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FEDERAL POLICY PROPOSAL

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Achieving Financial Security through Entrepreneurship

Policies to Support Financially Vulnerable Microbusiness Owners

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Creating and owning a business has long been a path to financial success and economic mobility. In fact, business equity represents nearly one fifth of total household wealth nationwide,[1] making it the second largest source of wealth beyond home equity. For low- and moderate-income (LMI) individuals, self-employment and business ownership can contribute meaningfully to family economic security.

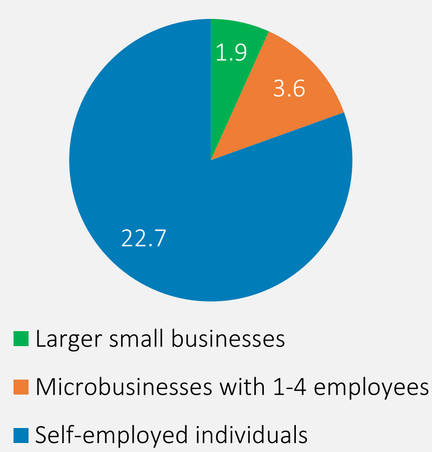
Millions of small business owners, however, struggle to achieve financial success, even as they prove to be skilled practitioners within their industry. Approximately 13 million microbusiness owners earn less than $50,000 per year.[2] But financial vulnerability is about more than just income; even microbusiness owners with higher earnings may experience financial instability if they lack the financial capability needed to manage business finances, have deeply intertwined business and personal finances, lack access to credit or have insufficient savings to provide a cushion against economic shocks. In fact, lack of savings is a critical financial challenge for microbusiness owners at virtually all levels of income. Recent CFED research surveyed nearly 1,000 microbusiness owners with annual revenues ranging from less than $30,000 up to $2 million, and found that more than half (55%) could cover just one month or less of business expenses using current savings and 30% had no savings at all.[3] When asked how they would deal with a $1,000 emergency business expense, 15% of survey respondents reported that they would be unable to cover it.[4]

These remarkably low savings levels create financial uncertainty and instability at both the business and household levels. Businesses with no savings tend to be younger, have lower revenues, and have lower total household incomes. Lack of savings leaves these businesses unable to deal with financial emergencies or even short-term cash flow shortages; one of the few tools microbusiness owners have in these situations is reducing or eliminating their own paychecks. In the long-term, lack of savings translates into lack of capital to support business

Approximately 92% of U.S. businesses are microbusinesses.

The vast majority of all small businesses are microbusinesses, or those with 1-5 employees, counting the owner.

Number of Small Businesses (In millions)



Source: U.S. Census Bureau, "Statistics about Business Size (Including Small Business)" and U.S. Census Bureau, "Nonemployer Statistics."

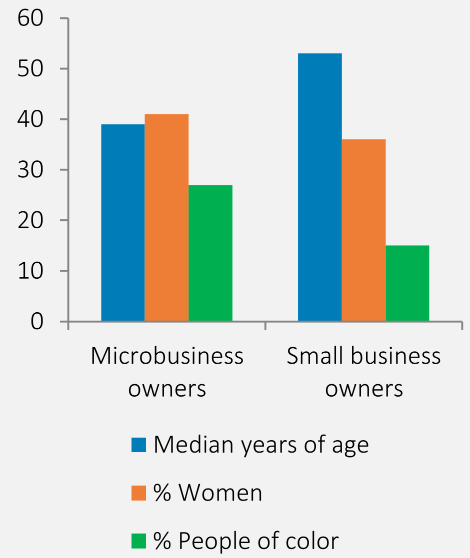
growth and create jobs, as well as reduced capacity to achieve personal and family goals such as providing higher education for children and preparing for a secure retirement.

