THE STATE OF SMALL BUSINESS HAWAI`I
2003

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INTRODUCTION

Small business owners are optimistic in 2003. Certainly, there are reasons they might not have been—a faltering economy on the mainland, a continuing weak economy in Japan, slow growth in Hawai`i after 10 years of nearly no growth, lingering effects of September 11th and its aftermath, and the threat of a second Gulf War with Iraq. But in the face of it all, they are optimistic about 2003.

The *State of Small Business Hawai`i 2003* examines attitudes, such as this one, of small business owners and managers about 2003 and looks back at their experience of 2002.

The data has led to four conclusions:

- Hawai`i's State Government should actively promote a broad range of types of businesses across all industries. Entrepreneurial businesses that become fast growth companies have diversity far greater than just being involved with high technology. While high technology clusters are desirable, Hawai`i is moving in that direction, if at all, very slowly.

- Hawai`i's State Government should actively expand programs to promote the availability of capital for seeding potential fast growth companies as well as providing venture capital. The shortage of capital available to Hawai`i's small businesses is a substantial impediment to growth. Small businesses must have timely and adequate access to loans and equity at a reasonable cost.

- Hawai`i's State Government should actively promote to small business owners management consulting and management training that leads to an increase in their knowledge of entrepreneurship and continuous quality improvement strategies. Appropriate management consulting and training reduce the risks to which small business owners and their equity partners are exposed.

- Hawai`i's State Government should actively promote the availability of critical research information to small business owners in order that they can make sound decisions that promote growth in their businesses and the economy. Businesses need many kinds of information if they are to make informed decisions that help them compete in the global economy. Small businesses often cannot devote the time or money to do research for themselves, nor do they often have the knowledge necessary to do research.

The evidence for these conclusions comes primarily from three sources: One source is a survey of Hawai`i's small business owners and managers. The other two primary sources of evidence come from a study entitled *Development Report Card for the States* published by the Corporation for Enterprise Development (CFED)[1] and *The 2002 State New Economy Index* published by the Progressive Policy Institute.[2] These two studies, which rank the 50 states according to 71 indices in the first and 17 in the second, are considered to be highly credible.

The wealth of a community is determined by the success of that community's businesses. The business sector is where jobs are created and where income is produced to pay taxes to support infrastructural needs of the community—whether roads, schools, a judicial system, social programs or any of the other necessary components of an ordered, caring, and productive society. Due to the economic slowdown in the 1990s, Hawai`i's per capita income has fallen compared to the rest of the nation, and its standard of living has suffered accordingly.

This report focuses on small business. In Hawai`i, business *is* small business. Small businesses in Hawai`i, represent 97.0 percent of all businesses, which is approximately 39,000 enterprises out of a total of 40,000.[3] 48.2 percent of all businesses in Hawai`i, according to the self-reporting in the survey, have annual sales less than $500,000 and 33.9 percent have annual sales under $250,000. Importantly, 85.3 percent of all businesses in Hawai`i have fewer than 10 full-time employees and 69.9 percent have five or fewer.[4] The most prevalent business in Hawai`i, then, is not just a small business, it is a micro-business. The sheer number of small and micro-businesses make them important to the economy of Hawai`i.

Yet even their number understates the importance of small and micro-sized businesses to the state of Hawai`i. Studies indicate that small businesses, especially micro-businesses with less than five employees, are the primary creators of new jobs in the economy,[5] the leading innovators,[6] and the primary exporters.[7]

This, the third annual Hawai`i Small Business Development Center Network (SBDC) survey, was conducted in order to better determine the state of small business in Hawai`i at the beginning of the year 2003. Because of the critical role of small businesses in the economy, this survey and the CFED ranking of the states provide information important to all citizens of Hawai`i, but above all to those engaged in making policy and those who influence the policymakers.

This report reflects the Hawai`i SBDC Network's ongoing commitment to the small businesses of Hawai`i and to the larger community through its primary tool—education. Information about the state of small businesses in Hawai`i is critically important for those who make decisions affecting business owners, their employees, and ultimately the state's economy, which affects all residents. The survey provides a snapshot of the opinions of Hawai`i's small business owners and managers at the beginning of 2003. The CFED ranking helps place the state of Hawai`i's small businesses in a national and global context.

SUMMARY OF THE HAWAI`I SBDC NETWORK SURVEY FOR 2003

This, the third annual Hawai`i SBDC Network survey of Hawai`i's small business owners and managers, reveals the perceptions of small business people across the state regarding their attitudes, levels of success, and plans for the future. This is a summary only. To review all of the data, see the online report at www.hawaii-sbdc.org by clicking on *Reports* in the left-hand column. A few of the more important of these survey results are summarized below:

- **52.3% of Hawai`i's small business owners believe the economy will improve in 2003.**

The big news in this year's survey is that 52.3 percent of small business owners and managers believe the economy will improve in 2003. Only 7.2 percent believe the economy will worsen. Even more optimistic are the small business owners of the neighbor islands of Hawai`i, Kaua`i, and Maui, of whom 56.1 percent believe that the overall state economy will improve. Interestingly, they indicate this will happen on O`ahu (56.1 percent) to a greater extent than on their own islands (45.9 percent). On O`ahu 44.5 percent predict a stronger economy in 2003.

