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The Honorable John F. Kerry, Chairman
Committee on Small Business and Entrepreneurship
The Russell Building
Room 428(A)
Washington, DC 20510

RE: Thomas D. Boston, Professor of Economics, Georgia Tech and CEO of EuQuant

Mr. Chairman and distinguished members of the Senate Committee on Small Business and Entrepreneurship, it is a distinct honor for me to testify before you. My comments today are based on my research as a Professor of Economics at the Georgia Institute of Technology (Georgia Tech) where one of my areas of specialization is small and minority business dynamics. Secondly, I am the owner and CEO of a consulting company. EuQuant specializes in economic and statistical research. As such, I share with you the urgency of addressing the important issues you are discussing and feel they must be placed at the top of our nation's priorities. To secure our country's future growth, economic viability and quality of life, we must make sure that small and historically disadvantaged businesses are able to participate fully in the opportunities and possibilities that accompany the growth and development.

Virtually all objective researchers and practitioners have come to recognize that small business innovation is a crucial, if not the most important, accelerator of economic growth. The distinguished economist William Baumol observed that when innovation is measured by the number of employees, small firms are 13 times more innovative than are large firms. In addition, their patents are twice as likely to rank among those having the highest impact.

Between 1998 and 2004 small businesses, meaning those with 500 or fewer employees, accounted for 50.5% of the total US GDP, 85% of value added in the construction, 67% of value added in professional and technical services and 48% of value added in the retail trades.

Mr. Chairman and distinguished Committee members, my company recently completed a study of the federal governments Small Disadvantaged Business Program (SDB). By matching firms that are SDBs with minority government contractors that have similar business characteristics but are not SDBs, we found that the annual value added of SDB program to US final demand is $6 billion.

Additionally SDBs add 124,000 jobs annually to the US workforce. More importantly, many of these jobs are in high poverty areas of the nation's largest central cities; where unemployment distress is most severe. For example, we found that 48% of the SDBs that operate in the City of Boston are located in high poverty areas, meaning areas where the poverty rate is 40% or higher. In Baltimore 69% of SDBs operate in high poverty areas and in Philadelphia 60% operated in high poverty areas.

The average revenue of these firms is $3.4 million, which means that many are poised for the next stage of growth. But this next stage typically involves access to capital and funding available through venture funds and other forms of debt and equity capital. While these SDBs are poised for the next growth spurt, many have exhausted their ability to borrow against their company's assets. Typically, companies in their situation need about a $100,000-$1 million or more injection of capital to expand their scale of operation. This would allow them to hire more staff, buy new equipment, increase their office space and purchase the resources that will allow them to successfully compete for business opportunities that require greater scale and capacity.

Minority owned businesses now comprise approximately 18% of the 23 million US businesses and they are growing very rapidly. The most recent data published by the US Census Bureau indicates that between 1982 and 2002 the percent increase in the number of firms owned by Hispanic Americans was seven times that of whites, the percent increase in firms owned by Black Americans was four times that of whites, the percent increase among Asians owned firms was five times that of whites and the percent increase of Native American owned businesses was 16 times that of whites.

If projected into the future, this represents a rapidly changing business demographic profile. Indeed, to a great degree public policies and societal changes are producing a growing parity in the number of businesses that are owned by minority and historically underrepresented groups.

But there remains a tremendous disparity in the relative capacity and scale of minority owned businesses in comparison to businesses owned by whites. For example, minority groups comprise 32% of the US population but own just 11.6% of all US businesses with employees and earn only about 5% of US business revenue. Further, the average revenue of each business is about one half that of the average revenue of businesses owned by whites.

The global nature of the world's economy is forcing upon small and minority-owned businesses the need to increase scale and capacity to compete successfully. Globalization has forced major corporations to reduce the number of firms they use in their supply chain. This means that each supplier must have a larger capacity. Likewise, there continues to be a persistent problem of government organizations bundling contracts. This makes it more difficult for small and minority businesses to gain access; unless they have scale and capacity.