Although most small businesses are microbusinesses, most government support for "small businesses" benefits firms with dozens of employees and millions of dollars in revenue. While the federal government allocates billions each year towards guaranteed loans to "small" businesses with fewer than 500 employees, it devotes only about $300 million to training and loans for microbusinesses.[5] Policy support for LMI microbusiness owners and entrepreneurs is also notably minor in comparison to policies that support other LMI populations. The multi-billion dollar federal workforce development system, for example, channels most of its support to traditional employment rather than entrepreneurship. Further, misconceptions about who small business owners are and what types of businesses they run have contributed to the development of federal small business policies that are poorly designed to address the needs of financially vulnerable microbusiness owners.

Additional policy support is necessary to ensure that the wealth-building and mobility-enhancing aspects of business ownership are meaningful and achievable for financially vulnerable entrepreneurs. This report identifies key policy recommendations to ensure that these entrepreneurs can successfully start and run businesses that contribute meaningfully to their families' financial security. Our recommendations address the challenges that prevent financially vulnerable microbusiness owners from successfully growing wealth through their businesses: low business and personal savings, lack of access to financial products and services—including credit—that meet their needs, constrained access to credit and limited access to business development services and resources. We focus particularly on the workforce and tax systems as delivery channels because these major public systems already offer limited support that reaches a small proportion of financially vulnerable microbusiness owners. Expanding that support would leverage these systems' large scale to reach millions more current and potential LMI microbusiness owners.

Demographics of microbusiness owners

Compared to the general population of small business owners, microbusiness owners are more likely to be young, women and people of color.



Sources: data on small business owners is from SBA and data on microbusiness owners is from AEO.

Supporting Entrepreneurship as a Path to Financial Security

Microbusinesses have too much of an impact on the economy to be ignored. More than 26 million microbusinesses have created their own jobs. The 3.6 million microbusiness owners who also employ others create an additional 1.7 jobs apiece, on average.[6] Including both owners and workers, that adds up to approximately 32 million Americans who are currently employed by microbusinesses. The Association for Enterprise Opportunity (AEO) estimates that the microbusiness sector as a whole generates almost $3 trillion in sales and receipts on an annual basis.[7] The self-employed alone account for almost $1 trillion in economic activity each year.[8] As the post-Great Recession economy remains fragile and only partially recovered, failing to equip these entrepreneurs with the tools they need to succeed in business is a missed opportunity to boost economic growth.

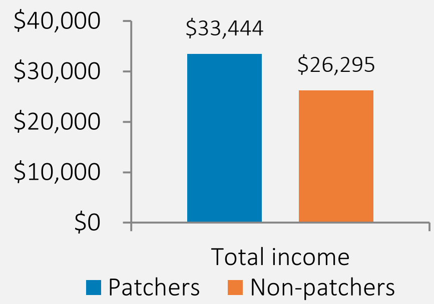
As more people become self-employed, refocusing small business policies toward microbusiness owners becomes imperative. Employers are increasingly reliant on consultants and contract workers as a cost-cutting measure. As a result, self-employment is growing. MBO Partners, a consulting firm for independent workers, estimates that by 2020, fully half of all workers will have spent some time self-employed during their career.[9] Acting now to improve public policies intended to support the self-employed will ensure that these workers can access resources that help them succeed when they do not have traditional wage employment.

Entrepreneurship provides opportunities for workers with little chance of securing high-quality jobs in the labor market to increase their income. For example, while most well-paying jobs require workers to have completed at least some higher education, starting your own business has no such barrier to entry. AEO found that only 37% of microbusiness owners possess college degrees. Many individuals who lack a college degree struggle to find employment that pays a livable wage, however, AEO's research finds that the median microbusiness wage is often significantly greater than minimum wage;[10] thus people who may be limited to low-wage positions as an employee may have higher earning potential through microbusiness ownership.