This change is a remarkable increase in optimism from the prediction for 2002 when only 24.0 percent of small business owners predicted an improving economy and 35.1 percent thought the economy would worsen.

Predicted Change in Statewide Economy for 2003

Change	2001	2002	2003	Change
Improve	41.6%	24.0%	**52.3%**	+ 28.3%
Worsen	11.1%	35.1%	**7.2%**	- 27.9%

The perceptions of small business owners about the economy are important because their predictions are among the factors weighed when determining whether to expand, redirect or retract their business activity. Thus, their perceptions influence reality and can intensify the direction in which the economy is moving.

In order to pursue the previous question further, a second question was asked of the small business owners and managers about whether the respondents believed their sales would increase in 2003.

- **58.9% of small business owners predict that their sales will increase in 2003.**

In 2003, 58.9 percent of Hawai`i's small business owners and managers predict that their own businesses' sales will increase. This *increase in sales* percentage is 20.6 percent higher than was predicted at the end of 2001 for 2002 (38.3 percent), and markedly higher than the percentage of business owners who predicted at the end of 2001 a growing economy for 2002 (24.0 percent).

Predictions by business owners for improved sales in 2003 is not as high as it was for 2001 when 59.0 percent believed their sales would increase, which is 17.4 percent higher than their prediction in 2001 for an *improving economy* (34.0 percent).

Changes Predicted in Sales

Changes	2001	2002	2003	Change
Increase	59.0%	38.3%	**58.9%**	+ 12.4%
Decrease	8.9%	16.3%	**5.3%**	- 11.4%

At the end of 2000, predicting an optimistic year for 2001, and at the end of 2001, predicting a pessimistic year for 2002, there was a difference between predictions for an improvement in the statewide *economy* and for an improvement for business *sales* of 17.4 percent and 14.3%, respectively. At the end of 2002, predicting for 2003, the difference between predictions for an improvement in the statewide economy and for an improvement for business sales is only 6.6 percent. It is reasonable to conclude from this that the prediction of increased sales at the end of 2002 for 2003 is a dampened optimism that is lower than what would have been expected.

The next series of survey results provide some of the reasons why small business owners may have a conflicted view of the next year and less than a fully optimistic one.

Reasons for optimism include the respondents' belief that the economy will improve (52.3 percent) and that the political climate may have become more supportive of business and the economy.

- **64.2% of Hawai`i's small business owners believe the 2002 election results will have a positive impact upon their business.**

When asked whether the results of the 2002 election (in which a Republican governor was elected) would have a positive effect on their business, 64.2 percent of the small business owners in the survey indicated that it would. Of that group, 44.8 percent believed the effect would be considerable ("Somewhat" and "A Lot"). On the neighbor islands, 68.8 percent indicate that there will be a positive effect on their business.

Positive Impact of 2002 Elections on Economy

Amount of Impact	No Positive Impact	Positive Impact
None at All	20.4%	
A Little		**19.4%**
Somewhat		**25.2%**
A Lot		**19.6%**
Totals	20.4%	**64.2%**

Factors that also may affect future plans of small business owners include indicators of current success. That is, if one is successful in the present, it is more likely that success will be predicted for the future. For instance, one question asked was whether in 2002 sales had increased in the respondent's business over the level of sales in 2001.

- **Sales increased for 9.1% more small businesses in 2002 than decreased.**

In 2002, 34.1 percent of small businesses had an increase in sales, whereas 25.0 percent had a decrease, with the result that sales increased for 9.1 percent more small businesses than decreased. This is an improvement over 2001 when the difference between firms with increased sales (28.6%) and decreased sales (38.5%) resulted in more firms having a decrease in sales (9.9 percent). Nevertheless, the number of firms experiencing a decrease in sales in 2002 was 25.0 percent—a significant number. Therefore, this measure may be a source of only minimal optimism.

Percent of Small Businesses Experiencing Changes in Sales from the Previous Year

Changes in Sales	2000	2001	2002	Change from 2001
Increased	52.4%	28.6%	**34.1%**	+ 5.5%
No Change	28.8%	13.3%	**34.3%**	+ 21.0%
Decreased	15.6%	38.5%	**25.0%**	- 13.5%

The change in the number of employees is a second factor that may influence small business owners' perception of their success during a particular year.

- **The number of small businesses that increased employees in 2002 was matched by the number that decreased employees.**

In 2002, those firms that *increased* the number of employees (16.6 percent) were 17.8 percent fewer than in 2001, and those firms that *decreased* the number of employees in 2002 (16.0 percent) rose by 15.0 percent from 2001. There was in 2002 no significant net gain in the number of firms *increasing* the number of employees (16.6 percent) from those that *decreased* employees (16.0 percent). This development, then, is not a cause for increased optimism for 2003.

One possible interpretation for these figures is that small business owners who at the end of 2000 were optimistic about the growth in their *sales* for 2001 (59.0 percent of companies) increased their *number of employees* (34.4 percent of firms) in 2001. Since actual *sales* for 2001 increased for only 28.6 percent of firms, the result may have been a small surplus of labor in 2002. Therefore, 16.0 percent of firms in 2002 decreased their number of employees, and the number of firms adding employees in 2002 (16.6 percent) decreased from the number of companies that hired employees in 2001 (34.4 percent).

