depending on the intermediary lender and costs to the intermediary from the U.S. Treasury. Generally these rates will be between eight and thirteen percent.[46]

Nationwide, in fiscal year FY 2005-06 this program provided 2,542 loans that totaled $33.1 million, a smaller amount than in FY 2001-02 when more than 2,600 loans were granted under this program, with a total dollar amount of $37.5 million. In California, in FY 2005-06, the program supported 140 loans totaling almost $2.4 million, while in FY 2001-02 there were 152 loans totaling $2.9 million.[47]

California Loan Programs

CALIFORNIA CAPITAL ACCESS (CALCAP) PROGRAM

Administered by the California Pollution Control Financing Authority (CPCFA), this program provides incentives for lenders (banks, community banks, saving and loans, and credit unions) to make loans to small “near bankable” businesses that do not quite meet most banks’ conventional underwriting standards.

Borrowers apply for a loan to a participant lender. The lender must apply to CPCFA to participate in CalCAP and enroll each loan that qualifies for the program. When a lender’s first loan is enrolled, CPCFA establishes a loss reserve account for that lender, using funds from its Small Business Assistance Fund. The borrower and the lender each pay a premium into this loan loss reserve account, and the CPCFA matches the combined premium, creating a reserve against losses in the lender’s CalCAP loan portfolio. The maximum premium that CPCFA will pay is $100,000 per loan. Lenders set all the terms and conditions of the loans and decide which loans to enroll into CalCAP. Lenders also determine the premiums paid by the borrower and lender.

Each participant lender has its own reserve account, so that the performance of loans by an individual lender does not affect other lenders. The lender’s reserve funds can be used to cover any loss from loans made by that lender under the program. The more loans a lender makes, the larger the reserve account, and if one of the loans defaults, the lender can immediately cover all

the loss. In the case of a loan default, lenders must return recoveries from the borrower (less expenses) to the portfolio loss reserve account.

Under this program, the maximum loan amount is $2.5 million. Loans can be short or long-term, have fixed or variable rates, be secured or unsecured, and bear any type of amortization schedule.

CalCAP provides additional risk coverage for loans, which are made by lenders to businesses located in economically distressed communities (enterprise zones). In these cases the CPCFA contributes to the reserve fund 150 percent of the combined premium payments by lenders and borrowers.[48]

In the first eleven months of 2006, this program loaned $67 million via 580 loans. This was a higher amount than in 2005 when $55 million was loaned through 644 loans. However, this amount was low compared to the almost $99 million guaranteed in 2001. The average size of the loans under this program has decreased from $289,000 to $79,000. In 2006 about 68 percent of the loans were microloans, while in 2001 this proportion was 33 percent and in 2000 was just seven percent.[49]

SMALL BUSINESS LOAN GUARANTEE PROGRAM

The Small Business Loan Guarantee Program is administered by the Business Transportation and Housing Agency through contracts between the agency and nonprofit financial development corporations located throughout the state. The program allows businesses to obtain loans they might not otherwise obtain and to establish a credit history for future loans.

Small businesses apply through eleven financial development corporations (FDCs) either directly or through their bank. Guarantees can cover up to 90% of the loan amount, but cannot exceed $350,000. The guaranteed percentage varies and is subject to negotiation between the FDC and the lender. The term of the loan guarantee may extend up to seven years. Interest rates are negotiated between the borrower and the lender. The FDC may charge a guarantee fee of up to 2% of the amount guaranteed, plus a documentation fee of $250. During the fiscal year FY 2005-06, this program guaranteed 1,127 loans totaling $161 million. This amount is 68 percent higher than the total loans in FY 2000-01 and 13 percent higher than the amount loaned last fiscal year. The highest increase in loans guaranteed through this program took place between FY 2003-04 and FY 2004-05 (24 percent).[50]

SMALL BUSINESS POLLUTION CONTROL TAX-EXEMPT BOND FINANCING PROGRAM

This program provides private activity tax-exempt bond financing to California businesses that meet the size standards set forth in Title 13 of the Code of Federal Regulations or are an eligible small business, which is defined as 500 employees or less, including affiliates, for the acquisition, construction or installation of qualified pollution control, waste disposal and/or resource recovery facilities.