Self-employment provides the opportunity to supplement household income. The FIELD program at the Aspen Institute has studied individuals and households combining employment income with earnings from self-employment. FIELD surveyed nearly 1,200 microbusiness owners who received services from a microbusiness development organization (MDO), and found that 37% pursued self-employment in addition to a traditional job. Self-employment income not only supplemented their personal earnings, but also enabled them to patch together various sources of household income to make ends meet for their family. "Income patchers" tended to have higher total earnings than to non-patchers. Of the microbusiness owners who were in poverty when they first received services, 84% of patchers successfully moved out of poverty by the time of the survey, compared to 70% of non-patchers.[11]

Self-employment boosts income.

A FIELD study found that microbusiness owners who had a business as well as a job ("income patchers) earned more than those who solely worked at their own microbusiness (non-patchers).



Source: FIELD, 2013.

Microbusiness can also be vital for income and wealth building in underserved communities. Research shows that microbusiness owners are more likely than the small business owner population in general to represent marginalized populations; they are more likely to be young, a woman, or a person of color. For these groups, which often face disadvantages in the labor market, entrepreneurship can offer benefits that traditional wage employment cannot. In 2010, for instance, female-headed family households in which at least one person owned a microbusiness generated $8,000 to $13,000 more in annual household income than similar households without a business owner.[12] This additional income could especially make a difference among single female-headed households, which are disproportionately likely to struggle with financial insecurity.

Many of the challenges that financially vulnerable microbusiness owners face could be alleviated by better targeting small business policies and programs to meet their needs. Successful and effective policies to assist LMI microbusiness owners do exist, but they are small in scale and can only serve a tiny percentage of these entrepreneurs. Those policies are valuable, but they do not comprehensively address key financial capability issues, such as low savings, difficulty with cash flow and revenue projections, need for affordable tax assistance and access to appropriate and affordable forms of credit.

Policies to Support Financially Vulnerable Entrepreneurs

Small business ownership can continue to be an engine of economic growth and source of upward economic mobility, but improved and additional policy support is necessary to ensure that these goals are achievable for entrepreneurs who start with few resources. Improved and additional policy support is necessary to maximize the productive capacity of microbusiness owners and to ensure that their success is not limited to the highest educated, highest earning few, but possible for all, regardless of income or circumstance.

Congress and the Department of Labor should leverage the workforce system to expand access to existing entrepreneurship training resources.

Very few workforce development agencies or organizations support entrepreneurship training, despite the potential for self-employment to lead to financial stability for unemployed and hard-to-employ workers. [13] Workforce development policies are overwhelmingly focused on helping clients find wage-based employment. Those who express interest in starting a business are instead actively steered away from entrepreneurship or find that the workforce system provides them little to no access to training and resources they would need to succeed as entrepreneurs. In fact, pursuing self-employment can cause unemployed workers to lose their unemployment insurance (UI) benefits, and prevent workforce training clients from continuing to receive services. In order to facilitate microbusiness access to the workforce system we recommend:

- **Congress should amend the Self-Employment Assistance (SEA) Program to enable more states to offer it to unemployed workers.**

    SEA allows UI claimants who are interested in entrepreneurship to participate in entrepreneurship training and start their businesses while receiving UI. The program has been independently evaluated and has demonstrated effectiveness in helping unemployed workers start successful businesses.[14] SEA is limited in scale for two main reasons. First, unlike most state-federal workforce partnerships, SEA requires state legislatures to authorize the program. Second, states, not the federal government, are solely responsible for paying for entrepreneurship training available to participants. In order to maximize SEA's potential, governors should be allowed to opt into SEA without requiring state legislative action; and DOL should allow states that offer SEA to use federal workforce training dollars to offset the cost of providing entrepreneurship training to participants, and develop training resources that are tailored to the specific needs of unemployed workers.

