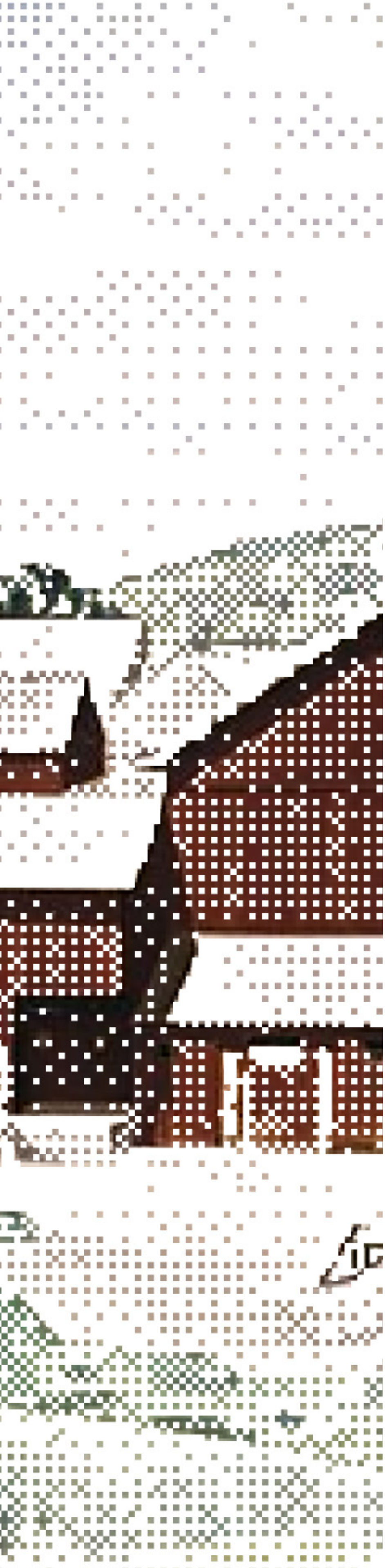

■ Industrial Power

Reforming the Small Business Administration

Samuel Hammond

SUMMARY

The Small Business Administration (SBA) possesses uniquely strong and underutilized authorities for supporting innovative American manufacturers. Congress has not passed legislation reauthorizing SBA since 2004, presenting an opportunity for a future reauthorization to leverage SBA's loan and investment authorities toward manufacturing and hard tech startups. Congress should reform the Small Business Investment Companies (SBIC) program to streamline fund applications and enhance the leverage available for investments in key manufacturing sectors; create an Innovation Growth Loan program to provide innovative manufacturers with scaling capital; and modify SBA's small business criteria to make it easier for manufacturers to expand beyond their "small" status without an abrupt loss in eligibility.

PROBLEM

Rebuilding America's industrial base will require growing a robust ecosystem of small and medium manufacturers, as even the largest manufacturers in the United States rely on smaller manufacturers and parts suppliers throughout their supply chain. However, the patient forms of debt and equity financing best-suited to manufacturing are chronically undersupplied in the US context. Rich nations with resilient manufacturing sectors, such as Israel and Germany, address these gaps in financing with industrial development banks.

While the US could adopt a similar approach by creating its own development bank, leveraging the latent authorities of the SBA offers a simpler path forward. Indeed, as an offshoot of the Reconstruction Finance Corporation, the SBA already has many if not most of the authorities associated with a development bank, from loan guarantees to equity issuance. The SBA's long-overdue congressional reauthorization thus provides an opportunity to redirect these authorities toward bolstering and scaling innovative small and medium manufacturers, including the sorts of hard-tech startups that venture capital has traditionally overlooked.

SOLUTION

Congress should reauthorize the SBA and include the following reforms:

- Streamline eligibility rules and licensing timelines for SBICs, while expanding the leverage available for investments in advanced manufacturing with specialized "Innovation Debentures."
- Establish a new Innovation Growth Loan program to provide scaling capital to R&D-intensive manufacturers seeking to ramp up production.
- Align the SBA's suite of policies with manufacturing priorities, including by amending and extending the criteria and review period for small and medium manufacturers, making it easier for firms to grow beyond their "small" status without an abrupt loss in eligibility.