Percent of Small Businesses with Changes in the Number of Employees from the Prior Year

Changes in Employees	2000	2001	2002	Change from 2001
Increased	27.2%	34.4%	**16.6%**	- 17.8%
No Change	60.7%	64.6%	**65.4%**	+ 0.8%
Decreased	12.1%	1.0%	**16.0%**	+ 15.0%

Factors that may be lowering the optimism of small business owners include the following:

- **53.0% of small businesses in Hawai`i continue to be adversely affected by September 11th.**

This percentage of 53.0 percent of small businesses that continues to be adversely affected at the end of 2002 by the events of September 11th and its aftermath is down from 80.2 percent at the end of 2001. This decrease may have contributed to a more optimistic assessment for the economy in 2003 as these firms return to more normal operations.

However, at the end of 2001, only 24.0 percent thought that recovery would take longer than one year, rather than the.53.0 percent of small businesses that indicate they continue to be adversely affected. For the 29.0 percent who thought recovery would be faster, their optimism regarding 2003 may be diminished. Additionally, 53.0 percent is a significant percentage and a substantial number of businesses—over 20,500 small businesses statewide. This factor is almost certainly still having a negative effect on expansion plans by these small business people.

Continuing Impact of September 11th

Significance of 9/11 Impact	End of 2001 None	End of 2001 Some	End of 2002 None	End of 2002 Some
None at All	19.1%		**45.4%**	
A Little		27.0%		**18.4%**
Somewhat		24.8%		**18.8%**
A Lot		24.2%		**14.4%**
Disastrous		4.2%		**1.4%**
Totals	19.1%	80.2%	**45.4%**	**53.0%**

In the two categories of greatest negative impact (labeled "A Lot" and "Disastrous"), the total percentage is down from 28.4 percent last year to 15.8 percent this year. Again, a marked decrease, but 15.8 percent is also a significant number of small businesses—over 6,000 across the state.

- **60.6 % of small businesses owners in Hawai`i believe that a war with Iraq will negatively impact their business.**

An additional negative impact that may be introducing a cautionary stance by small business owners as they plan for 2003 is the possible negative impact of a war between the United States and Iraq during 2003. Small business owners indicate that 60.6 percent of them believe a war with Iraq in 2003 would have a negative impact upon their business, and 23.4 percent believe it would have a significant negative effect ("A Lot" and "Disastrous"). That represents over 9,000 small businesses.

Negative Impact of a War with Iraq on Economy

Negative Impact of War with Iraq	Entire State None	Entire State Some	Neighbor Islands Only None	Neighbor Islands Only Some
Not at All	32.4%		25.8%	
A Little		15.0%		15.3%
Somewhat		22.2%		24.4%
A Lot		18.4%		22.0%
Disastrous		5.0%		6.7%
Totals	32.4%	60.6%	25.8%	68.4%

In conclusion, Hawai`i's small businesses owners and managers appear to believe there is reason for optimism, but also for some caution—what was termed earlier as "dampened optimism."

When asked what positively impacted their business during 2002, the surveyed small business owners selected the following reasons:

- **45.6% of small businesses experienced increased customer demand in 2002.**

The greatest number of small business owners (45.6 percent) indicated that increased customer demand had a positive impact upon their business in 2002, in part because of decreased competition (17.7 percent) and increased Internet sales (14.9 percent). The second highest positive impact is the increase in small business owners' knowledge about business (37.6 percent of owners), presumably gained from experience and continuing management development through workshops and from consultants.

Percent of Positive Business Impacts Cited

Positive Impacts Upon Small Businesses	2002
Increased Customer Demand	45.6%
Increased Knowledge about Business	37.6%
Reduced Operating Costs	18.3%
Lack of Competition	17.7%
Increased Internet Sales	14.9%

When asked what negatively impacted their business during 2002, the surveyed small business owners selected the following reasons, in addition to the events of September 11th and its aftermath:

- **More small business owners cited the increased costs of doing business as having the most significant negative impact on their business.**

While small business owners cite the increased costs of doing business as the most significant negative impact upon their business (55.7 percent), these costs include the increased costs of payroll taxes and medical insurance identified by 37.0 percent (second highest reason cited) and excessive governmental regulations noted by 31.2 percent (fourth highest reason cited). The third highest reason cited is decreased customer demand (33.7 percent).

Percent of Negative Business Impacts Cited

Negative Impacts	2002
Increased Costs of Doing Business	55.7%
Increased Costs of Payroll Taxes & Medical Insurance	37.0%
Decreased Customer Demand	33.7%
Excessive Governmental Regulations	31.2%
Increased Competition	28.1%
Inability To Obtain Capital	11.5%
Lack of Knowledge	9.2%

Interestingly, lack of knowledge was cited as a negative impact upon their business by 9.2% of small business owners, which represents over 3,500 small businesses.

As was cited earlier, small business owners indicate that 58.9% of them anticipate increased sales in 2003. They also indicate that these increases in sales would mean hiring additional employees and making capital improvements. In some cases, these increased sales would be the result of introducing new product lines.