CPCFA uses its Small Business Assistance Funds (SBAF) to help pay for the costs of issuance of tax-exempt bonds issued on behalf of small businesses for the acquisition, construction, or installation of qualified pollution control, waste disposal, waste recovery facilities, or the acquisition and installation of new equipment. The SBAF may be used to pay for costs such as letter of credit fees, transaction fees and other costs associated with the issuance of bonds. This assistance reduces the net cost of financing to the small business. In FY 2005-06, eight small businesses benefited from this program totaling more than $68 million. The previous fiscal year five businesses received a comparable amount from bond issues, while in FY 2003-04, twelve small businesses participated in this program receiving a total of $53 million.[51]

THE CALIFORNIA INDUSTRIAL DEVELOPMENT FINANCING ADVISORY COMMISSION (CIDFAC)

This program allows a business to borrow funds at competitive rates through the issuance of tax-exempt bonds enhanced by a letter of credit or as a private placement to sophisticated investors. Industrial Development Bonds can be used to finance industrial projects for assembling, fabrication, manufacturing, or processing which creates a product for sale, businesses that manufacture or process recycled or reused products and materials, and agricultural projects that process raw products for resale. The maximum amount of a bond issue is $10 million per applicant per public jurisdiction.[52] The total principal amount of bond issued under this program was $43.8 million in FY 2005-06, $24.3 million in FY 2004-05, $20.2 million in FY 2003-04, and $28.1 million in FY 2002-03.[53]

INDUSTRIAL DEVELOPMENT REVENUE BOND (IDB) PROGRAM

Industrial development bonds (IDBs) are tax-exempt securities issued by the California Infrastructure and Economic Development Bank (I-Bank), by local Industrial Development Authorities, or by Joint Power Authorities, to provide money for the acquisition, construction, rehabilitation and equipping of manufacturing and processing facilities for private companies. At least 95 percent of the bond proceeds must be spent on qualifying costs (such as equipment, land, or buildings). No more than 25 percent of the bond proceeds can be used to acquire land.

The project financed by the bonds must meet certain public benefit criteria established by the California Debt Limit Allocation Committee (CDLAC), which include, among other things, the creation, or retention of jobs. Interest rates are generally 20 to 30 percent below comparable commercial alternatives.

In FY 2005-06 two small manufacturing projects were financed with Industrial Development Bonds issued by the California Infrastructure and Economic Development Bank, totaling $12.2 million, with a tax-exempt component of $10.7 million. Since FY 2001-02, this program has financed two projects a year, with the exemption of FY 2002-03 when six projects were financed.[54]

RECYCLING MARKET DEVELOPMENT ZONE (RMDZ) REVOLVING LOAN PROGRAM

The California Integrated Waste Management Board (CIWMB) offers these loans to recycling manufacturers, especially start-ups and expanding companies located in designated zones, at low cost and below-market rates. Interest rates are fixed. There is no prepayment penalty cost. The maximum loan amount is 75 percent of the loan, up to a maximum of $2 million, whichever is less.

Borrowers may apply for subsequent loans for business expansions that bring about more waste diversion. However, a borrower may not have more than $3 million total principal outstanding on all RMDZ loans at one time.[55]

According to the program's supervisor," the first loans were funded in the second half of FY 2003-04 and in subsequent years the total loans made have varied from a low of $2.2 million (two loans) to a high of $11.5 million (18 loans). In FY 2005-06, 11 loans were funded for a total of $11.2 million. In FY 2001-02, eight loans were made for $4.8 million."[56]

Main changes to the program affecting the number and/or dollar amount of the loans made include approving loan applications on a continuous basis rather than a quarterly basis (change made in 1996) and increasing the maximum amount per loan from $1 million to $2 million (change made in 2000).[57]