JUSTIFICATION

These proposed reforms to the SBA are largely drawn from the SBA reauthorization proposed by the Senate Small Business Committee in 2019 under then-Chairman Marco Rubio. Inspired by analogous policies in Israel and Germany, the reforms seek to leverage SBA's existing authorities in debt and equity financing to serve as a quasi-development bank for advanced manufacturers. While the reauthorization was derailed by the COVID-19 pandemic, many of its core proposals are worth revisiting, and have the benefit of existing legislative text and background research.

Small Business Investment Companies

SBICs are privately owned and operated investment funds licensed and regulated by SBA that provide long-term debt and equity capital to small businesses. Created in

1958, the program operates as a unique public-private partnership where SBICs use their own capital plus funds borrowed with an SBA guarantee to make leveraged investments in qualifying small businesses.

SBICs have been credited with helping spur America's robust venture capital sector, but have since become overshadowed by private funds. This partly owes to cumbersome and outdated licensing regulations that privilege professional fund managers with a track record of realized returns. This disadvantages emerging VC funds and tech investors who may have gained substantial relevant experience as founders or in corporate development. Additionally, the focus on realized returns is out of step with the realities of modern early-stage venture financing, where returns may take longer to realize or come from alternative deal structures.

By streamlining and modernizing licensing processes and establishing clear timelines for SBA decisions, existing VCs could be induced to establish an SBIC on the side. The creation of specialized "Innovation Debentures" for advanced manufacturing investments would then enable the strategic and technical acumen contained with America's top VC funds to turn towards identifying investment opportunities in advanced manufacturing and hard-tech. Innovation Debentures would come with a revenue-based repayment structure to better match manufacturing's growth patterns, and include incentives to maintain US production, such as penalties for offshoring.

Innovation Growth Loans

The Innovation Growth Loan program is a proposal to create a new SBA loan category for R&D intensive advanced manufacturing seeking to scale their production. As detailed in the markup of the SBA Reauthorization Act of 2019, Innovation Growth Loans would:

- Provide loans of up to $50 million for scaling US-based manufacturing (defined by industry code and R&D intensity).
- Require at least 50 percent of funds to go toward productive capital assets
- Use tranched disbursement tied to growth benchmarks.
- Feature a revenue-based repayment structure.

The high-powered scaling capital and revenue-based repayment structure provided by Innovation Growth Loans are designed to allow advanced manufacturers to escape the "valley of death"—the $15–40 million funding gap that often forces innovative manufacturers to either relocate production overseas or sell to foreign acquirers. In exchange, tranched disbursements, growth benchmarks, and the requirement that funds be immediately put toward productive capital assets help to align incentives toward scaling while ensuring accountability.

Modernizing SBA definitions and review periods

Supporting these major initiatives would benefit from strategic reforms to SBA's overall approach to manufacturers. Such reforms would include:

- Extending manufacturers' size standard review period to five years to give firms more runway to grow before losing small business status.
- Increasing loan caps across existing programs like 504 loans to recognize manufacturing's higher capital requirements.
- Increasing SBA's coordination with the Manufacturing Extension Partnership program to help integrate technical assistance with capital access.

Taken together, these reforms would transform the SBA into a more effective partner for innovative manufacturers at all stages of growth, from early stage startup and initial scale-up through to maturation into large manufacturing enterprises. Rather than creating new agencies or authorities from scratch, the proposal leverages SBA's existing capabilities while redirecting them toward rebuilding America's industrial commons. ■

FURTHER RESOURCES

- SBA Reauthorization and Improvement Act of 2019
- SBA markup section-by-section, 2019
- Samuel Hammond and Connor O'Brien, "How Congress Can Address America's Startup Shortage," *National Review*, 2019

Samuel Hammond is Chief Economist at the Foundation for American Innovation. He previously worked as the Director of Social Policy for the Niskanen Center and as an economist for the Government of Canada specializing in regional economic development.