REPORT OF THE

VIRGINIA SMALL BUSINESS COMMISSION

TO THE GOVERNOR AND
THE GENERAL ASSEMBLY OF VIRGINIA

SENATE DOCUMENT NO. 33

COMMONWEALTH OF VIRGINIA
RICHMOND
1999

MEMBERS OF COMMISSION

Sen. Stanley C. Walker, Chairman
Del. A. Victor Thomas, Vice Chairman
Del. I. Vincent Behm, Jr.
Del. Robert S. Bloxom
Del. Vincent F. Callahan, Jr.
Del. Glenn R. Croshaw
Del. Franklin P. Hall
Sen. Charles R. Hawkins
Sen. Janet D. Howell
Sen. Edward L. Schrock
Robert A. Archer
Thomas E. Inman II
Jorge M. P. Ponce
Bernice E. Travers

STAFF

DIVISION OF LEGISLATIVE SERVICES

Arlen K. Bolstad, Senior Attorney
Robert A. Omberg, Staff Attorney
Cynthia G. Liddy, Senior Operations Staff Assistant

SENATE CLERK'S OFFICE
Committee Operations

John McE. Garrett, Deputy Clerk
Thomas C. Gilman, Committee Operations Coordinator,
Sergeant at Arms

Report of the
Virginia Small Business Commission

Richmond, Virginia
May 1999

To: The Honorable James Gilmore, Governor,
and
the General Assembly of Virginia

I. INTRODUCTION

A. OVERVIEW

This report summarizes the 1997 and 1998 activities of the Virginia Small Business Commission, a legislative commission devoted to promoting the interests of Virginia's small businesses. The Commission was established by the 1995 Session of the Virginia General Assembly, and is required by its enabling legislation (Va. Code § 9-336 et seq.) to undertake the following:

- Evaluate the impact of existing statutes and proposed legislation on small businesses.
- Assess the Commonwealth's small business assistance programs and examine ways to enhance their effectiveness.
- Provide small business owners and advocates with a forum to address their concerns.
- Report annually its findings and recommendations to the governor and the General Assembly.

The Commission is comprised of 14 members, including six members from the House of Delegates, four members from the Senate and four at-large members appointed by the governor. The at-large members are required to be individuals with small business experience or expertise.

The following General Assembly members served on the Commission in 1997 and 1998: Senators Stanley C. Walker of Norfolk, Charles R. Hawkins of Chatham, Janet D. Howell of Reston, and Edward L. Schrock of Virginia Beach, together with Delegates A. Victor Thomas of Roanoke, I. Vincent Behm, Jr., of Hampton, Robert S. Bloxom of Mappsville, Vincent F. Callahan, Jr., of McLean, Glenn R. Croshaw of Virginia Beach and Franklin P. Hall of Richmond. Gubernatorial appointees serving in 1997 and 1998 were: Robert A. Archer of Salem, Thomas E. Inman II of Williamsburg, Jorge M. P. Ponce of Centreville and Bernice E. Travers of Richmond. Senator Walker served as the Commission's chairman and Delegate Thomas as its vice chairman.

B. SUMMARY OF THE COMMISSION'S 1997 AND 1998 ACTIVITIES

The Commission convened two meetings between the 1997 and 1998 legislative sessions. The meetings focused on issues of continuing concern to the Commission such as child day care financing—viewed by Commission members as vital to small business employers and employees, alike—and health care coverage reforms and initiatives benefiting small business. The Commission also examined retail small business revitalization in Virginia's downtowns and main streets, microloans and initiatives, and capital access needs of rural small businesses. Additionally, annual reports from the Virginia Small Business Financing Authority and the Small Business Development Center Program, together with the first annual report from the Commonwealth Competition Council, were received and reviewed by the Commission.

The Commission's 1998 activities consisted of monitoring developments in the small business community and in receiving the Commonwealth Competition Council's fourth annual report. Included in that report were the results of the second statewide survey of agencies and institutions conducted by the Council. A copy of the report's introduction is attached. *(Appendix H)*

II. GOVERNMENTAL ASSISTANCE PROGRAMS FOR SMALL BUSINESS

A. SMALL BUSINESS AND STATE ECONOMIC DEVELOPMENT PROGRAMS

State-promoted economic development programs and their potential for generating small business opportunities are matters of continuing interest to the Commission. Commerce and Trade Secretary Robert Skunda told the Commission that small business had not been left out of the Allen Administration's economic development programs. In addition to companies like White Oak Semiconductor, Gateway 2000, and Frito-Lay, Secretary Skunda said that half of the new companies coming to Virginia in conjunction with economic development promotions are small businesses with less than 75 employees. The result was 211,000 net new jobs and $11.5 billion in investment. *(Appendix A)*

B. STATE-SPONSORED SMALL BUSINESS DEVELOPMENT FINANCING AND PROGRAMS

Small Business Development Centers

The Small Business Development Center Program provides management assistance and technical advice to small to medium-sized start-ups for new and existing businesses. The centers provide training in a variety of subjects, including how to start a business, manage cash flow, raise capital, and develop a business plan. This statewide program, funded through federal, state and private financing, operates out of 26 regional offices throughout the Commonwealth. Virtually all SBDC clients employ fewer than 100 employees.

The SBDC's director advised the Commission that in 1997 the program counseled over 10,000 businesses, and helped create or save about 3,000 jobs. The director also told the Commission that new SBDC staff professionalism requirements have been instituted, including requiring all regional center directors to have master's degrees. The Commission asked the director to pursue the completion of an updated small business needs assessment survey.

Virginia Small Business Financing Authority

The Virginia Small Business Financing Authority (VSBFA) has offered a variety of loan and guaranty programs through public-private partnerships to provide financing to Virginia businesses for growth and expansion. Established in 1994, The Authority offers industrial development bonds, a loan guaranty program, export financing assistance and similar programs including defense conversion and child day care financing programs. The Authority reported to the Commission that in fiscal year 1997, it helped arrange more than $64 million in business loans to 93 businesses in the Commonwealth, thereby creating or saving approximately 2,674 jobs. The 1997 General Assembly placed two new programs under the Authority's umbrella: the Virginia Small Business Growth Fund and the Virginia Export Loan Guarantee Fund.

The Small Business Growth Fund (also known as the Virginia Capital Access Fund) provides loan loss reserve funds for participating banks through matching VSBFA funds. The loan loss reserve fund (containing contributions by borrowers and lenders that are combined with matching amounts from the VSBFA) is designed to promote private market lending to small business loan customers who may be otherwise ineligible for conventional business loan financing. The 1997 General Assembly furnished a $350,000 appropriation which is expected to help leverage approximately $10 million in new loans.

The Export Loan Guarantee Fund is designed to increase access to capital for small businesses targeting international trade opportunities. The fund authorizes the VSBFA to guarantee up to 90 percent of the principal amount of commercial loans (up to a maximum of one million dollars in outstanding loan guarantees at any one time) made by a lender for the purpose of facilitating the sale of goods, products or services outside the United States by persons, firms or corporations which utilize a Virginia air, land or sea port to ship such goods, products or services. The 1997 General Assembly provided $750,000 in funding for the Fund in its inaugural year.

III. HEALTH CARE AND SMALL BUSINESS

A. HEALTH CARE REFORM AND VIRGINIA'S SMALL BUSINESS COMMUNITY

The Commission follows health care reform activities as they affect Virginia's small business community. The Joint Commission on Health Care staff briefed the Commission on (i) the federal Health Insurance Portability and Accountability Act (HIPAA) and (ii) the status of small group insurance reforms *(Appendix B).* A significant development was the 1997 General Assembly's enactment of legislation implementing HIPAA in Virginia. HIPAA (popularly known as the Kennedy-Kasselbaum bill) focused on such issues as guaranteed health insurance renewability, preexisting condition waiting periods, and credits for waiting periods served in previous coverage. Many of HIPAA's provisions had been previously enacted in Virginia as part of insurance reform legislation adopted in the past several years.

Commission members learned, however, that Virginia's "bare bones" essential and standard health care plans have had minimal impact. The General Assembly directed insurance carriers to offer these plans as a means of making basic health care coverage available and affordable to small businesses who might not otherwise offer health care coverage to their employees due to cost.

According to the Joint Commission, only 14 of the 70 carriers required to offer these essential and standard health care plans have sold any; the plans sold currently cover fewer than 100 employers with approximately 500 covered employees. Many employers are apparently unaware of these plans; it is also apparent that insurers are not expending marketing resources on them. However, the Joint Commission reported that it is reviewing options for fine tuning these plans including (i) expediting their review and updating, and (ii) strengthening marketing requirements to make employers more aware of them.