- **DOL should, as it implements new provisions of the Workforce Innovation and Opportunity Act (WIOA), identify how entrepreneurship training and development services can satisfy WIOA's Performance Measures.[15]**

    WIOA, recently passed legislation to reform the federal workforce training system, includes revisions to DOL's performance accountability system. For years, WIA's Common Measures have been used to evaluate whether workforce services, such as One-Stop Career Centers, are effectively connecting individuals to employment opportunities (e.g. by reporting the number of people who find jobs, whether they remain employed over time, and their average earnings). These measures fail to properly gauge the effectiveness of entrepreneurial training provided through the workforce system. Although DOL recognizes entrepreneurial training as a permissible use of WIA funds,[16] its failure to establish appropriate performance metrics creates a powerful disincentive for workforce agencies and organizations to provide entrepreneurship services. As a result, while 87% of Workforce Investment Board (WIB) directors report that entrepreneurship should be a career option for the unemployed, less than 5% say they provide all the services an entrepreneur needs to start a business successfully.[17]

    The passage of WIOA provides a key opportunity for DOL to implement performance measures that can accurately document the impact of entrepreneurship training provided through the workforce system. It must issue updated rules and guidance on the revised performance measures, and can use that process to address how workforce agencies can apply them to entrepreneurship training. Microbusiness and workforce experts have proposed feasible, effective performance measures for entrepreneurship training services delivered through WIA that should serve as the basis for the Department.[18]

Congress and the Internal Revenue Service should provide additional resources to microbusiness owners at tax time.

Tax time should be an opportunity for federal agencies to engage positively with microbusiness owners by providing education about their tax responsibilities, expanding access to affordable tax preparation assistance, and leveraging the tax code to address low liquid and long-term savings. Instead, tax time is a source of frustration for many entrepreneurs. CFED's research[19] indicates that approximately one in four microbusiness owners experience cash flow problems associated with tax time.

Despite strong political support for small businesses the individual tax code provides remarkably little support to microbusiness owners, the majority of whom are taxed as individuals rather than corporations. Improving the tax policies that impact microbusiness owners can help both new entrepreneurs and current microbusiness owners achieve greater financial stability. More effective tax policies targeting microbusiness owners' savings and investment needs must address both liquid savings—which can serve as startup equity and reduce financial vulnerability—as well as long-term savings that enable business growth and achieve household goals such as secure retirement. In order to achieve this we recommend that:

- **Congress should establish a New Entrepreneur Tax Credit that enables new microbusiness owners to offset tax-time cash flow challenges and incent business savings.**

  The New Entrepreneur Tax Credit (NETC) should be available in the first tax year in which the taxpayer earned self-employment revenues during all four quarters, and—to ensure it benefits the most vulnerable entrepreneurs—be limited to microbusiness owners with household earnings less than the median income. Establishing a lifetime limit on the value of the credit per tax filer would ensure that the credit is not predominantly claimed by serial entrepreneurs who build and sell businesses many times. The credit should be designed to deliver relatively small amounts of capital to a broad set of businesses. Although the NETC will have the highest impact if it is refundable, a less expensive and still effective option is to make it partially refundable.

- **Congress should simplify and expand the Saver's Credit to encourage LMI microbusiness owners to save for retirement.**

  The existing Saver's Credit is nonrefundable, needlessly complex and is defined by three sharp income eligibility cliffs. These shortcomings mean that only a very small percentage of low-income tax filers qualify for the credit, and an even smaller number actually claim the credit. By simplifying the Saver's Credit and making it refundable, Congress could provide additional support to all LMI workers and entrepreneurs interested in putting savings away for retirement.

- **Congress and the IRS should expand the Volunteer Income Tax Assistance Program's capacity to help LMI microbusiness owners navigate the tax system.**

  The IRS Office of Stakeholder Partnerships, Education and Communication (SPEC) Office should improve the support that the Volunteer Income Tax Assistance Program (VITA) delivers to microbusiness owners. VITA provides LMI tax filers with free tax preparation from IRS-certified volunteers. The program's capacity to serve a large volume of LMI microbusiness owners is limited by funding and program rules that preclude VITA sites from preparing all but the simplest Schedule C forms. Research from CFED's Self-Employment Tax Initiative (SETI) shows that VITA sites are capable of and willing to expand these services to microbusinesses if they were permitted to do so.[20] SPEC has the authority to lift the restrictions on Schedule C preparation at its discretion, without initiating the lengthy process of proposing a regulation for public comment. The