- **38.4% of small businesses plan to hire additional employees in 2003.**

While 58.9 percent of small businesses anticipate higher sales in 2003 than in 2002, 38.4 percent statewide (and 42.9 percent on the neighbor islands) intend to hire one or more employees in 2003. This is an increase from the 16.6 percent of firms that hired new employees in 2002. Additionally, 24.6 percent plan to make capital improvements in their businesses.

Businesses Planning Changes

Small Businesses Plan the Following Changes	2003 State	2003 O`ahu	2003 Neighbor Islands
Additional Employees	38.4%	35.1%	42.9%
Capital Investment	24.6%	22.3%	27.8%
New Product Line	26.1%	26.2%	25.9%

Being able to hire well qualified employees is important to small businesses with plans for expansion.

- **The difficulty in finding qualified employees continues to decline for the second year.**

The number of small businesses experiencing difficulty in finding qualified employees has decreased from a high of 71.1 percent in 2000 to a new low of 38.8 percent in 2002—a margin of 32.3 percent. A similar, though flatter trend exists on the neighbor islands.

Percentage of Firms with Difficulty in Finding Employees

% of Firms	2000	2001	2002	Change from 2001
Statewide	71.1%	51.2%	38.8%	- 12.4%
O`ahu	73.3%	45.2%	36.9%	- 8.3%
Neighbor Islands	68.9%	60.1%	43.1%	- 17.1%

It is also interesting to note some of the areas of business activity in which small businesses are engaged.

- **The number of small businesses engaged in exporting in 2002 remains the same as in 2001 at 6.2% and less than in 2000 at 8.5%.**

- **The number of small businesses engaged in marketing on the Internet at 27.6% in 2002 is up 9.1% from 2001 (18.5%).**

- **The number of small businesses engaged in selling products on the Internet at 20.4% in 2002 is up 3.9% from 2001 (16.5%).**

While Hawai`i continues to describe itself as the hub of the Pacific Rim nations, it does not earn that title because of a high level of exporting. Only 6.2% of the state's small businesses are engaged in exporting and that percentage has decreased from 2000 when it was 8.5%.

Areas of Small Business Activity

Percentage of Small Businesses Involved in	2002 State	2002 O`ahu	2002 Neighbor Islands
Tourism	39.6%	29.6%	53.6%
Internet Marketing	27.6%	26.5%	29.2%
Internet Selling	20.4%	19.2%	22.0%
Gov. Procurement	14.8%	18.2%	10.1%
Importing	14.0%	14.4%	13.4%
Manufacturing	13.0%	14.8%	10.5%
Exporting	6.2%	8.3%	3.4%

Importing is higher at 14.0 percent of companies, but importing is less important to a state's economy than exporting unless value is being added to imported products that then are exported. That does not appear to be the case in Hawai`i.

Using the Internet to sell products where actual orders are taken (as opposed to marketing on the Internet where no orders are taken) is an important means for businesses to expand from a local market to a global market. In 2002, 20.4 percent of small businesses were selling products using the Internet. That number represents a 5.0 percent increase from two years ago.

Business Activity on the Internet

Internet Activity	2000	2001	2002	Change fr Prior Year
Selling	15.4%	16.5%	20.4%	+3.9%
Marketing	23.5%	18.5%	27.6%	+ 9.1%

Using the Internet to market products, but not to sell them by taking orders, is an important precursor for many small businesses prior to selling products on the Internet. Thus, the increase in marketing in 2002 portends further increases in selling activity in 2003.

HIGHLIGHTS OF ECONOMIC DEVELOPMENT STUDIES ON HAWAI`I

Corporation for Enterprise Development 2002 Study

Development Report Card for the States 2002. The Corporation for Enterprise Development's (CFED) study released in December 2002, entitled *Development Report Card for the States 2002*, ranks the 50 states according to 71 economic indicators. The current study is the sixteenth annual study. The studies are based on the supposition that a state's economic performance is the result of the vitality of its businesses, which

Hawai`i's Report Card with State Rankings
Corporation for Enterprise Development

Hawai`i Economic Development Indices:	1998	1999	2000	2001	2002	State Rankings 2001	State Rankings 2002	Trend
Economic Performance:	**F**	**D**	**D**	**D**	**D**	**37**	**30**	↔
Employment	F	F	F	F	**D**	49	**37**	↑
Earnings & Job Quality	D	D	D	D	**D**	38	**35**	↔
Equity	C	C	D	D	**D**	39	**33**	↔
Quality of Life				C	**D**	28	**32**	↓
Resource Efficiency				A	**A**	9	**14**	↔
Business Vitality:	**F**	**F**	**F**	**F**	**D**	**48**	**29**	↑
Business Competitiveness	F	F	F	D	**C**	44	**24**	↑
Structural Diversity	D	D	D	D	**C**	36	**29**	↑
Entrepreneurial Energy	F	F	D	D	**D**	37	**33**	↔
Development Capacity:	**B**	**C**	**D**	**F**	**D**	**46**	**30**	↑
Human Resources	B	C	D	D	**D**	41	**36**	↔
Financial Resources	B	B	D	D	**D**	39	**31**	↔
Infrastructure Resources	C	D	C	D	**D**	43	**31**	↔
Amenity Resources				D	**C**	43	**23**	↑
Innovation Assets				C	**C**	35	**28**	↔

in turn is based in significant part upon the state's capacity for development. Consistent with this argument, the 71 economic indicators are consolidated into three primary categories—*Economic Performance*, *Business Vitality*, and *Development Capacity*—which are given grades of A for excellence (top 10 states) through F for failing (bottom 10 states), based upon their ranking with other states.