B. HEALTH INSURANCE PREMIUM SUBSIDIES FOR SMALL BUSINESS

Approximately 850,000 Virginians are currently without health care coverage. A high percentage of them are low-income individuals employed by businesses financially unable to offer health care benefits. A new demonstration, or pilot project, coordinated by the Department of Medical Assistance Services (DMAS) is intended to address this problem. The pilot will provide health insurance premium subsidies to qualifying small businesses in selected regions *(Appendix C)*. Its subsidies will be funded through the Virginia Indigent Health Care Trust Fund. The Fund, established in 1989, operates on legislative appropriations and hospital contributions to reimburse Virginia hospitals providing a disproportionate amount of unreimbursed care to indigent individuals.

The demonstration project will provide premium subsidies to full-time employees of small businesses who have not offered employer-sponsored health care coverage for the past 12 months. Eligible businesses must pay at least 50 percent of the premium cost for employee-only coverage, and eligible employees must have gross incomes of less than 200 percent of the current federal poverty guideline. Participating employees must also be ineligible for Medicaid.

According to DMAS, the subsidies described above will cover about 30 percent of the pilot's total cost. For example, if an eligible employee seeks family coverage requiring a $375 monthly premium, a $127.50 premium subsidy will be paid by DMAS. The employee would pay $187.50, and the employer would contribute $60 (representing 50 percent of an assumed $120 monthly premium for single coverage). The program is slated to begin in the Summer of 1998, and will be marketed through HMOs utilizing Essential Health Benefits Plans.

IV. CHILD DAY CARE FINANCING PROGRAM

The Child Day Care Financing Program—administered by the VSBFA—provides loans of up to $25,000 for improvements in child day care programs and facilities. The program provides direct loans to finance quality enhancements for child care programs or to meet or maintain child care standards, including health safety and fire codes. The program exists because bank financing for child care centers and providers is reportedly difficult to obtain since (i) prospective borrowers usually have little collateral, and (ii) day care businesses operate on thin profit margins. A program representative told Commission members that, since the program was launched in 1994, it has provided over $ 2.1 million in financing, creating 2,500 new child care spaces and over 135 new employment position.

The program attracted the Commission's attention in 1996 when funding for the program was not requested in Virginia's 1996-1998 Child Care and Development federal block grant application (as submitted by the Council on Child Day Care and Early Development Programs). Since the program has depended on these block grant funds for all of its operating funds, by the summer of 1996 it had no means of underwriting new loans. The Department of Social Services received responsibility for administering this block grant program in 1996 after the Council was eliminated.

The Commissioner of Social Services ultimately advised the Commission that the Department of Social Services would provide funding for the $170,000 in outstanding loan requests submitted in 1996. Additionally, a 1997 General Assembly budget amendment placed a $750,000 Child Day Care Financing Program obligation in the Departmental budget, without a special appropriation. The VSBFA's representative told the Commission that the Department and the VSBFA were making arrangements for transferring the funds into the program.

The Commission was also advised that no funding for the Child Day Care Financing Program was requested as part of the Department's current federal block grant application. A Department representative told the Commission that the Commonwealth's current inventory of child care providers and spaces is sufficient to meet existing need, and that re-targeting priorities in the block grant is appropriate—particularly in light of welfare reform legislation requiring work by public assistance recipients, thereby creating a demand for child care subsidies. Commission members asked that additional Departmental funding be provided to the program in 1998.

V. CAPITAL ACCESS NEEDS OF RURAL SMALL BUSINESSES

Whether access to credit in rural areas has become a problem and a serious barrier to economic development is a subject under study by the Rural Economic Analysis Program (REAP) sponsored by Virginia Tech. The Commission examined this issue in 1996 with the assistance of REAP's coordinator, Dr. Wayne Purcell. The Commission made no recommendations in 1996 but did receive information about the pilot program after which the Virginia Small Business Growth Fund (administered by the Virginia Small Business Financing Authority and discussed earlier in this report) was modeled.

Purcell furnished the Commission an update on the REAP study. The study, he reminded Commission members, concentrated on Brunswick, Halifax, Grayson, Mecklenburg and Patrick Counties *(Appendix D)*. Approximately 2,000 surveys were sent to a random sample of farm and nonfarm businesses located within the survey area. The survey posed questions about credit availability, access and denial. The REAP study concluded that rural financial market conditions in Virginia do not reveal widespread inadequacies and that there has been no massive market failure. Cash flow and collateral requirements are the most common reasons for loan denials in this small business loan market.

The REAP report concluded, however, that there were certain inadequacies in this market, chiefly loan-customer ignorance of key information such as (i) available governmental loan programs or business assistance, and (ii) interest rates or loan conditions in the local market. The report also noted that the average size of loans sought by the survey respondents was very small (ranging from $5,000 to $20,000) and that lenders are frequently disinterested in loans this small because loan preparation, investigation and processing costs may make them uneconomical.

Another important conclusion was REAP's assessment of governmental involvement in this market. It noted, for example, that only a small percentage of rural businesses reported using state programs such as the Small Business Development Center Program. Dr. Purcell agreed with Commission members that these programs need greater visibility and that their successful marketing could lead to increased and helpful program utilization in these rural markets. He also noted that private lenders should be encouraged to facilitate borrower use of these programs as well.

VI. SMALL BUSINESS MICRO-LOANS AND INITIATIVES

The smallest of Virginia's small businesses are sometimes called micro-enterprises; loans made to meet their credit needs are known as micro-loans. A business needing a $10,000 loan to start a dry cleaning business, for example, may experience difficulty obtaining a business loan from banks, credit unions or other conventional lenders. The reason: loan underwriting and processing costs relative to this loan size make such lending barely profitable, if at all.

A. VIRGINIA ENTERPRISE INITIATIVE PROGRAM

The Virginia Enterprise Initiative (VEI) Program, a lending program developed in 1995 in conjunction with the Small Business Development Center (SBDC) Program and administered by the Department of Housing and Community Development (HCD) addresses this lending gap. An HCD representative updated the Commission on VEI's current status *(Appendix E)*. VEI provides modest start-up loans—many under $10,000—to low- and moderate-income individuals who want to start businesses but are unable to qualify for conventional business loans supported by the SBDC program. VEI has four components: training, technical assistance, micro-loans and follow-up support.

VEI is funded principally through legislative appropriations. In the Commonwealth's current budget biennium, VEI will receive approximately one million dollars per year. The funding has helped leverage an impact beyond this amount, through VEI-funded loan loss reserves provided private financial institutions. According to HCD, VEI's early impact in its first 18 months of operation has been significant. HCD statistics show that over 343 loans were made, creating 261 new businesses and 824 new jobs. Moreover, nearly 1,500 individuals received business training in the process.

The Commission was briefed on BusinessStart, a VEI-funded program operated out of Abingdon *(Appendix F)*. A program representative told the Commission about the program's operation in eleven counties and two cities in Virginia Planning Districts 1, 2 and 3. A total investment of $124,500 in loan funds in Dickinson County, for example, has generated seven new retail businesses. The combined monthly sales of $43,000 for these businesses in 1997 have resulted in the following: (i) the creation of 19 full- and part-time jobs, (ii) combined sales taxes of approximately $2,000 per month, and (iii) projected additional tax revenues (in all categories) of approximately $21,000—based upon the then-current sales figures.

Notably, all of the new business owners involved in these seven new businesses were low income; six of the seven were previous recipients of state or federal public assistance. BusinessStart's representative emphasized that in addition to the direct public benefit of new tax revenues generated by these businesses, the public also benefits from eliminating public assistance payments to individuals who become tax-generating entrepreneurs through the Virginia Enterprise Initiative Program.

B. REGIONAL COMPETITIVENESS ACT

HCD also briefed the Commission on the small business implications of the Regional Competitiveness Act (RCA), a 1996 General Assembly initiative designed to encourage regional cooperation in resolving key economic competitiveness issues. The governor announced, in September, awards of nearly $6 million in RCA economic development incentive grants. The grants were awarded to seven regional economic development partnerships, including those in the Hampton Roads, Northern Virginia, and Shenandoah regions.

The grants are important to small businesses because one criterion heavily weighted in the award selection process is economic development which includes job creation. According to HCD, small business-related activities included in regional plans included micro-enterprise programs, technology workforce training, workforce assessment, and military privatization opportunities. HCD administers the program and will conduct annual reviews of each region's progress in achieving its stated goals.