REPLACEMENT OF UNDERGROUND STORAGE TANK (RUST) PROGRAM

The State Water Resources Control Board offers direct grants and loans for replacement of underground storage tanks (RUST). The program helps small business owners or operators of underground petroleum storage tanks, who are unable to find conventional financing for meeting underground storage tanks requirements. Typically, loans are provided to cover planning, permits, drawings; excavation and removal of tanks, lines, and dispensers; installation of new tanks, lines, dispensers, under-dispenser containments, electronic monitoring system and enhanced vapor recovery system. Applicants must provide evidence that their site(s) is in current compliance. The maximum loan amount is $750,000. Loan terms can be ten or twenty years, depending on the type of security provided by the borrower. Interest rates charged under this program are below conventional market rates. A loan fee of 2% is paid at loan closing.

This program also provides grants (up to $50,000) for underground storage tank removal and replacement. Grants up to $30,000 are available for underground storage tanks installed after July 1, 2004, to help underground storage tank owners pay for costs associated with leak detection equipment and system testing.[58]

Currently, the State Water Resources Control Board allocates $8 million annually for the RUST Grant and Loan Program. During FY 2005-06, this program issued 24 loans totaling about $4.9 million and $2.6 million through 63 grants. In FY 2003-04 the RUST program provided 33 loans adding up $6.7 million and 47 grants totaling $2.2 million.[59]

CAPITAL FINANCING

Businesses evolve through various stage of development and need funds to finance the capital needs required in each of those stages. Capital for early stage financing is the most difficult to obtain. Typically, companies need capital for the following uses:

Early stage financing refers to seed, research and development, start-up, and first stage financing.

- *Seed financing* is the small amount of capital needed to prove a concept and qualify for start-up capital. Seed financing may be used for product development and building a management team.
- *Research and development financing* are funds to support basic research.
- *Start-up financing* is the capital provided to companies completing product development and initial marketing. Companies at this stage have not yet sold a product commercially but they are essentially ready to do business.
- *First stage financing* is capital to initiate full-scale manufacturing and sales. This kind of capital is provided to companies that have already developed a prototype or service for which commercial feasibility has been proven.

Second-stage financing are funds for working capital for the initial expansion of a company.

Mezzanine financing or third-stage financing is capital provided for a major expansion of a company whose sales volume is increasing and that is breaking even or profitable. The funds can be used as working capital or for the development of an improved product.

Sources of Capital Financing

Entrepreneur's equity, resources of family and friends, and angel investors are the primary source of early stage capital financing. State, universities, and federal laboratories and foundations are the primary sources of funds for seed capital. Corporate investors may also provide funds for new technologies to enhance their processes or launch new products.

