Modest sales expectations and limited access to bank credit may be curtailing small businesses' plans for hiring and capital investment.

Given that the small business sector is the most dynamic one in terms of its capacity to generate jobs, it is of vital importance for policymakers to understand the financial needs and constraints it faces. Capital adequacy is generally considered a central factor in determining the success of any enterprise. Insufficient equity capital or retained earnings may precipitate the need for bank borrowing, and such borrowing can put a firm in a precarious position. Unlike investors who supply equity capital and are willing to wait for a return, banks will not wait to receive their interest payments. Difficult macroeconomic conditions exacerbate cash flow problems. Although all firms must deal with these problems of finance, they are particularly significant for small businesses, whose product diversity, technological flexibility, markets, and sales revenues tend to be limited compared to those of large firms.

Commercial banks tend to be the single most important external source of credit for small businesses (Meyer 1998). This has a number of implications for small firms, especially the smallest. First, the largest of the small firms are a minority of small businesses, but account for a majority of small business credit. Cole, Wolken, and Woodburn (1996) report that small firms with more than $1 million in sales constitute less than one-fifth of small businesses, but account for more than two-thirds of the credit that all small firms obtain. This suggests that the majority of small firms, those whose annual sales are less than $1 million, are at a disadvantage in their efforts to get bank credit.

Second, a number of authors (Berger and Udell 1996; Peek and Rosengren 1996) have argued that financial innovation and changes in bank regulation in the 1980s and 1990s may have made banks less willing to lend to small firms. Of course, tightness of credit will also depend on phases of the business cycle, and so overall business conditions must be taken into account when trying to gauge the extent to which the smallest firms are discriminated against (Avery, Bostic, and Samolyk 1998).

Third, the tumultuous waves of bank collapses and mergers in the 1980s and 1990s may have contributed to small businesses' reduced access to credit. Deregulation, mergers, and
consolidation of the banking industry from 1987 to 1993 sharply lowered the proportion of small banks, which are the banks that specialize in small business lending (Berger and Udell 1995; Cole, Wolken, and Woodburn 1996). Although the current economic expansion has led to an increase in the supply of credit and to an easing of the conditions under which it is granted, a slowdown could accelerate the disappearance of small business lenders and thereby increase the liquidity squeeze faced by borrowers.

The financial constraints faced by small businesses are of particular relevance now. As we enter a late phase of the business cycle, several authors have questioned the ability of the U.S. economy to continue on its robust course (Godley 1999; Wray 1998). An economic slowdown, with its attendant collapse of demand and reduced availability of both internal and external finance, would hit small business harder than it would hit big business and consequently would reduce small business's ability to generate jobs.

One of the objectives of the 1999 Levy Institute Survey of Small Business was to investigate the extent to which gaining access to finance is a major difficulty for small businesses. The survey was conducted in the winter of 1999 on a random sample of 536 small businesses, defined as firms employing between 5 and 500 employees. Of the total sample, 486 firms were asked questions directly pertaining to their finance requirements and their plans for expansion of both employment and productive capacity.

Almost 44 percent of the firms said their expansion plans would be financed internally, that is, financed by business retained earnings or personal resources, such as equity and loans from principal owners and other members of firms or from family and friends. About 21 percent said that expansion would be financed externally by bank credit. (The total of these two figures is roughly that found by Berger and Udell [1998], who report that funding by the principal owner, commercial bank credit, and trade credit constitute around 70 percent of small business finance.) Another 20 percent of survey respondents said they would rely on a variety of nonbank forms of financing, such as venture capital and loans and grants from development agencies. The relatively small share of bank finance is consistent with the recent trend. Cole, Wolken, and Woodburn (1996) found the percentage of firms obtaining credit from banks fell from 44 percent in 1987 to 36.8 percent in 1993. However, commercial banks remain the largest single source of credit for small firms.

In response to the question "What is the most important factor determining your hiring plans (for the coming year)?" almost 42 percent of the firms cited demand conditions, in other words, sales expectations. The importance of sales expectations is consistent with the importance of finance by business retained earnings for small firms.

To the question "Aside from hiring, in what way(s) do you expect your business to expand in 1999?" almost 42 percent of the firms responded that they do not plan to expand productive capacity at all and only 12 percent said that they plan to purchase new equipment and machinery.
Businesses were also asked about actual income in 1998, expected gross sales in 1999, and expected increase in sales in 1999. Tables 1 and 2 reveal apparent inconsistencies in their expectations. Table 1 shows that gross sales expectations for 1999 were similar to actual incomes in 1998 for small businesses of all sizes, although there was a small increase in the proportion of firms with sales expectations exceeding $5 million. (Note that the high degree of nonresponse makes inferences from the numbers in Table 1 rather weak from a statistical standpoint.) In short, expectations were modest. On the other hand, Table 2 shows that almost 24 percent of all firms expect sales to increase by 10 to 50 percent, a figure that suggests that a sizeable number of firms have reasonably healthy expectations.

The survey findings suggest that a large proportion of small businesses expect to face some internal cash flow constraint in the coming year since this internal cash flow is largely contingent on sales. One may surmise that at the same time their expectation of securing external finance, especially bank credit, is not likely to be high since credit is granted largely on the strength of sales and the amount of retained earnings.

Would efforts to raise consumer demand by lowering interest rates give a boost to sales expectations? Apparently not, according to the firms surveyed. Although about 30 percent said they would expect sales to increase if interest rates declined, almost 50 percent said they would not expect sales to be affected. This suggests either that the products sold by a large number of small firms are not interest sensitive or that many firms do not feel optimistic about future demand in this phase of the business cycle. However, these firms' expectations may not be borne out in reality if a lower interest rate policy leads to positive macroeconomic consequences and thereby boosts consumer demand.

What are we to conclude from this information on financing, sales expectations, and expansion plans? Essentially, these results show that in this late phase of the business cycle small firms are relatively cautious about their sales expectations even in the midst of the general mood of economic euphoria that is reflected in the stock market. The heavy reliance by a large portion of this sector on internal finance to fund expansion raises questions about its growth potential if the U.S. economy slows down in the coming year. In addition, in a downturn the cash flow squeeze would be exacerbated by tight credit markets.
If it is true that small businesses will face a cash flow squeeze in the near future, then remedial policy measures are needed. Given firms' current expectations about demand, government subsidies for worker training will be insufficient to ease the cash flow squeeze; about 68 percent of businesses said they would not be induced by such subsidies to hire new workers. Programs to provide credit at interest rates not otherwise available to small businesses and to stimulate investment, such as the Small Business Administration's 504 loan program, 7A loan guarantee program, and Community Express program, might help. Also, because, as the survey shows, many small businesses either are not aware of government programs or do not use them, the creation of programs to ease their situation should be accompanied by improved means of disseminating information about them.

References


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