VII. COMMONWEALTH COMPETITION COUNCIL REPORT

The 1997 General Assembly directed the Commonwealth Competition Council to furnish an annual report on its activities to the Commission, in addition to the Governor and the General Assembly. The Council, established by the 1995 General Assembly, is designed to identify government services that could or should be better performed, in whole or in part, by the private sector. Additionally, the Council is required to develop a competitive program to encourage innovation and competition within state government.

The Council's executive director briefed the Commission on the Council's mission and accomplishments, explaining a five-step process by which the Council identifies government programs or services that could be aided by competition. The privatization and competition review process focuses on cost, quality and impact. Several government services currently under review by the Council include debt collection by the tax department, bookstore operations at a community college, and computer repair services by a criminal justice agency.

VIII. REVITALIZING RETAIL SMALL BUSINESS IN VIRGINIA'S DOWNTOWNS AND MAIN STREETS

Vacant storefronts in aging retail business districts are a sight familiar to most Virginians. In many communities, retail shopping has moved to suburban shopping malls, or to regional super stores offering a wide variety of retail goods under one roof. The Commission asked representatives of Virginia's retail, government and economic development communities whether retail small business can be revitalized in the Commonwealth's aging shopping districts.

A representative of the Greater Richmond Retail Merchants' Association told the Commission that retail small business's departure from old retail districts has resulted, in some degree, from burdensome business climates some cities and towns create with high BPOL and energy surtaxes, inadequate parking, and poor security—to name several problem areas. He suggested that localities wanting to redevelop their core retail districts should pay attention to how they are taxing their small business based, examine their small retail business permitting processes, and focus on furnishing better security in their shopping areas.

A Metro Richmond Convention and Visitors Bureau representative told the Commission that one way to revitalize a core city's downtown is to provide a substantial downtown destination that will create collateral retail opportunities. He discussed a proposed expansion of the Richmond Convention Center in which the Center's exhibition space would be nearly tripled. The expansion plan envisions new retail establishments e.g., copy centers and other service-oriented businesses clustered in the convention center's expansion zone.

The Town of Warenton's economic development director furnished a different perspective, noting that finding money to do simple things—like painting retail buildings' rear facades to encourage customer use of off-street parking—is often a key ingredient in revitalizing a main street shopping area. Encouraging residential development in main street areas is also important to revitalization, and is an area where state and local tax credits could be helpful in encouraging mixed-use building redevelopment, e.g., bottom floors are renovated for retail and upper floors for residential use. She suggested possibly expanding the state's enterprise zone program (providing business tax credits to qualifying businesses) to include the redevelopment and revitalization of retail districts in nonblighted areas.

IX. 1998 ACTIVITIES

The Commission's 1998 activities consisted of monitoring developments in the small business community and in receiving the Commonwealth Competition Council's fourth annual report. Included in that report were the results of the second statewide survey of agencies and institutions conducted by the Council. A copy of the report's introduction is attached. *(Appendix H)*

X. CONCLUSION

The Commission members noted solid progress in bringing capital access to the small business community through state programs integrating private lenders. The innovative Virginia Small Business Growth Fund's use of loan loss reserve funds to leverage a $375,000 legislative appropriation into $10 million in new small business loans illustrates this progress. Similarly, the Virginia Enterprise Initiative Program—the state's microloan program—demonstrates that small loans plus an investment in mentoring can produce new jobs, new tax revenue, and big opportunities for small entrepreneurs.

The Commission strongly recommends, however, that administrative agencies associated with programs such as VEI and the Virginia Small Business Growth Fund focus on publicizing their availability. The ultimate success of these programs and others—such as the Virginia Small Business Development Center Program—will be measured by the scope of their outreach. That effort—and other critical efforts such as bringing affordable health insurance to small businesses—will require initiative and creativity. The Commission looks forward to working with agencies and small businesses alike to achieve these important goals.

Respectfully submitted,

Stanley C. Walker, Chairman
A. Victor Thomas, Vice Chairman
I. Vincent Behm, Jr.
Robert S. Bloxom
Vincent F. Callahan, Jr.
Glenn R. Croshaw
Franklin P. Hall
Charles R. Hawkins
Janet D. Howell
Edward L. Schrock
Robert A. Archer
Thomas E. Inman II
Jorge M.P. Ponce
Bernice E. Travers

Remarks by Secretary Robert T. Skunda
Small Business Commission
Richmond, Virginia
July 31, 1997

- Mr. Chairman, Thank you for this opportunity to share my thoughts with the Small Business Commission this morning. I am joined by:
  - Dave Dickson, Director, Department of Business Assistance
  - Bob Wilburn, Director, Small Business Development Centers program
  - Cathy Surface, Executive Director of the Virginia Small Business Finance Authority

- I am delighted to be able to provide a brief overview of the state of small business in Virginia and the Governor's accomplishments in promoting small business development.

- Dave, Bob, and Cathy will present a more detailed overview of their programs and what successes have been achieved.

- All of you are familiar with Governor Allen's economic development accomplishments over the past three years- 211,000 net new jobs and $11.5 billion in investment.

- Almost every day, you can open the paper and see big deal being announced bringing hundreds of new jobs and millions in investment.

- Moreover, when fully in place, these record investments will generate over 140,000 new <u>additional</u> jobs, on top of those which we have seen created thus far.

- While major new investments like White Oak Semiconductor, Gateway 2000, and Frito-Lay, for example, tend to get most of the publicity, it is small businesses that are generating a significant number of the new jobs which have been created during the past three years.

- In fact, approximately 1/2 of all announcements in the past 3 years of new companies who are coming to Virginia are small businesses of less than 75 employees.

- There are now more small businesses in Virginia than ever before, and their growth continues at an astonishing rate. Because there are so many small businesses in Virginia, (almost 163,000), their demands on government are both diverse and extensive.

- Now to some degree, I contend that the demands of small business are no different from the demands of large business, at least so far as the business climate and burden on business that is imposed by government is concerned.

- I firmly believe that this administration has taken a number of steps to meet these demands and make our small businesses even stronger and more competitive.

- These accomplishments, which we have been able to achieve in cooperation with you and the other members of the General Assembly, will help keep Virginia's economy strong into the 21st century.

- Some examples of these accomplishments include:

A. Unemployment Insurance Tax Cut
   - $154 million in estimated reduction over next 6 years
   - 60% (89,000) of all businesses in Virginia will pay no tax for next 4 years
   - money which can be used for reinvestment, expansion

B. Passed a worker re-training tax credit, which will encourage all employers to invest in their most important asset -- their people (30% tax credit for community college courses and $100 credit for private school courses).

C. Further improved Virginia's enterprise zone program to make incentives even more attractive and useable by businesses as an encouragement to invest in "targeted areas." This follows actions in earlier years to double the number of zones in Virginia from 25 to 50.

- added job grants as an optional incentive, recognizing many small, start-up business may not be able to take full advantage of corporate tax credits, for example.

E. After some initial problems the previous year, the Governor supported the creation of the Virginia Export Loan Guarantee Program. This program will provide loan guarantees to companies looking to export if they use Virginia Ports. The program was funded at an initial level of $750,000.

F. In 1995, we created the Virginia Capital Access Program which has successfully completed its first pilot year and expand the availability of business financing and loans for working capital. Under the pilot program $58,000 in state funds have leveraged over $2.2 million in new capital -- a 40:1 ratio! This program will now be funded at $350,000 which could lead to an additional $14 million in loans to Virginia's small businesses.

- Cathy Surface, Executive Director of the VSBFA will give some details about these last 2 programs as well as talk about our existing small business financing initiatives including the Virginia Economic Development Revolving Loan Fund and the loan guarantee program.

- These session accomplishments add to the progress we have made together over the past three years which will particularly benefit small businesses:

A. BPOL reforms, which the Governor first championed in 1995. Eliminated BPOL in businesses with gross revenues under $100,000 and on venture capital companies which has helped spur an explosion of new venture capital firms in NoVA. Successful "first steps" in reform last year, but we realize the job is not done.

B. DHCD's Virginia Enterprise Initiative was created in 1994 and we have continued its funding for 3 years. The VEI is a microenterprise loan program which helps businesses with 5 employees or less who need capital and technical assistance to jump-start venture. Loans for such ventures are typically high risk and less than $5,000.

C. Venture Capital Roundtable was created as part of continuation of the General Assembly's Joint Subcommittee to Study Capital Access and Business Finance.
- Working with CIT to create a Seed and Venture Capital Fund. Getting close to an exciting announcement in the near future.

Department of Business Assistance

- I believe that one of the most successful legacies of the Allen Administration will be how we have restructured economic development -- not only to help with business recruitment, but more importantly to emphasize business retention and work with meeting businesses needs -- in particular, small businesses.