To achieve greater capacity minority businesses must move to the next level. Most often this requires external capital. Yet numerous studies continue have documented the racially discriminatory barriers minority firms encounter when pursuing debt and equity funding.

Ken Cavaluzzo (1999) analyzed credit applications, loan denials and interest rates paid across gender, race and ethnic characteristics of the small business owners. He gathered data on businesses that applied for credit and those that did not apply because they felt their application would have been turned down. He found large unexplained differences in denial rates between African American and white male owned companies that could only be attributed to discrimination.

Susan Coleman (2004) examined access to the capital for women and minority owned small firms and found that after controlling for differences in human capital characteristics of owners, minorities were significantly less likely to be approved for loan requests and they were also significantly less likely to apply for loans because they assumed they would be denied. Karlyn Mitchell and Douglas Pearce (2004) found that African American and Hispanic firms are significantly less likely to receive bank loans than are white business owners.

Mr. Chairman and distinguished Committee, I started my testimony by talking about the tremendous contribution to the US economy made by businesses that participate in the government's SDB program. Now I would like to bring your attention to a feature of that program that makes it very difficult for participants to achieve scale and capacity, access external sources of capital, financing and bonding and move to the next level of growth.

As you know the SDB program imposes a ceiling of $750,000 on the personal net worth of a business owner to be eligible to participate. EuQuant's recent study found that the ceiling causes an undue burden on small disadvantaged businesses for the following reasons:

- A business owner's personal net worth determines his or her ability to pursue external capital and bonding, which in turn determines the size and capacity of contracts their business is able to perform.

- Our study found that personal net worth is closely related to the average revenue of a firm. Specifically, we found that a 10% increase in a firm's average revenue over a three-year period is associated with a 4% increase in personal net worth of the firm's owner. Therefore, if personal net worth is constrained, the capacity of the firm to grow revenue will also be constrained.

- The personal net worth ceiling has not been adjusted for inflation since 1998, which means its real inflation-adjusted value is $558,070.

- The current ceiling was not based on an empirical study, but was determined subjectively. Furthermore, despite the fact that industries have different capital requirements; the federal government currently has only one PNW ceiling for all industries.

- The current personal net worth ceiling is reducing the potential revenue of SDB by about $1 million annually. Finally,

- We found that in a case study of seventeen SDBs, their average revenue decreased by 45% when they were forced to graduate from the program because of the personal net worth ceiling. The owners indicated that the ceiling had constrained their ability to gain access to bonding and external sources of finance and capital required to compete successfully as prime contractors.

Mr. Chairman, because of the excesses of the.com era, the VC industry today has become more rigorous in conducting due diligence. Most firms have moved away from making seed capital or start-up investments and instead invest in later stage companies that have already proven their business model concept by using their own money and the money provided by friends, family and individual angels. Were it not for the fact that the growth of SDBs is being constrained by the personal net worth ceiling, some of these companies would be prime candidates for venture capital funding. They have the precise profile that VC funds require.

This committee could facilitate a tremendous leap forward for minority firms in gaining access to capital, bonding and venture capital funding if it would simply make adjustments to one of the federal government's own regulations. By this I mean altering the personal net worth ceiling that is used as criteria for eligibility in the SDB program. The study EuQuant recently conducted was commissioned by the Congressional Black Caucus Foundation and that study made specific recommendations for adjusting the personal net worth ceiling. Those recommendations reflect the influence of inflation, the capital requirements of industries and the market capacity that historically disadvantaged firms would have achieved but for the current personal net worth ceiling.

Rather than reviewing those specific recommendations, I would simply ask that I be allowed to submit that report as a part of this record. The report is entitled "Increasing the Capacity of the Nation Small and Disadvantaged Businesses (SDBs). It Was Published October 16, 2007 and conducted by my company, EuQuant.

Thank you very much.

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