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The Small Business Advocate

Advocacy: the voice of small business in government

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Advocacy Study Examines Small Business Credit Structure, Highlights Widespread Use of Trade Credit

by Chad Moutray, Director of Economic Research

The Office of Advocacy has just released a new study examining small businesses' use of credit and the use of bank credit (loans) and supplier credit (trade credit). While there is a wide and growing literature on bank credit, trade credit has received less attention. As the new study documents, trade credit is almost as pervasive as bank credit in both incidence and volume. In this time of tightened credit, small businesses are looking not only to financial institutions, but also to their suppliers, as sources of funds. While policymakers have focused on how to get banks to increase lending to small firms, they should also address the equally important trade credit channel of funding.

In conducting their normal operations, businesses of all sizes extend credit to one another in the form of "accounts receivable." For instance, a firm might submit an invoice with the "terms of trade" being "2/10 net 30." This means that a 2 percent discount is given for payments made within 10 days or the full amount is due in 30 days. This practice is referred to as "trade credit"—an instrumental tool for business financing. *Bank Credit, Trade Credit or No Credit: Evidence from the Surveys of Small Business Finances,* by Rebel A. Cole of Krähenbuhl Global Consulting, finds that three out of five small firms use trade credit. The pervasive use of trade credit shows that it is an important, albeit specialized, form of financing for small businesses.

The fact that trade credit typically is more expensive than other forms of credit undoubtedly influences its use. In the example cited earlier (2/10 net 30), the implied annual interest rate is 45.5 percent for firms that pay on the 30th day. Consequently, firms tend to use trade credit as a short-term finance tool. Its use reflects suppliers' interests in encouraging more sales, rewarding creditworthy customers, and adhering to common industry practices.

Businesses' use of credit varies by industry. Firms that use neither bank nor trade credit are primarily found in the service sector or wholesale and retail trade sectors. Those that utilize both bank borrowing and trade credit are more likely to be in the manufacturing and construction sectors.

The research describes other characteristics associated with the different kinds of small-business borrowers. Firms that use trade credit tend to be larger and more liquid, but they also have lower credit scores. Small businesses that use bank credit are larger, younger, and less liquid. Companies that utilize neither bank nor trade credit are significantly smaller, more profitable, more liquid and of better credit quality.

The study provides interesting clues into the borrowing behavior of small businesses. It highlights the fact that trade credit and bank lending are complementary in nature, with a large segment of business owners utilizing both sources of funding. Therefore, even though it uses older data—the SSBF was discontinued after the 2003 survey—the study has important policy implications for today's economy. Many small firms cite access to credit as a concern. This is in line with the current debate on the availability of business credit, much of which focuses on ways to encourage more bank lending. Yet, more recent surveys also suggest that many businesses have tightened their terms of trade; the result is a further squeeze on small firms already worried about financing. This analysis suggests that issues of access to credit should be extended to include trade credit—a financing mechanism that provides its own unique set of challenges in tough times.

The report is located on Advocacy's website at **www.sba.gov/advo/research/rs365tot.pdf**.

In This Issue

Four New Interns Join Advocacy for Summer 2010

by Patrick Morris, Public Liaison and Media Manager

The summer internship offers students the opportunity to garner "real life" experience in their area of study. This summer, the Office of Advocacy is fortunate to have four talented interns assisting the staff in our mission as advocate for small business in the federal government.

Three interns are assisting the legal staff in the Office of Interagency Affairs. Kate Aishton is a third-year law student at Georgetown University Law Center. She is from Peachtree City, Georgia, and has a background in broadband policy. Aishton is working on telecommunications and media regulations. She earned a master's degree from the University of Southern California's Annenberg School for Communications and a bachelor's from Reed College in Portland, Oregon. She has been actively involved in Washington-area farmers' markets and currently serves as a market manager.

A native of Gainesville, Virginia, Melodie Bales is conducting research on the Equal Access to Justice Act to determine whether small entities are benefiting from the statute. Bales is a third-year law student at Catholic University's Columbus School of Law, where she is an editor of the *Law Review.* She is a graduate of Mount St. Mary's University in Emmitsburg, Maryland. Bales has served as a research assistant for Columbus School Professor Mark Rienzi and as a research intern for D.C. Superior Court Judge Fern Flanagan Saddler. She enjoys cooking, reading, running, and traveling in her spare time.

Amy Siadak is a third-year law student and Thurgood Marshall Scholar at the George Washington University Law School. She is examining the foreign affairs exemption to the Administrative Procedure Act and its relationship to the Regulatory Flexibility Act.

The Office of Advocacy's 2010 summer interns are, from left, Melodie Bales, Reese Higgins, Kate Aishton, and Amy Siadak.

The Small Business Advocate

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Siadak is also assisting staff with projects focusing on procurement and the environment. She is a graduate of Northern Illinois University and a native of DeKalb, Illinois. She enjoys travel and baking, and is an avid games enthusiast.

Advocacy's fourth intern, Reese Higgins, is assisting the Office of Information. Higgins is a junior at the University of Maryland's Phillip Merrill College of Journalism, where he is an Arts Scholar. Higgins is updating Advocacy's communications databases. He has also covered D.C. events and Capitol Hill hearings and contributed articles and blog posts since week one in the office. Higgins is the arts and entertainment editor at the *Diamondback,* the university's independent student newspaper and program director at the university radio station. His assignments have included interviewing Al Green, Yoko Ono, and Lily Tomlin.

The office welcomes the energy, dedication, and fresh outlook of all four interns.