- This new function was created in July, 1995 in the dividing of economic development responsibilities which led to the creation of the Department of Business Assistance of the Department of Economic Development.

- While the Virginia Economic Development Partnership (also created in the restructuring) manages national and international business recruitment, DBA serves as an umbrella entity to meet the cross-sectional needs of Virginia's existing business community by grouping the Commonwealth's business assistance programs.

- Dave Dickson will explain more about DBA shortly.

- Just last February, DBA recruited Bob Wilburn to be the new Director of Small Business Development. Bob came from New Hampshire where he served as an SBDC Director for the last 3 years. Bob's business experience includes 25 years of mixed "corporate" and small business ownership. Throughout his career, Bob has been a proponent of small business, serving in many capacities including the Director of a Chamber of Commerce.

- Since his arrival to DBA, Bob has made an extraordinary effort to visit virtually every SBDC to evaluate their needs and programs and I am confident you will be impressed with the progress that has been made.

- I would like to commend Bob for helping to bring these initiatives to fruition.

Conclusion

- The willingness of a small businesses to take risks and the drive to succeed, are characteristics essential to Virginia's, and the nation's, economic well-being.

- It takes a lot of nerve to invest in an idea, and in today's competitive global market place, it takes nothing short of rolling up the sleeves and working hard to see that idea turn into a successful business.

- We recognize that small businesses power the economic engines of the Commonwealth.

- And they will play an increasingly important role as big business continues to streamline and improve its bottom line in the competitive global economy.

- And we will continue to do everything we can to assist entrepreneurs turn ideas into profit, investment and jobs for the citizens of Virginia.

- Thank you.

SMALL BUSINESS-RELATED HEALTH CARE LEGISLATION IN 1997 SESSION; WORK OF JOINT COMMISSION ON HEALTH CARE IN 1997

Presented to:
The Virginia Small Business Commission

Patrick W. Finnerty
Senior Health Policy Analyst

Richmond, Virginia
July 31, 1997

Small Business-Related Health Care Issues: 1997

2

Presentation Outline

- ***Health Insurance Portability and Accountability Act (HIPAA)***
- **Status of Small Group Insurance Reforms**
- **Options Currently Being Considered by Joint Commission on Health Care**

Small Business-Related Health Care Issues: 1997

3

Major Provisions of Health Insurance Portability and Accountability Act (HIPAA)

- Small and Large Group Health Insurance Reforms
- Individual Health Insurance Reforms
- Medical Savings Accounts Pilot Program
- Favorable Tax Treatment for Certain LTC Policies
- Increased Tax Deductions for Self-Employed

Joint Commission on Health Care

Small Business-Related Health Care Issues: 1997

4

HIPAA Group Health Insurance Reforms

	Previous Virginia Group Reforms			Impact of HIPAA		
	Prim. Sm. (2-25)	Sm. Grp (2-99)	Lrg. Grp. (>99)	Prim. Sm. (2-25)*	Sm. Grp. (2-50)	Lrg. Grp. (>50)
No Exclusions	✓	✓		✓	✓	✓
Pre-Ex Limits	✓	✓		✓	✓	✓
Pre-Ex Credits	✓	✓		✓	✓	✓
Guar. Renew.	✓	✓		✓	✓	✓
Guar. Issue/Mod. Commun. Rating	✓ (Essential & Stand. Only)			✓ (All Products)	✓	

* Modified Community Rating Applies Only to Essential & Stand. Plans

Joint Commission on Health Care

Small Business-Related Health Care Issues: 1997

5

HIPAA Individual Health Insurance Reforms

- Existing Virginia reforms:
  - guaranteed renewability
  - limits on pre-existing condition waiting periods
  - credits for waiting periods served in previous coverage
- Additional HIPAA reforms for "eligible individuals":
  - guaranteed issue of all products
  - no pre-existing condition exclusions

Joint Commission on Health Care

Small Business-Related Health Care Issues: 1997

6

Other Key Provisions of HIPAA

- Reforms do not apply to accident-only, disability, limited disease, hospital indemnity insurance, or Medicare supplemental plans
- HIPAA group reforms apply to ERISA-exempt groups
- Pre-existing condition waiting periods limited to a 6 months "look-back" provision
- SB 1112/HB 2887 implement HIPAA in Virginia

Joint Commission on Health Care

Small Business-Related Health Care Issues: 1997

2

Presentation Outline

- Health Insurance Portability and Accountability Act (HIPAA)
- *Status of Small Group Insurance Reforms*
- Options Currently Being Considered by Joint Commission on Health Care

Joint Commission on Health Care

Small Business-Related Health Care Issues: 1997

8

Small Group Market Reforms Have Had Minimal Impact

- Only 14 of 70 carriers have sold "Essential" or "Standard" Plans
- Only 96 employers, 565 employees are enrolled
- Many employers are not aware of plans/reforms

Joint Commission on Health Care

Small Business-Related Health Care Issues: 1997

9

1997 Legislation to Enhance Impact of Reforms

- House Bill 2786
  - increased inpatient hospitalization benefit from 21 to 365 days
  - expanded statutory authority of the Special Advisory Commission on Mandated Health Benefits to review and update Essential and Standard Plans

Joint Commission on Health Care

Small Business-Related Health Care Issues: 1997

10

Presentation Outline

- **Health Insurance Portability and Accountability Act (HIPAA)**
- **Status of Small Group Insurance Reforms**
- ***Options Currently Being Considered by Joint Commission on Health Care***

Joint Commission on Health Care

Small Business-Related Health Care Issues: 1997

11

Options for "Fine-Tuning" Existing Market Reforms

- Expedite review and update of Essential & Standard Plans
- Strengthen marketing requirements to make employers more aware of plans
  - periodic advertisement in newspapers as required of "open enrollment" carriers
- Extend existing guaranteed issue and rating reforms to "Groups of 1" (self-employed/sole proprietors)

Joint Commission on Health Care

Small Business-Related Health Care Issues: 1997

12

Other Options Under Consideration

- Extend Existing Market Reforms To Other Groups/Individuals or Other Policies
- Extend rating reforms to other policies issued to primary small employers (2-25)
- Extend existing rating reforms to other larger groups (26-50)
- Establish or encourage formation of a "purchasing pool" for small groups
  - study expansion of THE LOCAL CHOICE program

Joint Commission on Health Care

SMALL BUSINESS-RELATED HEALTH CARE LEGISLATION IN 1997 SESSION; WORK OF JOINT COMMISSION ON HEALTH CARE IN 1997

Presented to:
The Virginia Small Business Commission

Patrick W. Finnerty
Senior Health Policy Analyst

Richmond, Virginia
July 31, 1997

Health Insurance Demonstration Project

Project Overview

given to the

Virginia Small Business Commission

by the Department of Medical Assistance Services

October 1, 1997

Project Background

- The Health Insurance Demonstration Project was developed in response to the General Assembly's desire to address the problem of the uninsured in Virginia. (Approximately 13% or 850,000 Virginians are uninsured)
- SJR 315 (1993) directed the Technical Advisory Panel to develop a proposal to explore alternative ways to use the Indigent Health Care Trust Fund to provide health insurance coverage to the uninsured

Project Goals

- To provide health insurance for low-income employees of small businesses
- To determine what level of subsidy will induce this population to purchase health insurance
- To develop public/private partnerships
- To test the project in one or more pilot sites

Eligibility Criteria

- Full-time employees of small firms
- Gross income less than 200% of poverty
- No health insurance; ineligible for Medicaid
- U.S. citizen/eligible alien, Virginia resident
- Employed in, and resident of the geographic area covered by the pilot
- Employer must pay a least 50% of the premium for employee-only coverage
- Employer has not offered health insurance for at least 12 months

Project Financing

- Donations from hospitals are used to fund the premium subsidy
- Inova Health System is committed to funding a pilot project in Northern Virginia; Sentara and Carilion Health Systems are potential contributors
- Cost-sharing provisions require contributions from employers and employees
- The subsidy will represent 30% of total cost of providing health insurance

Proposed Subsidy Levels

PREMIUM PAYMENT	TYPE OF POLICY Single	Dual	Family
Total Monthly Premium	$120.00	$250.00	$375.00
Employer Contribution	$60.00	$60.00	$60.00
Employee Contribution	$30.00	$125.00	$187.50
Monthly Subsidy	$30.00	$65.00	$127.50

Project Administration

- HMO will be responsible for marketing the program to employers and employees
- HMO will provide the Essential Health Benefits Plan to the employees
- DMAS will administer Trust Fund donations
- DMAS will determine eligibility
- DMAS will remit the subsidy for eligible employees to the HMO

Current Status

- Emergency regulations have been promulgated
- Contract between DMAS and the HMO(s) is being developed
- Project will be operational in Summer of 1998

4

Access to Capital in Rural Virginia:
A Barrier to Economic Development and Diversification

by

Wayne D. Purcell
Professor and Coordinator
Rural Economics Analysis Program
Department of Agricultural and Applied Economics
Virginia Tech

and

Zana Kruja
Research Assistant
Department of Agricultural and Applied Economics
Virginia Tech

July 1997

Prepared for presentation to Virginia's Small Business Commission, Richmond, VA, July 31, 1997.