ANGEL INVESTORS

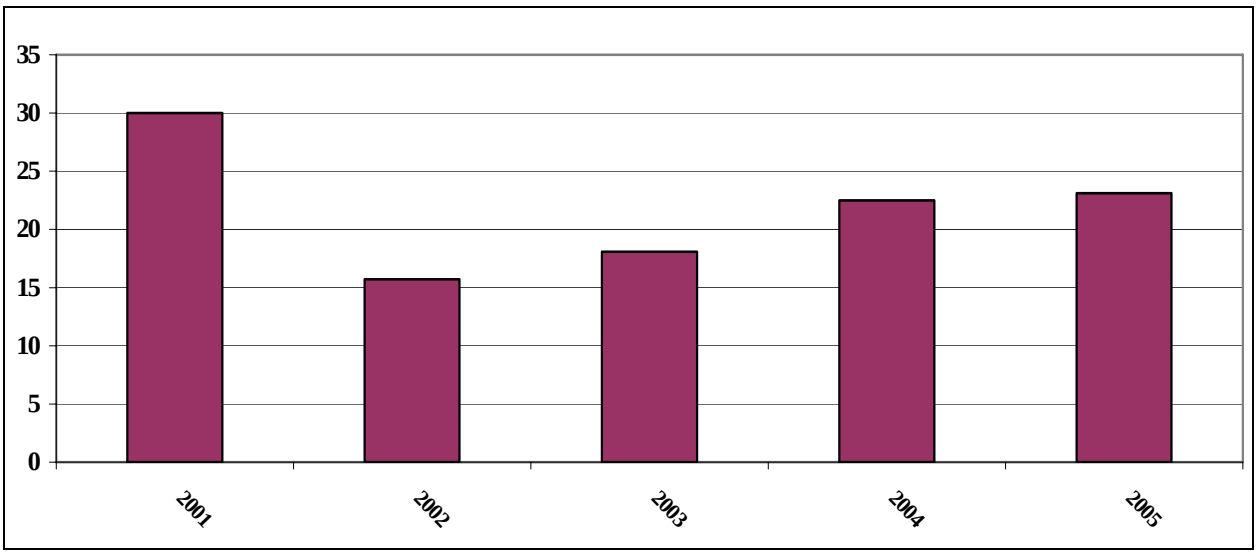
Angel investors are "high net worth individuals,"[i] that invest on their own account providing early stage capital for private companies.

Angel groups have several characteristics: loosely to well-defined legal structures; part-time or full-time management; standardized investment processes; a public face usually with a Web site and public relations activities; and, occasionally a traditionally structured venture capital/angel investing fund.

According to research conducted by Jeffrey E. Sohl at the University of New Hampshire's Center for Venture Research, there were approximately 50 formal business angel groups in the United States five years ago. In 2006, the Angel Capital Association counts more than 150 angel groups in the U.S. and about 20 in California.

Reports by Professor Sohl estimated that the angel investor market declined in 2002 by almost 50 percent with total investment of $15.7 billion, down from the previous year of $30 billion. More recent reports estimate that since 2003, the angel investor market has been recovering; increasing by 15 percent in 2003, 24 percent in 2004, but showing an only modest increase of 2.7 percent in 2005 (see Figure 9).[60]

Figure 9: Angel Investment in the U.S. (In $Billion).



Source: Prepared by California Research Bureau using data from reports by Center for Venture Research at the University of New Hampshire, Whittemore School of Business and Economics.

The $23 billion angel investments in 2005 were allocated in 49,500 deals for early stage development. Most of these investments were in technology. Healthcare services/medical

[i] Usually an accredited investor (as defined in Regulation D under the Securities Act of 1933 or Securities Exchange Commission, Rule 501) .

devices and equipment sector received 20 percent of this investment, followed by software (18 percent), biotech (12 percent), and other high tech electronics/information technology activities. Angel organizations can fill the funding gap (estimated between $500,000 and $2,000,000 to $5,000,000) or capital need that is too high to be covered by company founders, friends, family, and individual investors, but too low to attract the interest of venture funds.[61]