Under this study, Hawai`i has received the grades shown above, covering the last five years. For the purposes of *The State of Small Business Hawai`i 2003*, the category of *Business Vitality* is the most important because it measures the results of the business sector of the economy. However, *Business Vitality* is considerably determined by *Development Capacity.* Also, *Business Vitality* determines *Economic Performance,* which then in a feedback cycle influences *Business Vitality.*

**Business Vitality in Hawai`i.** While Hawai`i received a grade of F in the category of *Business Vitality* for eight consecutive years, the grade was moved up to a D this year. A higher grade was earned because two of the three indices comprising the *Business Vitality* category—*Business Competitiveness* and *Structural Diversity*—increased from Ds to Cs while the third—*Entrepreneurial Energy*--maintained a D.

Of course a D is better than an F for the *Business Vitality* category, but a D is nonetheless a seriously troublesome predictor if the goal is sustained economic development.

Business Competitiveness Index. The index *Business Competitiveness*, one of the three indices comprising *Business Vitality*, is no higher than a C because of its grades in the subindices of *Traded Sector Strength* (F) and *Changes in Traded Sector Strength* (D). When industries sell products and services beyond the state's boundaries (which is what is measured in the *Traded Sector Strength* subindex), they bring income into the state and

Business Competitiveness with State Rankings

Subcategories	2001 Rank	2002 Rank	Trend
Hawai`i's Grade	**D**	**C**	↑
Subindices:			
Traded Sector Strength	43	43	↔
Change in Traded Sector	32	32	↔
Business Closings	30	23	↑
Competitive Index		4	
Manufacturing Capital Investment	33	20	↑

drive the rest of the economy. This is a critical measure. Hawai`i ranks 43rd among the 50 states (the same as last year), up from 46th two years ago.

What this means is that Hawai`i does little value adding, especially exporting, and thus few of its companies bring new monies into the state, compared to other states. *Changes in Traded Sector Strength* indicates that there has been a slight improvement in a trend toward more exporting since 1996. In this category, Hawai`i ranks 32nd among the states, which while flat with 2001 is up from 46th in 2002, which was a relatively unchanged ratio since 1992. It is, then, an indication of an improving trend

Hawai`i earned a C in the subindex *Business Closings*. CFED states: "The most basic indicator of the competitiveness of the businesses in a state is whether businesses survive." The strength of competitiveness is measured by the number of businesses that fail, the assumption being that the businesses failing did so because of strong competition. Hawai`i has a high level of business closures and, thus, earns a C. This ranking does not take into consideration that Hawai`i has had a relatively flat economy at "recessionary levels" for 10 years, which may have been the cause of more closures than competitiveness. It is surely true that many of the surviving businesses are leaner and stronger for the poor economy and therefore more competitive, but some are also leaner and weaker for the poor economy and less competitive, not because of competition, but because of a decreasing market.

Structural Diversity Index. The importance of structural diversity for Hawai`i is great. It is based on the premise that a state's industries must be sufficiently varied so that the economy will increase even if some markets are adversely affected by changes. Historically, Hawai`i has not had a diverse economy. From the grade of a D for many years, Hawai`i advanced to a C in 2002.

The ranking for *Sectoral Diversity* subindex, which is a measurement of the degree to which income generated by a state's traded sector is spread across a range of industries rather than being concentrated in a few, is 45th among the states, up from 47th, but still an F. In the Hawai`i SBDC Network survey of small businesses, 39.6 percent of the respondents indicated their business had some involvement in tourism. That makes Hawai`i vulnerable to the fickle vicissitudes of tourism.

Structural Diversity Index with State Rankings

Subcategories	2001 Rank	2002 Rank	Trend
Hawai`i's Grade	**D**	**C**	↑
Subcategories:			
Sectoral Diversity	47	45	↑
Dynamic Diversity	15	13	↑

Entrepreneurial Energy Index. The *Entrepreneurial Energy Index* measures the extent to which a state increases the number of new companies and creates new jobs in those businesses. Two years ago Hawai`i moved from an F to a D in this index. This year it maintained that ranking, but improved its score slightly from 37 to 33.

The subindex *New Companies* is a critical measurement in this category. The number of new companies seeking account numbers from the state employment services department determines the number of new companies. The assumption is that these are the companies that intend to hire employees. In Hawai`i, however, between 20,000 and 25,000 new GET licenses are granted annually, but only about 3,500 new businesses annually fall into the category of intending to hire employees. In this category, Hawai`i ranks 22nd among the states, the same as last year, and up from 27th in 2000.

The subindex *Changes in New Companies* examines the trend in new venture formations from year to year. Hawai`i ranks 16th in the nation on this measurement. This is a decrease from last year's ranking of 5th, but up from 2000 when it was 47th. The fluctuations are indicative of instability in the state's economy.