Access to Capital in Rural Virginia: A Barrier to Economic Development and Diversification

Background

In focus group meetings conducted by Virginia Tech's Rural Economic Analysis Program (REAP) as part of the Tobacco Communities Project in 1994 and 1995, lack of access to capital was presented as one of the major hurdles to rural development. Specifically, lack of access to capital was said to be a problem for tobacco-producing families seeking to adjust and/or diversify into other on-farm enterprises or start non-farm economic activities.

Inadequacies in rural financial markets are often important reasons why rural areas lag behind urban areas in economic development. Credit access is an important factor influencing the level and pace of economic development. A survey conducted by the National Association of Counties (NACO), the National Association of Development Organizations (NADO), and the National Association of Towns and Townships (NATaT) in December 1992 showed that

> ...local officials cited as a second priority[1] the need to create and expand the credit available to businesses as a means of enhancing the economic development potential of their communities (Blue Ridge Study, p. 1).

Capital market failures can have a significant negative impact on economic development. According to research by Litvak and Daniels, there are two important facts to consider when dealing with the issue of capital market failure. First, the authors note that the majority of businesses that suffer from capital market imperfections are small businesses. Second, and very important, it is small firms that contribute significantly to job creation, especially in rural areas.

Non-farm small businesses are becoming more and more important because of economic and social changes in process in the Commonwealth. Farming has not been, for decades, the dominant economic activity in rural Virginia, but agriculture and agribusiness are very important. A study by Johnson and Wade indicates that the agricultural sector contributes about 14 percent of all jobs in Virginia and generates some 11 percent of gross state product (Johnson and Wade). Cumberland and Highland Counties are actually the only counties with over 20 percent of earnings coming from farming. This suggests the need for increased emphasis on the support of small non-farm businesses in rural areas if these areas are to maintain their economic viability. Non-farm small businesses will often be the source of employment for members of farm families looking for jobs off the farm if they are displaced because of changes in tobacco or other commodity markets.

Lending to new businesses or small businesses trying to grow involves risks that some banks are apparently not willing to take. Virginia's banks seem to undervalue the assistance given by the Small Business Administration (SBA) guarantee program, which reduces the risk represented by small businesses loans. None of the SBA certified banks (Larson *et al.*) is

[1] The first priority was related to infrastructure concerns.

included in the Virginia's top 10 lenders to small businesses[2]. From this finding arise two questions: "Why do the top 10 lenders not use the SBA guarantees?" and "Why are the SBA certified lenders not very active in financing the small businesses?"

The Problem

Some immediate and important related questions emerge immediately. Does capital access in rural Virginia represent a challenge for new or expanding operations, especially small businesses? Related, does the anecdotal evidence that suggests there *is* a problem mean that the state's programs, institutions, and policies are not effective? Answers to these related questions are not easy. A comprehensive study on capital access in rural Virginia has never been conducted. The national literature on the access of rural businesses to financial markets and the need, if any, for government involvement is becoming outdated. Most of the research done in this field dates from the 1980's. Financial markets have undergone substantial changes since that time, and new analysis is needed. In sum, there was a need for an analysis of the situation in Virginia to document the effects of recent changes in rural financial markets, the reactions of the financial market participants to ongoing changes, and whether there appears to be a need for the Commonwealth to get further involved to facilitate robust economic activity in Virginia's rural communities.

Objective

The primary objective of this study was to determine how well the capital market is functioning in rural Virginia and to identify any overall financial market inadequacies. A related and complementary objective was to determine whether a further state presence is needed to facilitate economic development in rural communities.

The Analysis

Principal components analysis was used to determine the most relevant county-level economic measures to be used in selecting sample counties for a survey. For budgetary reasons, five counties were chosen. The sample selection process ensured wide variation in characteristics of local capital markets with a minimum sample size. The main objective was to achieve a good representation of all levels of development in rural Virginia. Given the possible adjustments facing tobacco producers, a tobacco-producing county was selected from each of five groups of counties that had been grouped by the principal component analysis that looked at a broad economic profile of each rural county. The five sample counties were Grayson, Halifax, Patrick, Mecklenburg, and Brunswick.

Businesses in rural areas can be grouped into two major groups: farm and non-farm. There are more than 2,000 non-farm businesses and about 4,000 farms in the five sample counties. A mail survey was sent to a random sample of these businesses the second week of October 1996. A postcard reminder was mailed the third week of November, and a second survey was mailed later during the second week of December. The overall rate of response for farm and non-farm businesses combined was 22.3 percent. There were 148 farm businesses and 251 non-farm businesses that returned usable surveys. The breakdown by county was as follows:

[2] Small Business Grows Strong in Virginia, (http://www.sbaonline.sba.gov/).

County	Number of Business Firms Responding
Brunswick	46
Grayson	68
Halifax	101
Mecklenburg	115
Patrick	69

Two methods were used to collect information from the local capital suppliers. A questionnaire was mailed to all financial institutions in the sample counties which provides capital to local businesses. A later telephone survey was used to supplement the written responses. A total of 38 banks provided information, with bank numbers by county as follows:

County	Number of Banks Responding
Brunswick	3
Grayson	9
Halifax	9
Mecklenburg	10
Patrick	7

Findings

In general, rural financial market conditions in Virginia do not reveal widespread inadequacies. There has been no massive market failure. Businesses that have been turned down on loan applications do not represent the majority of the respondents, but the rate of loan denials is higher than the national rate. Businesses that use non-local financing, a possible sign of local market failure, are not huge in number. Businesses that say they are not satisfied with the performance of the local financial market do not represent a big majority of the respondents. But there were indications of significant problems along all these dimensions. Further, knowing that the survey data do not and could not represent the opinions of businesses that were not able to start up or went out of business because of lack of financing would suggest that a turn-down rate of 10 percent or more can be symptomatic of a serious issue. The survey showed that 10 percent of the firms who use or have sought loans have been turned down one or more times in recent years. It is also important to emphasize that the responses show that the majority of respondents who are not satisfied with the current market conditions expect to need financing during the next year.

Source of Problems

Very importantly, the analysis revealed that the reasons why some rural businesses in Virginia are denied financing have nothing to do with the risk of the economic activity underlying the loan requests. Some firms are apparently disadvantaged compared to other firms because of the presence of side effects of government programs and government policies. Some other firms are at a disadvantage because of the inability of local markets to appropriately serve types of businesses that represent somewhat unusual or different economic activity. For these latter firms in particular, the market is not functioning adequately. Efforts to diversify will, of course, often involve new, different, and high-tech types of economic activity.

Sources of Financing as an Issue

The financial institutions that supply capital to small businesses in the sample markets are mainly commercial banks, and the main source of financing is the business or commercial loan. The only alternative source of financing is loans from family/friends.

In the sample, there are three banks scoring above the national average in small business lending activity. Two of these banks are located in Grayson County and one is in Patrick County. Conversely, there were some banks that scored significantly below the national average for their size category. The lenders' perception of recent changes in local financial markets indicates they feel they face increased competition in the local financial markets. Lenders have expanded financial product lines, offered easier terms, and have been, reportedly, taking more risk during the last two years. All responding large lenders (those with more than $3 billion in total assets) did report positive growth in their small business loan portfolio departments.

Almost all responding local lenders report pre-venture and start-up stages of new small businesses as the most difficult stages to be financed. Ownership transition ranked second. On average, local lenders report spending more effort on start-up business loans compared to loans to businesses in other stages of their growth or development cycle. In particular, more time is spent developing economic and marketing forecasts, in onsite visits and counseling, in personal finance and tax planning, and in arranging outside assistance.

On State Involvement

As would be expected, the responses of the local lenders show that guarantees are of more importance in the start-up stage compared to other stages. All bank respondents prefer direct loans as compared to loans backed by government guarantees. The banking community, it appears, is divided into two groups. One group strongly agrees with the idea that the government should get more involved in facilitating credit availability through such as risk reduction programs. The second group strongly disagrees, suggesting a preference that state government not be involved in any way in what they see as private business.