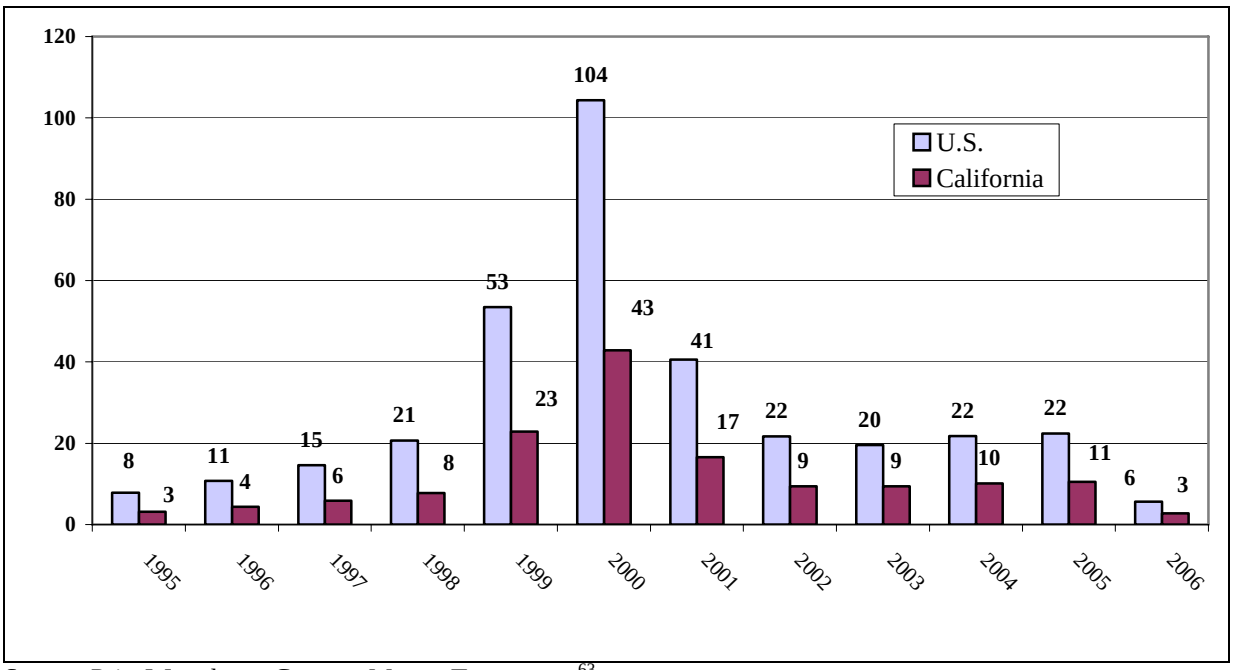
The same research indicates that the number of women-owned ventures seeking angel capital is low, but the percentage that obtains angel investments is higher than the average. In contrast, a higher percentage of minority-owned firms look for investments but only a very low percentage actually obtain angel investment.[62]

VENTURE FUNDS

Venture capital generally does not fund basic innovation or start-ups. Only about three percent of the $22 billion that venture capitalists invested in 2005 went to firms in an early stage of development. Venture capitalists invest in business sectors that are growing rapidly and seek to exit the company before the industry becomes mature.

In 2000 the U.S. Venture Capital investment was $104.4 billion and California's share was 41 percent. In 2005, venture capital dwindled to $22.4 billion in the U.S., higher than the 1998 level, but 78 percent lower than the 2000 level. In California, this reduction was 75 percent, with total venture capital investment of $10.5 billion. Figure 10 shows venture capital investment since 1995 in the U.S. and California.