Entrepreneur Start-Up Growth Act, introduced in 2011 by Representative Judy Chu (D-CA), proposed a pilot program to test the feasibility of expanding VITA support to self-employed tax filers. That legislation provides a model for administrative or legislative proposals.[21]

Congress should provide additional funding to expand VITA's services for the self-employed. VITA sites that have participated in the IRS-SETI-National Community Tax Coalition (NCTC) sponsored Schedule C pilot consistently report challenges related to raising the additional funding needed to increase services provided to low-income Schedule C filers. One way to ensure that these services are sustainable is to authorize VITA sites to test the feasibility of implementing pay-what-you-can sliding-scale client fees for certain services beyond preparation of basic tax returns.

Federal agencies that provide resources to small business owners should jointly implement strategies to increase entrepreneurs' financial capability.

Microbusiness owners' households frequently suffer greater financial instability due to vulnerabilities in their businesses. For example, many microbusiness owners will delay or reduce their own paychecks to maintain positive cash flow—taking income away from their households. Two-thirds of those who say they struggle with cash flow have skipped paying themselves altogether.[22] And while those without cash flow problems were most likely to be building personal savings for long-term assets such as retirement and higher education, those with cash flow problems were less likely to be trying to build emergency savings, or to lack savings goals.[23] Given the close relationship between business balance sheets and household balance sheets, policies that help microbusiness owners build greater financial capability can also have positive impacts on financial stability at the family level. Current small business policies do not effectively or comprehensively address business owners' financial capability, but there are opportunities to do so through existing federal programs. Policies designed to boost microbusiness owners' financial capability must provide effective financial training and education, incentives to save and access to appropriate amounts and types of credit. To achieve these goals, we recommend:

- **The Small Business Administration (SBA), Community Development Financial Institutions Fund (CFDI Fund) and other agencies providing microbusiness technical assistance should work together to develop resources that effectively increase clients' financial management skills.**

  The federal government provides an array of education, technical assistance and one-on-one counseling to microbusiness owners. The Small Business Administration administers the Small Business Development Centers (SBDCs), Service Corps of Retired Executives (SCORE), Women Business Centers (WBCs), and Program for Investment in Micro-Entrepreneurs (PRIME). CDFI Fund awards grants to microbusiness development organizations (MDOs) across the country to provide technical assistance to LMI entrepreneurs. Smaller programs tailored to microbusiness owners exist within the Department of Agriculture (USDA) and Department of Commerce.

  All these programs provide some financial education to clients, but the majority of grantees' programming concentrates on the financial knowledge and skills needed to start a business, such as how to create a business plan, how to keep records documenting your expenses and income and how to make a profit and loss sheet. These are worthwhile topics, but they are incomplete without additional skills such as forecasting revenues and expenses, tax compliance and planning for growth. More attention should also be paid to enhancing business owners' ability to balance the health of their business' finances and their personal financial security. SBA and the CDFI Fund should coordinate with other microbusiness-serving agencies to create resources and develop standards that encourage technical assistance providers to implement effective strategies to boost clients' financial capability. This support could take the form of shared funding priorities across multiple departments, potentially highlighting financial coaching as a more effective approach to financial education.

- **The SBA and CDFI Fund should help microloan borrowers develop business savings.**

  SBA and CDFI Fund administer microfinancing programs through the SBA Microloan Program and CDFI loans to microfinance intermediaries. Each agency should explore and develop pilot programs to provide microbusiness owners receiving these loans with an optional savings feature. Savings features could be modeled after products that already exist, such as the Borrow and Save consumer loan programs implemented by some CDFI-certified and low-income designated credit unions.[24] Both long-term and short-term savings should be permitted, allowing microbusiness owners to assess and address their savings needs according to their own goals. As depository institutions may be necessary partners for organizations that only provide loans, SBA and CDFI Fund could encourage partnerships between loan funds and CDFI-certified banks and credit unions to provide savings products to microbusiness owners.