Importance of the Local Bank

Local banks are the source of information on financing issues for 86 percent of business respondents. This finding is potentially very important. While the local bank will often not extend the loan for reasons that are not related to the riskiness of the loan request (e.g., an enterprise with which the bank has little or no experience), the bank is still the predominant source of information and advice. Whether they refer clients to what could be competitors emerges as an obvious question, one the survey did not address directly.

Debt vs. Equity Financing

Of all respondents, 66 percent report new debt financing during the last two years. Equity financing during the last two years is reported by only 26 percent of respondents. The majority (86 percent) of new equity financing is reported by businesses in on-going and stable growth stages.

In general, the loan market in rural Virginia is characterized by limited use of debt financing and by small loan sizes (less than $100,000). The results indicate that rural businesses in Virginia tend to be very conservative in using debt financing, and lenders are also very conservative in extending debt financing, especially for venture and start-up needs.

Loan Denial

Seven percent of rural business respondents report they have recently experienced loan denials. Businesses which experienced loan denials represent 10 percent of businesses which use any debt financing. Loan denial differs across counties. Halifax County reports more loan denials compared to other counties (13 percent of respondents located in this county) and Patrick County follows with 9 percent of all business respondents. The most common reasons for loan denial are inadequate cash flow projections and/or inadequate business plans and collateral requirements that cannot be met, especially by start-up options.

Loan denials for reasons other than the riskiness of the loan request are important indicators of credit market inadequacy. The analysis shows that three non-risk characteristics of small businesses are significant determinants of whether a loan will be denied. They are (1) the number of non-local locations, (2) the amount of the short-term loans, and (3) the number of competitors in the local market.

The more non-local locations a business firm has, the less likely it is to experience loan denial in the local market. This suggests local banks are responding to the possibility that the business firms can and will turn to banks in other non-local areas for loan needs.

The more short-term loans the firm has, the more likely it is for the firm to experience loan denial. Debt-to-asset ratios are legitimate measures of a firm's ability to pay, but the analysis accounted for these measures and the number of short-term loans was still a significant factor. It is not a measure of the riskiness of any particular loan request.

Firms with fewer than 10 competitors are more likely to be denied debt financing. This finding suggests firms in the less familiar and new areas of economic activity are more likely to be denied debt financing. This, again, is a factor influencing loan decisions that is not related to the riskiness of the loan, and appears in service, high-tech, computer-based, and other types of relatively "new" business activity.

Partnerships are less likely to face loan denial relative to sole proprietorships. Corporations are more likely to be denied loan requests and, the survey shows, less likely than sole proprietors to search for funding in non-local financial markets. Retail, service and manufacturing sectors are more likely to face loan denial than are farms and agricultural businesses. Construction businesses are the exception and appear to suffer fewer loan denials than agricultural businesses. In addition, construction businesses are less likely to search for financing in non-local markets compared to agricultural businesses.

Businesses with more than 5 percent sales increases during the last two years are less likely to be denied loan financing compared to businesses with no change in sales or with lower rates of change. Businesses with more than 5 percent sales decline and businesses which are too new to report sales change during the last two years are more likely to be denied financing. These are expected results, suggesting lenders are reacting to the growth levels of borrowing firms as an indicator of overall economic well-being of the firms.

Non-local Financing

Some 63 percent of respondents which report new debt financing use only local financing (within 15 miles) and only 6 percent use only non-local financing. Lenders' experience with the economic activity involved appears to be an important factor in determining whether potential borrowers search for funds in non-local markets. When local lenders are specialized in lending to a specific sector, such as retail sales or producers of a particular and familiar product/service, firms are less likely to need to search for funds in more distant financial markets.

Satisfaction with the Local Market

The survey included a question asking business firms to rate their overall level of satisfaction with their local financial market. Partnerships and corporations are more likely to be satisfied with the performance of those local financial markets than are sole proprietorships. Firms with more than $100,000 annual sales are more likely to be satisfied with the local market conditions as compared to smaller firms with sales of less than $100,000. Large firms' overall satisfaction with the local markets might be determined by the relatively better access to sources of equity financing which is characteristic of large companies.

Size of the lender is a significant determinant of businesses' satisfaction with local market performance. In general, respondents are more pleased with performance of the larger lenders.

The majority of the business firms who are not satisfied with the performance of the local market come from the group with fewer than 10 business competitors in the local market area. This implies that when banks are not as familiar with the kind of business, financing difficulty is more likely. In specific counties, such as Patrick County, businesses show a higher percentage (18 percent) of business firm respondents not satisfied with the local market performance.

More experienced business managers appear to face more financing difficulty in the local market. This is a possible sign of financial market problems, suggesting an inability of local banks to capitalize on intangible assets such as the manager's experience. Manager's experience should be an important factor in determining the credit worthiness of a company given that other measures of financial well-being of the firm were included in the analysis.

Government Involvement

The government is already present in the market. The question is whether the government presence is fulfilling the mission for which it was designed. Many government programs are already available to rural businesses. However, there appear to be problems related to their effective use.

Only a small percentage of rural businesses report using state programs from the Small Business Development Centers. The findings clearly show there is a reluctance to use state and federal government programs. The majority of respondents who say they do not think that it would be easier to obtain financing through these assistance programs have, in fact, never used them.

Clearly, business firms have limited knowledge of existing state programs. It is surprising to find that the overwhelming majority of respondents do not know about the state programs that are in place. These programs are set up to help small businesses, but the business public either does not know about the programs or do not feel they can provide significant and cost effective assistance.

Most of the respondents who do use the state programs do not see any advantage to their use compared to direct private financing. Also, most of the respondents who use these programs are not in favor of government involvement. The policy issue here, it would appear, is whether these programs are designed correctly. If the end user does not perceive a difference between the use of these state-assisted programs and direct bank financing without state program involvement, then questions of design and effectiveness of the state programs have to be raised.

Some of the government supported institutions designed to provide assistance to rural businesses are recognized as a major source of information and technical support, but others are not. This finding raises a question as to how to make their presence better known in the rural areas and, related, how to assure that they do in fact assist rural businesses in overcoming the difficulties imposed by market inadequacies.

In addition to these points, it is important to mention that the responses show government involvement to be a very sensitive issue. While there are many respondents who think that there is a need for government involvement, there are many others who become almost aggressive in their responses, expressing their opposition to the idea that the government can do anything to improve the functioning of private rural capital markets. Most of them accompany such responses with a statement against the tax system. They believe that the "only" thing that the government can do is to reduce taxes, so that the small businesses could be more motivated to produce, expand, and create more jobs. It would appear the respondents were sometimes seeing a government presence as regulatory versus facilitative, and this issue may need to be further studied.

Policy Issues and Recommendations

Several policy issues emerge from the findings of this survey. First, there are significant differences in the way financing needs are met in different economic sectors in rural areas. Non-agricultural businesses face more problems compared to farm businesses. Agricultural businesses are less likely to be denied financing. They are more likely to find financing in the local market and are less likely to need to search for non-local financing. Agricultural businesses are also more likely to be satisfied with performance of the local capital market. In other words, this study confirms the findings of other researchers who find that financing rural small non-farm businesses should follow the experience of financing agricultural businesses where Farm Credit and other government programs are present to help finance farm business activities.

While it seems that access to capital is easier for farmers because of Farm Credit and other institutions dedicated to the farming sector, it is important to recognize that rural development and economic well-being depend on the success of non-farm businesses as well. There is a need to evaluate the existing government programs and determine their direct and indirect effects in supporting rural development. This is especially important now that many tobacco farmers may seek to diversify into non-farm businesses and/or find off-farm employment with such businesses. The issue here is whether the same kind of assistance and services offered to agricultural producers should be offered to non-farm rural businesses as well.

Given the higher satisfaction of agricultural businesses with the current situation, experiences from agricultural financial markets might be used to include non-agricultural rural businesses in government sponsored programs. In addition, banks should be encouraged to use existing state and federal programs by reducing paperwork and by ensuring timely collection of guarantees. Both paperwork and timeliness appeared as reasons existing government programs are not widely employed.

Cash flow and collateral requirements are the most common reasons for loan denial. The question is whether the state should become involved and alleviate the restrictions posed by these loan conditions. Collateral requirements are especially restrictive for businesses that need capital investments that have a low or non-existent collateral value. High technology equipment, equipment that could be obsolete in a short time and equipment with no broad market value are difficult to use as collateral. Yet, in modern society, it is often just such technology, computers or software developments, that are the keys to business success. Action is needed to satisfy the need for alternatives to collateral based loans. Given that it is normal for a start-up business to lack the necessary collateral, it may be very important to provide assistance to these businesses and/or to cover from other sources at least part of the initial investment costs. Economic development grants could be considered for this purpose or a credit access program could be employed to reduce the risk of venture capital and start-up loans. If this kind of assistance is accompanied by rigorous analysis of the business plan and the loan application, it is possible to encourage these small businesses without interfering with the normal functioning of financial markets.