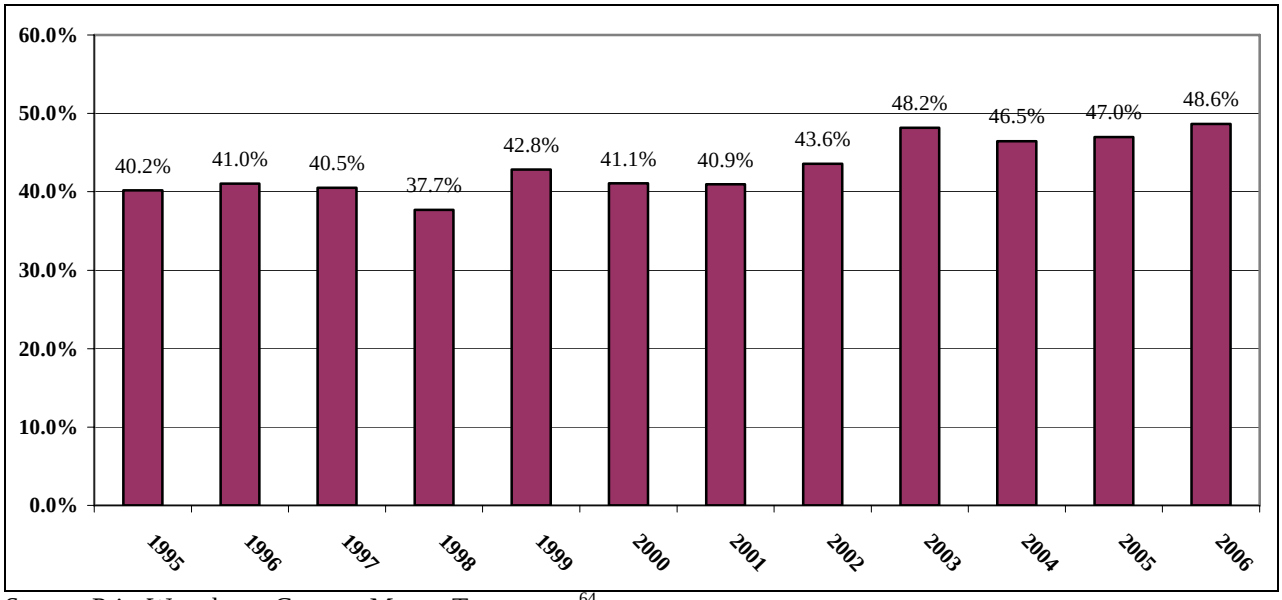
Figure 10: Venture Capital in California and the U.S. 1995-First Quarter of 2006, ($Billions).



Source: PriceWaterhouseCoopers Money Tree report.[63]

Figure 11 shows the California share of U.S. venture capital investments. With the exception of 1998, California has consistently received more than 40 percent of all venture capital investment in the U.S. and in 2006 this share increased to about 49 percent. However, capital venture investment in 2006 is significantly lower than in 2000 (see Figure 10).

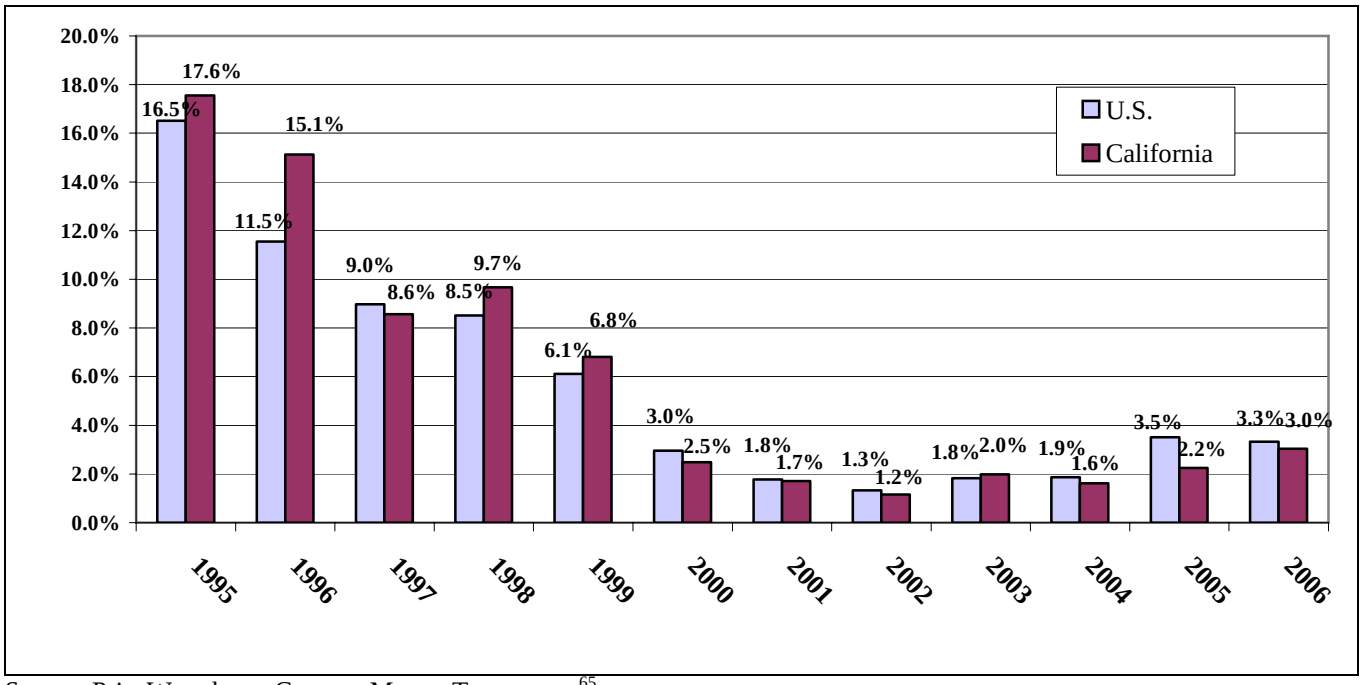
Figure 11: California Share of U.S. Venture Capital Investments, 1995-First Quarter of 2006.