Entrepreneurial Energy Index with State Rankings

Subcategories	2001 Rank	2002 Rank	Trend
Hawai`i's Grade	**D**	**D**	↔
Subcategories:			
New Companies	22	**22**	↔
Change in New Companies	5	**16**	↓
New Business Job Growth	48	**48**	↔
Technology Jobs	47	**49**	↓
Initial Public Offerings	34	**28**	↑

One of the better indicators is the subindex *New Business Job Growth*, which measures the number of new jobs being created in a state among relatively new companies. This subindex provides a view of the dynamism of a state's business sector through new job creation. Hawai`i ranks 48th, the same as last year. This ranking indicates that few new businesses in the state are generating jobs. In part, this lack of newly created jobs is due to not having an entrepreneurial tradition in the state, which means that few firms take full advantage of market opportunities.

The size of the *Technology Jobs* sector tends to correlate highly with strong economic growth in a state. This occurs because a high number of technology companies, in addition to often being high growth companies, increase opportunities for clustering, agglomeration, economies, and dynamic interactions that increase the chances for producing commercially successful companies. Hawai`i ranks 49th, down from 47th last year.

CFED writes about the value of initial public offerings: "The number and/or value of initial public offerings is an excellent indicator of the growth potential of small companies. The rate and value of IPOs reflects the competitiveness of the state's small business sector. While many innovative and successful companies choose to remain under private ownership, companies that tap into the vast capital resources of the financial markets generate the largest absolute gains in employment and revenue." Hawai`i ranks 28th. That sounds better than it is, because Hawai`i is tied with 22 other states for last place at 28th. The *Entrepreneurial Energy* index, together with the *Traded Sector Strength* subindex of the *Business Competitiveness* index and *Sectoral*

Diversity subindex of the *Structural Diversity* index, are indicators of the structural weaknesses of Hawai`i's economy. The small number of jobs being created by new businesses, the lack of fast-growth companies such as high technology companies, the low number of businesses engaged in adding value or exporting, and the lack of a diversified economy—all are significant problems in Hawai`i according to the data in the CFED study.

Other Rankings Directly Impact Business Vitality. The CFED categories are heavily interrelated. Two subindices from the *Development Capacity* category directly impact the *Business Vitality* category. They act as leading indicators of business development and are predictive of the future.

Hawai`i's ranking (under the *Financial Resources* index) in the *Venture Capital Investments* subindex at 12th for the second year is quite high. If this rate of investment continues at this pace (and it may be due to newly passed legislation for tax credits to investors), it will spur a more rapidly developing economy.

The *Small Business Investment Corporations* subindex offers target financing to economically and socially disadvantaged entrepreneurs. Ranked at 45th this year, down from 48th last year, it is a missed opportunity for the state.

The *Loans to Small Businesses* subindex is 43rd among the states, down from 36th last year. That is a low figure, especially considering that 97.0 percent of all businesses in Hawai`i are small businesses. The Hawai`i SBDC Network survey indicated that 12.1 percent of small businesses applied for a loan (which equates to over 4,700 firms). The survey also indicates that 11.5 percent of small businesses said that a negative impact on their business was an inability to obtain capital or loans.

The measurements listed under the *Innovation Assets* index are all indicative of ways that the scientific and university communities can stimulate business vitality. Two are of particular importance—the *University Research and Development* subindex (University of Hawai`i) ranking 7th, down from 4th last year, and the *Small Business Innovation Research Grants* (SBIR) subindex ranking 21st, down from 20th last year. The *University Spin-Outs subindex* ranking 41st, down from 39th last year, remains a considerable opportunity for Hawai`i given the other two factors.

Business Vitality is the factor that drives a state's economy. Hawai`i received a D in 2002 after receiving an F for eight consecutive years. If Hawai`i's economic performance is to improve, then a strategy must be developed to move this sector further forward. See Policy Recommendations below.

PROGRESSIVE POLICY INSTITUTE'S THE 2002 STATE NEW ECONOMY INDEX

The 2002 State New Economy Index. This study, *The 2002 State New Economy Index*,[8] is an attempt to use a relatively new set of economic indicators to measure the transformation of a state from the traditional manufacturing economy, which lasted from approximately 1938 to 1974, to the newly emerging economy that is based on ideas, innovation, and technology. The index is composed of 17 economic indicators that are summarized under five primary categories–*Knowledge Jobs*, *Globalization*, *Economic Dynamism and Competition*, the *Transformation to a Digital Economy*, and *Technological Innovation Capacity*. The states most often cited as exemplifying the new economy are California and Massachusetts.

In *The 2002 State New Economy Index*, Hawai`i ranks 35th (a grade of D) out of the 50 states, down from 26th (a C grade) in the 1999 index (the only previous survey conducted). This ranking of 35th and a downward trend offers little comfort for those who believe Hawai`i should put their major business developmental assets into high technology companies. (For another view of Hawai`i's economy in terms of high technology and industry clustering, see: *Hawaii: Profile of the State Economy, Prepared for Governor Benjamin Cayetano* by Michael E. Porter of the Institute for Strategy and Competitiveness at Harvard Business School at http://www.isc.hbs.edu/.)

The overall ranking for Hawai`i is as high as it is due to a few subindices such as *Foreign Direct Investments* (Hawai`i ranks 1st among the states now as it did in 1999), and *Education Level of the Manufacturing Workforce* (again, Hawai`i ranks 1st among the states now as it did in 1999).