The cash flow issue may be addressed in a different way. Accurate cash flow projections are difficult to compile by new and small businesses. This study shows that market projections are the specific part of the plan where respondents need the most technical assistance. Clearly, there is a benefit if the government is involved in providing or facilitating the provision of this kind of technical assistance.

The majority of new financing is provided locally. This is a positive finding, but it could pose a problem for the future. It is known that the banking industry is undergoing consolidation. What will happen with these small businesses which currently raise most of the debt capital through the local banks as consolidation continues? Will the large national or regional banks be interested in and able to evaluate the loan applications of small rural businesses?

In all analytical models used in the study, form of ownership is an important factor in determining financing difficulty. Corporations are more likely to be satisfied with the local market conditions than are sole proprietorships. This might be explained by their better access to equity financing. Access to equity financing is reported by only a small number of rural businesses and is obtained mostly through informal (often family) markets. Banks, which are the major source of financing in rural areas, do not provide equity financing and have only limited access to long-term sources of financing. Equity capital is often not available for starting small businesses. Most equity investing is made available to finance the expansion of on-going businesses. Virginia's Small Business Development Centers (SBDC) report cases where they have been looking for investors, but investors were not interested. The presence of state facilitated mechanisms that provide equity financing could be very beneficial to rural community economic activity.

The study suggests there is market inadequacy or market failure since what appear to be successful firms are sometimes denied debt financing. Firms with experienced management and positive annual rates of growth are denied debt financing. This is especially likely when the loan is for expansion into a "new" type of economic activity. There is apparently a frequent mismatch between the type of financing needed in terms of production, service, retail, etc., economic activity requests and the available financing. Filling this void could be considered a correcting of a market inadequacy and could be an important facilitative role for the state.

Low debt to assets ratios are characteristic for the majority of respondents. This suggests that rural businesses are conservative and borrow little money. However, it is interesting to note that among the respondents who know more about the available state programs, the respondents with "no-debt" and "less than 10 percent debt" form the majority. An immediate question is one of how to explain their knowledge of these state-assisted financing programs. A logical implication is that they have been seeking financing but for some reason they are not being able to get it. This could be added evidence of the above-mentioned mismatch of funds.

The average size of loans reported by the respondents is very small. Small businesses often need small loans ranging from $5,000 to $20,000. Banks are often not very interested in this size loan since there are fixed costs related to every loan application.

In additional to capital investment, operating capital is needed for new and expansion businesses. Firms are not likely to obtain this type of capital from the existing private local market in Virginia's rural communities. If the government is to help provide debt capital, programs should be designed to provide small size loans to meet the somewhat unique needs of small rural businesses. Further, since equity financing also appears to be needed in the rural areas, a revolving pool of start-up and expansion capital for small loans or for equity capital could be very important to the level of economic activity achieved in rural communities.

The number of short-term loans carried by the business significantly affects the probability of loan denial. This finding might be related to the need of local lenders to diversify their loan portfolio. Borrowers should not be penalized, however, for reasons other than the risk that they represent to the lender. The number of loans can be high even when debt-to-asset ratios and other measures of financial wellbeing suggest a financially sound business. The issue here is how to assist banks to be more active in accepting all viable loan applications. Risk pooling mechanisms might be considered as a possible solution to this problem.

Another sign of market inadequacy is the fact that firms involved in economic activities somewhat unfamiliar to the area face major difficulties in the loan market. This suggests that the experience (or lack thereof) of local banks in a certain business determines in large part the chances of loan approval. When the local bank is not familiar with a type of business activity, loans are difficult to get. Lenders' experience with different types of business activity is a significant factor in explaining why borrowers sometimes have to search for funds in non-local markets. In addition, the firms with non-traditional business activity form the majority of the respondents who do not believe the local market are meeting or will meet their future loan needs. This suggests again that a mismatch exists between the type of financing requests and the available financing. Banks could be encouraged to cooperate with non-local banks with expertise in these "unusual" types of business, or the state could offer help in analyzing the loan applications dealing with the less familiar types of activity. Clearly, this area needs attention if diversification is an objective. High-tech and value-added processing activities, service businesses, and telecommunications that allow residents in rural communities to participate in the move to home-based employment will often be "unfamiliar" activities to loan officers in local rural banks.

A market is not complete if information is not available. The fact that some of the respondents who borrowed money during the last year do not offer any opinion on the interest rates and other loan conditions in the local market might suggest a lack of information. This finding is supported by the fact that banks are the only source of information on financing sources for the majority of the respondents and the respondents have little awareness of competitive programs. All this indicates that there is the need for an information clearinghouse on financing issues.

Overall, there are significant indicators of inadequacy and problems in Virginia's rural community financial markets. There are a number of ways in which an expanded state presence could provide facilitative and non-intrusive services that would enhance the level, diversity, and viability of economic activity and development in Virginia's rural communities. The need for adjustment and diversification is growing, and there is a related need for a state presence to help ensure money is available to allow that adjustment and diversification to take place in a progressive and orderly manner.

References

Blue Ridge Region Development Bank Feasibility Study. Prepared by the Fifth Planning District Commission in conjunction with the Blue Ridge Region Economic Development Commission. April 1993.

Johnson, Thomas G., and Ernie W. Wade. *The Economic Impact of Agriculture in Virginia.* REAP Report, Virginia Tech, VCE 448-217, REAP R019, 1994.

Larson, Paul *et al. The Virginia Entrepreneur's Guide: How to Start and Manage a Business in Virginia."* University Press, 1994.

Litvak, L., and Belden Daniels. *Innovations in Development Finance.* Council of State Planning Agencies, 1979.

Virginia Enterprise Initiative Program

1997

Department of Housing & Community Development

Virginia Enterprise Initiative Program Background

- DHCD staff presented VEI Program concept two years ago
- Goal - serve as catalyst for bringing together resources to meet needs of entrepreneurs
  - Creates self employment opportunities
  - Provides access to capital for those unable to get conventional financing

Background cont'd

- That concept is now a functioning program
- Current biennium VEI allocated $998,911 per year
- 15 VEI sites selected in 1995

Virginia Enterprise Initiative Program

Overview

- VEI sites include 4 basic services
  - Technical assistance
  - Microloans
  - Follow-up assistance
  - Business skills training
- Loans range from $500 to $25,000
  - Most under $10,000

Overview cont'd

- Loans go to entrepreneurs without other access to capital
- VEI funded loan loss reserves facilitate partnerships with banks for loan capital
- VEI includes range of organizations
  - Local governments
  - Community-based organizations
  - Chambers of commerce
  - Anti-poverty programs

Virginia Enterprise Initiative Program

Current Status

- VEI funds used for training, operation, and loan loss reserve
- 13 banks have capitalized $1.6 million in active loan pools for microenterprise
- Some federal SBA funds also used for loan pools
- 14 VEI sites implementing on-going microenterprise programs today
- Significant portions of the state are not presently covered

Virginia Enterprise Initiative Program

Early Impact

- VEI projects fully operational for 18 months
- 824 new jobs created
- 261 new businesses created
- 1,488 people receiving business training
- 343 loans made
- $4 million in loans approved
- Leveraged $7 million in other funds
- $2,063 cost per job in general funds

Department of Housing & Community Development

BusinesStart Statistics: One Program's History

Location: Abingdon, Virginia Years in Operation: Three
Jurisdictions Served: Eleven Counties, Two Cities (Planning Districts 1, 2 and 3)
Number of Loans: 70 Dollars Loaned: $990,700,000
Average Loan Size: $14,152
Total # Business Basics Training Sessions: 86
Total # Individuals Completing Business Basics Course: 923
Total # Jobs Created and Retained: 192

ECONOMIC ASSUMPTIONS: A Case History

A look at how one county has been impacted by this program.

Dickenson County currently has **seven** fully operating BusinesStart Businesses. A total investment of $124,500 in loan funds has been made available to these six businesses. Additionally, each entrepreneur received individual technical assistance from BusinesStart staff. The **total** number of hours of technical assistance these businesses has received is estimated at 840. **At an approximate cost of $40 per hour** (which includes overhead), **the cost in technical assistance for six loans was approximately $33,600 - or $4,800 per business start up.** Here is the payback:

* Four of the seven businesses are retail establishments. The combined total monthly average sales for these businesses is currently approximately **$43,000.** These businesses contributed sales taxes of **$1,827** in one month - or 76% of the total cost per business start-up. In a year, they will contribute over **$21,000** in taxes, assuming their sales stay flat.