Source: PriceWaterhouseCoopers Money Tree report.[64]

Figure 12 shows the percent of venture capital investment in start-ups in the U.S. and in California.

Figure 12: Share of Start-Up Investments in Total Venture Capital Investments, U.S.and California, 1995-First Quarter of 2006.



Source: PriceWaterhouseCoopers Money Tree report.[65]

The share of investments in start-ups in the U.S. decreased from 16.5 in 1995 to 3.5 in 2005 and in California, this reduction went from 17.6 in 1995 to 2.2 percent in 2005. In 2005 more than three quarters of all venture capital was invested in Silicon Valley firms, and most of the rest of investments took place in Southern California. Most of the investments went to the software, telecommunications, networking and equipment, and medical devices and biotechnology industries.

THE FEDERAL SMALL BUSINESS INVESTMENT COMPANY (SBIC) PROGRAM

Small business investment companies (SBICs) are financial institutions created to make equity capital and long-term credit (maturity of at least five years) available to small independent businesses.

The SBICs are privately organized and privately managed firms licensed by the U.S. Small Business Administration, which set their own policies and make their own investment decisions. In return for pledging to finance only small businesses, SBICs may qualify for government-backed long-term loans at favorable rates. SBICs provide venture capital to small independent businesses, including start-ups.

A corporation, limited partnership or limited liability company may apply to the Small Business Administration for a license to operate as a Federal Licensee under the rules and regulations issued by the Small Business Investment Act of 1958.

The two primary criteria for licensure as an SBIC are qualified management and sufficient private capital. SBA reviews and approves prospective management teams based upon both their professional capabilities and character. Once licensed, each SBIC is subject to annual financial reporting and biennial onsite compliance examinations by the SBA, and is required to meet certain statutory and regulatory restrictions regarding approved investments and operating rules.[66]

Most SBICs are owned by relatively small groups of local investors. Many, however, are owned by commercial banks. Some SBICs are corporations with publicly traded stock.[67]

STATE-SPONSORED VENTURE CAPITAL PROGRAMS

To help start-ups, some states have implemented a variety of state-sponsored seed and venture capital programs. Usually these programs look for the direction of investment towards companies or sectors that are overlooked or not attractive enough for venture capitalist investors. States invest either directly in companies, or in privately managed funds that are restricted to invest in targeted firms. Target firms can be selected by geographic location, industry, or stage of development, depending on the policy goals of the program. Other programs invest in private venture capital partnerships, along with other investors. The intention of these models is to attract experienced investors to meet the capital needs of local businesses while diversifying risks.

Examples of pure public models funded only with state funds and managed by a public entity are in Utah, Arkansas, and Iowa. These states allocate state funds for venture investing.