The latter subindex is less significant than it may first appear because the manufacturing sector of the economy in Hawai`i is very small (only 13.0 percent of the respondents in the Hawai`i SBDC Network survey of small businesses indicated that they engage in any type of manufacturing). Also, in Hawai`i many degreed individuals work in positions that on the mainland would not as likely employ someone with a degree due to the scarcity of career positions and a strong desire to remain in Hawai`i. (Even so, Hawai`i has the highest net migration in the nation, according to the CFED state rankings.)

The overall ranking dropped from the 26th percentile in 1999 to the 35th percentile in 2002 because a number of high ranking indices dropped precipitously. In the *Technology in Schools* subindex, Hawai`i was ranked 3rd in the nation in 1999, but now ranks only 26th. This subindex measures the number of schools wired for the Internet and the number of teachers with technology training. In the *Job Churning* subindex, Hawai`i was ranked 10th in 1999, but now ranks only 28th. This subindex of the *State 2002 New Economy Index* measures the number of start-ups and business failures as a share of all companies. The assumption is that businesses must fail if a transformation is to occur from the old to the new economy. While this may be true, the high ranking is likely distorted due to the long period of economic stagnation in Hawai`i. That is, business failures were often caused by the poor economy creating a decreased market, not because of competitiveness or new economy challenges.

Other subindices indicate areas of concern for Hawai`i, especially concerning its ability to sustain economic growth. For instance, in the *Gazelle Jobs* subindex, which measures jobs in

Hawai`i's Scores in State Rankings
The 2002 State New Economy Index

Hawai`i Economic Development Indices:	1999	2002	Trend
Overall Score*	**26**	**35**	↓
Aggregated Knowledge Jobs	21	**22**	↑
Information Technology Jobs (jobs in IT but in non-IT firms as a share of total jobs)		**37**	
Managerial, Professional and Technology Jobs (as a share of the workforce)	40	**44**	↓
Workforce Education Levels	10	**10**	↔
Education Level of the Manufacturing Workforce		**1**	
Aggregated Globalization Score	2	**3**	↓
Export Focus of Manufacturing (per manufacturing worker)	45	**20**	↑
Foreign Direct Investment (percentage of workforce employed by foreign firms)	1	**1**	↔
Aggregated Economic Dynamism Scores	45	**49**	↓
"Gazelle" Jobs (jobs in companies that have grown 20% or more over 4 years or more)	50	**50**	↔
Job Churning (new start-ups and business failures as a percentage of all firms)	10	**28**	↓
Initial Public Offerings (measure of the value and number as a share of GSP)	46	**34**	↑
Aggregated Digital Economy Scores	16	**37**	↓
Online Population (percentage of adults with Internet access)	21	**40**	↓
Number of Commercial Internet Domain Names	13	**8**	↑
Technology in Schools (use of computers and Internet)	3	**26**	↓
Digital Government (use of digital technologies in state government)	45	**40**	↑
Online Agriculture (percentage with Internet access and computers)		**34**	
Online Manufacturers (percentage with Internet access)		**48**	
Broadband Telecommunications (use and deployment over telephone lines)		**19**	
Aggregated Innovation Capacity	41	**35**	↑
High-Technology Jobs (as a share of total employment)	46	**46**	↔
Scientists and Engineers (as a percentage of the workforce)	19	**18**	↑
Number of Patents (per 1,000 workers)	47	**40**	↑
Industry Investment in Research and Development (as a percentage of GSP)	50	**49**	↑
Venture Capital (invested as a percentage of GSP)	30	**21**	↑

* Because of differences in methodology, not all changes in ranks between 1999 and 2002 are fully comparable. They are presented here as indicators of trends, not absolute rankings.

fast-growth companies, Hawai`i ranks 50th now as it did in 1999; in the *High-Technology Jobs* subindex, Hawai`i ranks 46th now as it did in 1999; in *Industry Investment in Research and Development*, Hawai`i ranks 49th now, up from 50th in 1999. Overall, T*he 2002 State New Economy Index* is even less favorable to Hawai`i than it may have initially appeared.

That, however, does not change the desirability of taking those steps that will move Hawai`i into the new economy. *The 2002 New Economy Index* advocates for the following strategies: "To succeed in the New Economy, states will need to overhaul their familiar approaches to economic development. . . . this report focuses on eight key steps states can take to 'get better' in the New Economy: 1) focus on the quality, not just the quantity of jobs; 2) know your state's function in the global economy; 3) get smart about business incentives; 4) co-invest in the skills of the workforce; 5) co-invest in an infrastructure for innovation; 6) support industry clusters; 7) boost quality of life; and 8) help more regions succeed in the New Economy."

CONCLUSIONS

**The Hawai`i SBDC Network Survey.** The Hawai`i SBDC Network survey of small business owners and managers, the very people who are struggling to build a vital business sector to support the increased well being of Hawai`i's citizens, indicates that in 2002 only a minority (34.1 percent) saw a sales increase and fully 25.0 percent saw their sales decline.