* The combined total monthly sales for the seven businesses is currently over **$60,000.** All of these these businesses are locally owned. They buy locally and they spend locally. Economists estimate that sales generated from this kind of business can turn over in a community six to nine times. Taking the conservative turn-over of six, the impact of these six businesses could be over **$4,320,000** annually.

* These seven businesses have created 19 full and part time jobs. As the businesses grow, more of the jobs are full time and the hourly pay rate is increased.

* All of the entrepreneurs involved in this county were low income. Six of the seven entrepreneurs were previously on some sort of state or federal program prior to starting their businesses: unemployment or disability benefits, food stamps, public assistance or housing assistance. These savings to the tax payer must be factored in when assessing the effectiveness of this program.

Regional Competitiveness Program

1997

Department of Housing and Community Development

Regional Competitiveness Program

- Regional Competitiveness Act passed in 1996
- Funding incentives to regions which come together to jointly address key economic competitiveness issues
- $6 million in funding for 1997-98
- Governor Allen appointed 12 member advisory committee

Regional Competitiveness Program

- DHCD conducted 5 input sessions in October-November 1996
- Funding guidelines distributed February 1997
- 17 regions submitted requests for qualification in first round - July 1, 1997
- Second round - December 1, 1997

Department of Housing and Community Development

Regional Competitiveness Program

- 7 regions qualified for funding
  - Crater Regional Partnership
  - Hampton Roads Regional Partnership
  - Northern Virginia Regional Partnerships
  - Region 2000
  - Shenandoah Valley Partnership
  - Southside Regional Partnership
  - Virginia's River County

Regional Competitiveness Program

- Economic competitiveness issues defined by and for region through strategic plan
- Importance of small business to economy recognized in funding proposals

Regional Competitiveness Program

- Proposed activities relevant to small business include:
  - Microenterprise programs
  - Technology workforce training
  - Workforce assessment
  - Military privitization opportunities

ANNUAL REPORT
OF THE ACTIVITIES, FINDINGS AND RECOMMENDATIONS OF THE COMMONWEALTH COMPETITION COUNCIL

To
The Governor
The General Assembly of Virginia and
The Small Business Commission

Richmond, Virginia

December 1, 1998

I. INTRODUCTION

This is the fourth annual report issued by the Commonwealth Competition Council to inform the Governor, the General Assembly of Virginia, and the Small Business Commission of the Council's findings and recommendations as required by § 9-349 of the Code of Virginia. The report is also distributed to executive branch agencies.

This report includes the results of the second statewide survey of agencies and institutions conducted by the Council. The report is submitted with the expectation that it will be used to foster an element of competition; to introduce a new effective privatization method through employee stock ownership plans (ESOPs); as an instrument for agencies and institutions to compare their operating commercial activities; and to reveal the innovative potential of alternative capital financing methods of capital projects included in the last four years (2000-2004) of the Commonwealth's "Six-Year Capital Outlay Plan."

The report is presented in three parts:

Part I - This part is a copy of the Executive Summary of the "Employee Stock Ownership Plan (ESOP) Pre-Assessments" report presented to the Council on September 14, 1998 by an expert ESOP pre-assessment team. The Executive Summary reveals three major state functions that are potentially successful ESOP implementation opportunities. Copies of the entire ESOP pre-assessment report are available at the Council's office.

Part II - This is a detailed statewide summary of the commercial activities performed by agencies and institutions. With the 1998 General Assembly adding the definition of "commercial activity" (§ 9-341 of the Code of Virginia) to the Virginia Government

Competition Act of 1995, the Council conducted the first statewide survey to detail how agencies and institutions perform their commercial activities. This part of the report is organized in two sections for each Secretariat - commercial activities performed in-house and commercial activities performed by private firms. There is a separate section on the Department of Mental Health, Mental Retardation, and Substance Abuse Services and the Community College System.

Part III - This part of the report is a detailed summary of potential alternative capital financing methods for capital projects included in the last four years (2000-2004) of the Commonwealth's "Six-Year Capital Outlay Plan." The Appropriation Act and guidelines issued by the Secretary of Finance allow for alternative financing of capital projects. The Council provided a list of fifteen (15) definitions and examples of alternative financing methods (refer to *Appendix A*) to the agencies and institutions that have capital projects in the capital plan. The information in **Part III** of this report assesses the feasibility of using non-traditional methods of financing to fund high capital requirements of the Commonwealth.

The Council is grateful to all the agencies and institutions that participated in both the commercial activity survey and the capital project alternative financing survey. It should be noted, however, that the following organizations did not respond to the Council's request for survey information:

Department of Fire Programs
Department of Minority Business Enterprise
Gunston Hall Plantation
Medical College of Virginia Hospitals
State Board of Elections
Virginia Port Authority

II. FINDINGS & OBSERVATIONS

The finding and observations included herein are in relationship to the three sections included in this report.

- The federal government has implemented the first major government employee stock ownership plan (ESOP) privatization and by all accounts it has been highly successful. As a result of this success, the federal government is seriously considering other ESOP privatizations.

  State and local governments have not been innovative in embracing this concept as an effective method of providing goods and services. The Commonwealth is the first state to study ESOPs as a method of providing government services and is the first state to conduct ESOP pre-assessments on a variety of state functions. Of eleven state functions studied in 1998. three have been determined by a team of ESOP experts to be potential successful ESOP implementation opportunities.

ESOPs are an integral part of the ownership solution--giving capitalism a human face and encouraging all participants in the economy to share the responsibilities and reap the rewards of success. Employees are likely to become better stewards of all the systems of which they are part--social. political, fiscal and cultural--as they gain a personal stake in the economic system. This has taken place in the United States with the creation of ESOPs as well as with numerous private and public sector ownership engineering initiatives around the world.

- The commercial activity surveys indicate that the private sector provides a great deal of services to the Commonwealth. These surveys were not designed to evaluate quality or cost of services but to assist Cabinet Secretaries. agency directors. and heads of institutions in reviewing the consistency of how activities are performed and to invite meaningful dialogue among and between management personnel. Two examples/inquiries of how this information may be meaningfully applied are listed below. These examples are not intended to single out any one Secretariat area. but to merely show the value of the compilation of the information. There are many other examples in **Part II** that can generate a valuable exchange of information and experience with the potential of improving service.

  a). Why do some agencies in a Secretariat perform personnel/contractor background investigations or security clearances while others do not?

  b). Should there be consistency in how bookstore operations are managed? Of the 16 four-year and related higher education institutions, 6 bookstores are managed by the institutions and 10 are managed by private firms. In the Community College System. a similar pattern exists. Of the 23 community colleges, 8 bookstores are managed in-house and 15 are managed by private firms.

- The capital project surveys reveal approximately **90** major capital projects of both new construction and additions and/or improvements to current structures with an estimated construction cost of over **$700** million that have been identified with potential alternative financing methods.

  An example of an alternative financing arrangement is underway at Virginia Commonwealth University. Virginia Commonwealth University is currently pursuing construction of a 400-bed student housing facility as a **design-build-operate** project. JPI Educational Services. a subsidiary of JPI. Inc., the largest national developer of apartments. was one of six respondents to VCU's request for proposals. As this annual report goes to press. VCU was developing and negotiating details of the arrangement. The general concept is that once the project is completed, JPI will operate the facility and the private bonds will be paid on a rental basis from funds derived from student rental fees.

III. RECOMMENDATIONS

Three recommendations result from the information in this report:

- It is recommended that funding be provided by the Governor and the General Assembly to conduct full feasibility "plan of action" studies for the purpose of providing a detailed analysis to determine the full ESOP viability of the three ESOP pre-assessment candidates identified in **Part I** of this report.

- It is recommended that the commercial activities reported in **Part II** be used as a basis to determine areas of service delivery improvements in each respective Secretariat.

- It is recommended that the capital project survey results in **Part III** be used for capital decision-making in the 1999 and 2000 sessions of the General Assembly.

IV. CONCLUSION

The Council believes that this annual report continues to emphasize the value of the Council's activities. The information included herein supports the mission of the Council in examining and promoting methods of providing a portion or all of select government-provided or government-produced programs and services through the private sector and to advise the Governor, the General Assembly, the Small Business Commission, and executive branch agencies of the Council's findings and recommendations.

Virginia enjoys a national reputation for sound financial management. The information and recommendations in this report can enhance Virginia's reputation as a leader in the field of government innovation, and has the potential of providing significant cost savings and revenue enhancements to the Commonwealth.

Respectfully Submitted,

Commonwealth Competition Council