From the Chief Economist's Desk

Cultivating High-Impact Firms: A Key Prescription for Recovery

by Zoltan Acs, Chief Economist

Jockeying for position on whom to assist in creating jobs is heating up. While small businesses are recognized as longstanding contributors to job creation, there are different types of small businesses. The Global Entrepreneurship Monitor (GEM) survey shows that what increased in 2009 was the necessity entrepreneurship rate, that is, businesses started by people who have lost their jobs and cannot find employment. In fact, this has been increasing steadily since 2005. The rate of nascent entrepreneurship—which measures individuals deliberately planning a business launch—has been heading down over the same time period.

In fact, the GEM survey shows that entrepreneurial attitudes in the United States have worsened since 2006, with people perceiving less opportunity, more fear of failure, and fewer startup intentions. Consequently, entrepreneurial activity has declined by most measures, including the nascent entrepreneurship rate, new business ownership rate, and early stage entrepreneurial activity.

The Kauffman Foundation has just released the Kauffman index of entrepreneurial activity showing that the number of U.S. business startups launched in 2009, the third year of the current recession, reached record highs—exceeding the number of startups during the peak 1999-2000 technology boom. African Americans and older Americans experienced the greatest increases in business-creation rates from 2008 to 2009. Unfortunately, much of this is necessity entrepreneurship. The bulk of these self-employed do not and will not hire workers. Recent research shows that people who are solo entrepreneurs as measured by the Kauffman Survey are motivated more by desperation than business opportunities.

However, what is most disturbing is that entrepreneurial aspiration—the next new "big idea"—has also declined in the population. Aspirations reflect the qualitative nature of entrepreneurial activity.

"Unless we change the incentive structure, the 'best and the brightest' will continue to practice unproductive or even destructive entrepreneurship."

For example, entrepreneurs differ in their aspirations to introduce new products and production processes, and to export. The number of entrepreneurs reporting that their product is new on the market, has few competitors, has an international orientation, or will create jobs in the future all declined from around 2005.

In other words, high-impact entrepreneurship—the kind of firms that create most of the jobs, most of the innovations, and most of the competitiveness of our great economy—appear to be on a long-term decline. While most nonemployer firms can be started with little or no money, high-impact firms are a different story. They need real money—debt plus equity. In other words, they need access to the capital markets.

The cyclical downturn in entrepreneurial aspirations in the United States can be traced not so much to the recession as to the financial crisis. While financial innovation played a crucial role in innovative entrepreneurship in the past, the current crisis gives us pause. The financial situation has been poisoned by years of neglect, dozens of bad decisions, and ineffectual federal regulation. Without addressing the financial crisis, finance will not flow to new firms to create the innovations needed to fuel growth.

Creative finance can be the lifeblood of entrepreneurship, but today it is more like a parasite, with entrepreneurs increasingly in service to finance rather than the other way around. Unless we change the incentive structure, the "best and the brightest" will continue to practice unproductive or even destructive entrepreneurship.

Office of Advocacy research confirms that most jobs are created by high-impact firms (gazelles); unless Americans are willing and able to become high-impact entrepreneurs we cannot compete in the global economy, innovate to create growth, or reduce unemployment. While a million new self-employed are helping lower unemployment and keep their own heads above water, it will also take a few hundred thousand high-impact firms to renew our economy's momentum.

For More Information

Learn more about the trends cited in this article at the following sites:

The Global Entrepreneurship Monitor (GEM) survey: **www.gemconsortium.org**.

Kauffman Index of Entrepreneurial Activity: **www.kauffman.org/uploadedfiles/kiea_2010_report.pdf**.

Regulatory News

Advocacy and Commerce Visit Two Pennsylvania Foundries

by Bruce Lundegren, Assistant Chief Counsel

Representatives of the Office of Advocacy (Charles Maresca and Bruce Lundegren) and the U.S. Department of Commerce (Martin Johnson) recently visited two small metalcasting foundries in Pennsylvania. They were joined by representatives of the American Foundry Society.

The first stop on the tour was the Buck Company in Quarryville, Pennsylvania. Buck Company is a jobbing foundry that has the ability to cast ferrous and nonferrous alloys—a combination unique in the industry. The range of activities allows Buck to produce quality castings for a large variety of markets, including construction, fittings, valves, railroad, and automotive. Matt Sullivan, executive vice president at Buck, hosted the visit and explained the casting process, as well as how the industry has had to adjust to foreign competition, high electricity costs, and complex health and safety regulations.

The second stop was Boose Aluminum in Reamstown, Pennsylvania. Tour host and Boose President Roger Boose took pride in being the third generation of his family to run the company. Founded in 1933 by his grandfather, Boose produces aluminum castings for a broad array of uses, such as medical equipment, aftermarket automotive, marine, electrical, ornamental, and military. Like Sullivan, Boose cited foreign competition, high electricity costs, and compliance with complex federal regulations as important issues for the industry.

Two representatives of the American Foundry Society, Stephanie Salmon and Tom Slavin, also participated in the tour. Of particular interest to them are two forthcoming rules from the Occupational Safety and Health Administration (OSHA) on occupational exposure to crystalline silica and explosion hazards from combustible dust. Since casting molds are packed in sand (silica) and the operations generate significant amounts of dust, the details of OSHA's approach to these two issues will be especially important to them.

The Office of Advocacy represents small businesses in the regulatory process, so it was very interesting to see how these small businesses operate and how federal regulations affect them. The Department of Commerce's Manufacturing and Services division is responsible for safeguarding the American manufacturing sector, so this tour provided a unique insight into a basic industry trying to navigate in the modern regulatory and economic climate.

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