Examples of programs that invest in private venture capital firms are in Oklahoma, Louisiana, New Hampshire, Hawaii, Pennsylvania, and Texas. These programs are generally organized as a quasi-public, not-for-profit corporation, or public authority, and are governed by a publicly appointed board of directors. Some of these efforts have been successful. Funds are obtained from various mechanisms including dedicated state revenues (for example revenues from oil and gas revenues or state's lottery revenues), or providing investment tax credits to investors in state targeted type of projects.

Some states provide tax credit incentives for private indirect fund investment. For example, the certified capital companies or CAPCOs models provide tax credits to insurance companies for 100 to 120 percent of the amount they loan to or invest in CAPCOs. [i] Missouri, Louisiana,

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[i] For a complete discussion of capital programs please see: 1) Koehler, Gus, and Rosa Moller. *Business Capital Needs in California: Designing a Program*. Sacramento: California Research Bureau, California State Library, April 1998. 2) Heard, Robert G. and John Siebert. "Growing New Businesses with Seed and Venture Capital: State Experiences and Options." Washington. D.C.: National Governors' Association. 2000. 3) United States General Accounting Office (GAO). "Small Business Efforts to Facilitate Equity Capital Formation." Washington D.C.: GAO, September 2000. 4) The National Association of Seed and Venture Funds." "Seed and Venture Capital. State Experiences and Options. Chicago: The National Association of Seed and Venture Funds May 2006.
[i] CalPERS "California Public Employees' Retirement System Statement of Investment Policy for Economically Targeted Investment Program." Sacramento: CalPERS. February 14, 2005.
[i] Information received by e-mail from Clark McKinley and Jesus Arguelles Investment Officers of CalPERS, dated January 10, 2007.

Wisconsin, New York, Oklahoma, Texas, Alabama, Florida and the District of Columbia have variations of this type of program.

In California, state pension funds have invested in private venture capital partnerships, in part to direct capital towards projects that benefit economic development and local businesses. The California Public Employees' Retirement System (CalPERS) has adopted a goal of investing two percent of their investment portfolios in domestic emerging markets-communities that have struggled to attract investment capital, but hold great potential for financial returns and economic success.[68] In May 2001, the CalPERS Investment Committee established the California Initiative Program. Through this initiative the CalPERS Investment Committee approved $475 million of commitments, which were allocated to ten private equity funds and earmarked for investment in "traditionally underserved markets primarily, but not exclusively, located in California." So far CalPERS has allocated more than $350 million to private equity investment in underserved California businesses.[69] According to a CalPERS report:[70]

- Forty-eight (or 71 percent) of the California Initiative companies are headquartered in California, and 51 (or 75 percent) of the companies employ a significant proportion of their workforce in California.

- Approximately 40 percent of California residents employed by California Initiative companies live in economically disadvantaged areas of the state.

- Nearly three quarters of California Initiative companies have less than 100 employees and 15 percent of the companies have less than ten employees.

[i] CalPERS California Initiative. "Impacting California's Underserved Communities: An Initial Assessment." Sacramento: CalPERS. February, 2006. http://www.calpers.ca.gov/eip-docs/about/press/news/invest-corp/cal-init-assess.pdf

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ENDNOTES

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[2] Small Business Administration. Office of Advocacy. "The Small Business Economy. A Report to the President." Washington, D.C. 2005.
[3] Typical individual member investments are about $50,000, with totals raised from $100,000 to $ 1 million.
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[5] http://www.census.gov/csd/susb/susb.htm .
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[31] A study documenting this was done by Jonathon Zinman, MIT dissertation chapters 1 and 2. "The Real Effects of Liquidity on Behavior: Evidence from Regulation and Deregulation of Credit Markets." Research Summary 223, November 2002 http://www.sba.gov/advo/research/rs223tot.pdf.
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[44] www.sba.gov/financing/sbaloan/cdc504.htm
[45] Source: SBA administration. Data received by e-mail from Shawn McKeehan, Special Assistant to the AA/FA, Dated December, 2006.
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[49] Data provided by Aaron Todd, CalCAP Program Manager, though e-mail dated January 2, 2006.
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