- **The Consumer Financial Protection Bureau (CFPB) should provide clear guidance to Fair Credit Reporting Act (FCRA) regulated firms on the use of alternative credit data to ensure that all consumers, including entrepreneurs, have the opportunity to build credit.**

  Credit is one of the primary tools that microbusiness owners can use to manage cash flow, but many LMI business owners lack access to basic mainstream products such as credit cards and lines of credit. CFED's research found that among microbusiness owners who have applied for and been denied loans, 28% cite insufficient credit history as the reason.[25] They are among as many as 54 million "credit invisible" Americans who have insufficient credit history to generate a credit score. Without established credit histories, consumers must rely on payday loans and other high-cost alternative financial services.[26] For microbusiness owners, this may mean merchant cash advances—cash infusions offered in exchange for assigning a set percentage of future revenues to the lender.

  The Fair Credit Reporting Act (FCRA) regulates companies involved in creating credit histories. FCRA impacts what information credit reporting agencies (CRAs), such as Experian and TransUnion, include in individual consumers' credit reports. The Act also influences the information about individual consumers that "data furnishers" provide to CRAs, such as mortgage payments. Alternative data collection and analysis methods go beyond the data typically collected and maintained by the major consumer credit bureaus hold the potential to provide a more complete picture of an individual's credit history. Common types of alternative data include rent, utility and phone payments. Alternative data policies would benefit a broad population of individuals beyond LMI microbusiness owners, but thin-file microbusiness owners may have the most to gain. Using alternative data to establish credit histories would help millions of microbusiness owners who can't borrow at all gain access to basic credit products such as personal and business credit cards, business lines of credit, and other low-balance, affordable products.

  Alternative data credit reporting has taken hold to some degree in the private sector, but it remains outside of the mainstream. Concern about Fair Credit Reporting Act (FCRA) compliance is an important contributing factor to lenders' reluctance to rely more on alternative data. FCRA clearly authorizes data furnishers and CRAs to report and document payments on term loans and revolving credit accounts. It also prohibits the inclusion of certain types of information in credit reports. But alternative data falls into a gray area. The CFPB, as the primary regulator implementing and overseeing FCRA-covered financial institutions, could provide supervisory guidance detailing criteria that firms could use to determine what forms of alternative data are acceptable to use for underwriting and even to incorporate into boutique and mainstream credit histories.[27] Congress could also spur action through the legislative process, using the 2013 Credit Access and Inclusion Act (H.R. 2538 in the House; S. 1613 in the Senate) as a template.[28]

- **The Department of the Treasury and Congress should provide access to myRA to the self-employed.**

  In early 2014, President Obama announced during his State of the Union address that the Department of the Treasury would create a new retirement savings vehicle intended to extend access to simple, affordable retirement savings accounts to the 70 million workers who lack access to employer-based retirement. While many wage employees have access to employer-sponsored retirement savings accounts, few LMI microbusiness owners are able to access the type of accounts necessary to plan for a secure retirement. The My Retirement Account (myRA)[29] will be piloted in 2014-2015 with a range of employers and workers, then gradually rolled out to all employers, no matter how small, as an optional benefit for employees. MyRA is built on the Roth IRA platform,[30] which means that contributions are eligible for the Saver's Credit and may be used flexibly to meet short-term savings needs, often without incurring penalties.[31] That flexibility could be an especially valuable feature for microbusiness owners facing occasional cash flow difficulties. Prospective entrepreneurs who have myRA accounts could also use them to serve as startup equity when starting a business.

  As Congress and the Department of the Treasury plan for future efforts to expand myRA from the pilot stage to widespread access, they should consider the 23 million self-employed Americans who have the least access to affordable, easy retirement savings accounts. Simply making myRA available to the self-employed would greatly improve their capacity to achieve long-term financial security. This could be accomplished in several ways; one option is to make it possible to open and make deposits into a myRA account through the IRS 1040 tax form.[32] Another option is to work with membership associations that provide services such as insurance to the self-employed to add myRA to their product offerings, coupled with assistance setting up regular contributions.

- **The CDFI Fund should create an innovation initiative to partner with CDFIs to develop new financial products and services designed to meet the needs of the average microbusiness owner.**

  A final opportunity for the CDFI Fund is to partner with CDFIs to directly support the development of innovative, affordable products and services that address financially vulnerable microbusiness owners' needs. The CDFI Fund is the best-positioned agency to host such an initiative because it has considerable flexibility to allocate its budget to areas and projects that it prioritizes. It also has the strongest ties of any federal agency to the field of nearly 900 nonprofit and for-profit financial institutions that are certified CDFIs. The variety of CDFI types—loan funds, credit unions, banks and venture capital funds—is also a benefit, as different types of organizations have different capacities to deliver products and services. There is precedent for this type of initiative, both within the CDFI Fund and at other federal agencies. The CDFI Fund's Native American CDFI Assistance Program (NACA) has awarded technical assistance funds to Native American CDFIs that are developing new products and services.[33] Outside of the CDFI Fund, Project Catalyst at the CFPB is an ongoing initiative that partners with financial services providers to develop and test innovative new products and services that meet the financial management needs of consumers. Its early partnerships address issues such as automatic bill payment and use of prepaid cards. At times, Congress has also played a role in initiating these partnerships, such as DOL's Workforce Innovation Fund.[34]

  Taking leadership on this issue by investing resources to spur innovation will lead to a greater variety of financial management tools for microbusiness owners to overcome common financial challenges, which, in turn, increases their capacity to achieve financial security through business ownership and grow their businesses in ways that create jobs. This initiative should focus on products and services that relate directly to microbusiness owners' financial challenges, particularly: 1) lack of liquid savings; 2) inability to accurately forecast future revenues and expenses; and 3) insufficient credit history to have access to mainstream borrowing options. It should be noted that the product and/or service solutions to the financial challenges listed above will vary in design as well as provider. For example, the lack of liquid assets can be addressed either through new savings products and incentives or with short-term credit products, and different CDFIs will bring different solutions to the table. Moreover, the inability of small businesses to accurately forecast revenues will require both technical assistance and financial services, such as mobile apps, to effectively address. Thus, we recommend that an innovation investment initiative at the CDFI Fund should seek out a range of approaches to effectively match the diversity of challenges that microbusiness owners face.

Many CDFIs would be capable of implementing well-designed products and services and could offer them at lower cost than mainstream financial services firms. They are not, however, capable of investing significant sums in product development, as they rely on CDFI Fund grants and loans, other public programs, and philanthropy for the majority of their funding. By partnering with these CDFIs, the CDFI Fund would subsidize the costs of product development and create unique new resources for the field based on the findings and outcomes of the initiative. From ideation and design to testing, piloting and preparing for implementation at scale, the CDFI Fund can deliver valuable technical assistance and expertise, as well as provide research and evaluation capacity that the participating CDFIs are unlikely to have on their own. Because significant proportions of potential partners are depository institutions, the CDFI Fund should consult with regulators for community banks and credit unions, the National Credit Union Administration (NCUA) and the Federal Deposit Insurance Corporation (FDIC). Consulting with CFPB would also be helpful, as the Bureau has regulatory authority for the types of financial services that may be developed.

Conclusion

The recommendations in this report will assist advocates and policymakers in new efforts to support entrepreneurship as a source of family financial security, job creation and economic growth. These practical, actionable reforms will enable millions of financially vulnerable microbusiness owners to achieve financial success in their businesses and help their families grow wealth and move up the economic ladder, while enhancing the capacity of the microbusiness sector to create jobs and growth for the U.S. economy.

CONTACT THE AUTHOR: This proposal was written by Katherine Lucas McKay, Senior Policy Analyst, with thanks to Alicia Atkinson.

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