In part the decline in sales was due to the negative impact of the events of September 11, 2001, and their aftermath. Respondents to the survey at the end of 2001 indicated that 80.2% of their businesses were adversely affected and 28.4% were significantly affected. Nearly four months after the event, they anticipated that recovery would take another six months (24.8%), or in some cases another year or longer (20.6%), and in over 1,300 instances they indicated they would never recover (3.4%). At the end of 2002, respondents indicated 53.0% of them were still affected adversely within their businesses by those events. In part, the less than robust sales in 2002 were due to a decline in the economy that began prior to September 11th.

The respondents are also concerned about the adverse affects upon their businesses by a second Gulf War in Iraq (60.6 percent). They also indicate that increased costs of doing business are having a negative impact on their business (55.7 percent of them), including increased costs of payroll taxes and medical insurance (37.0 percent) and excessive governmental regulations (31.2 percent). Over these matters, they have little control.

In the face of these problems, the business owners and managers indicate they are optimistic about the economy in 2003 (52.3 percent) and believe their sales will increase (58.9 percent). In part, this optimism is due to the election of a Republican governor in 2002 (cited by 64.2 percent), but also it is due to increased customer demand (45.6 percent) and increased knowledge (37.6 percent). The optimism might have been greater except for the negative impacts cited by them. Their optimism can be characterized as "dampened optimism."

However dampened the optimism, small business owners indicated in the survey that they would act on their optimism by hiring additional employees (38.4 percent), making capital investments (24.6 percent), and introducing new product lines (26.1 percent).

Few small businesses are involved in exporting (6.2 percent) and those have decreased from two years ago (8.5 percent). More are engaged in Internet marketing (27.6 percent) and importantly Internet selling (20.4 percent—an increase of 5.0 percent from two years ago). The number involved in governmental procurement (14.8 percent). Each of these represents opportunities for businesses to increase sales beyond the local market.

The Corporation for Enterprise Development Study. The Corporation for Enterprise Development states that the economic development goals of all states are (1) the increased well-being of its citizens and (2) the acknowledgement in policy decisions that the ability of the state to deliver a more widely shared standard of living depends upon (a) the vitality of its businesses and (b) the strength of its human, technology, and financial resources and of its innovation assets.

This study indicates that Hawai`i lacks a vital business sector The state has severe problems in lack of exporting (and import substitution), in the lack of diversity of industries, and in the failure of new companies to create jobs. State adopted policies that directly address the problems of businesses—and not only reducing taxes and reducing burdensome regulations—can improve the business sector and strengthen the economy, benefiting all of Hawai`i's citizens.

The Progressive Policy Institute's Study. The Progressive Policy Institute's study, *The State New Economy Index*, is an attempt to use a new set of economic indicators to measure the transformation from the traditional manufacturing economy to the new emerging economy based on ideas, innovation, and technology.

Since the first PPI study in 1999, Hawai`i has slipped from ranking 26th among the 50 states of the nation to 35th in 2002. The study is considerably less favorable to Hawai`i than it initially appears to be. While the study indicates the desirability of pursuing the new economy, it demonstrates that Hawai`i must pay attention to the highly diverse range of potentially fast growth companies and not merely those involved in high technology. The state's policies, for example, need to support and assist a potentially fast-growth national retail chain as well as software firms.

Notes of Caution. Two notes of caution about studies such as these: (1) All indices rely on measurements that are less than up-to-date, often by as much as one or two years. Therefore, conclusions must be tempered by the realization that some measures may have changed. (2) Indices are difficult to interpret. What may be true for the nation as a whole, may not be true in a particular state, especially one as unique as Hawai`i. The more one can fill in a broader context for a particular index, the greater the accuracy of the conclusions that can be drawn.

WHAT THE SURVEY AND STUDIES SUGGEST

From the perspective of public policy, there emerge from the data in the Hawai`i SBDC Network survey for 2003, the Corporation for Enterprise Development state rankings for 2002, and the Progressive Policy Institute's state rankings for 2002 a sense of the difficulty in building a strong economy in Hawai`i that is sustainable without specific public policies to address the problems indicated. A strong, sustainable economy will require a broad, diverse range of businesses that understand how to take advantage of market opportunities. Many of these businesses, far more than now, need to be engaged in exporting or import substitution. All of them need to understand how to strategically plan for continuous quality improvement and how to implement those plans in order to successfully compete globally over time.

A Vision for a Vibrant and Sustainable Economy. Any vision for a developing, sustainable economy needs to be based upon two factors:

1. **The Highest Priority.** A vibrant and sustainable economy, based upon the vitality of its business community, is the foundation for fulfilling nearly all other needs in society appropriate to governmental action, whether those of quality education, crime reduction, creation of infrastructure or environmental protection. This reality makes building the economy the highest priority.

2. **Creating the Conditions under which Small Businesses Thrive.** A vibrant and sustainable economy is created when government through specific policies fosters within the business community the conditions under which small businesses thrive. There are five such conditions:

    a. **Entrepreneurial Understanding.** The business, educational, and government communities must understand the principles of small business creation and growth, especially those involving entrepreneurship as a particular way of doing business. The definition of entrepreneurship makes market opportunity the central event, which in turn places the needs and desires of the client as the driver of business activity. It also recognizes that resources can be obtained and should not be a determining factor when market opportunity is present. Finally, it is premised on the notion that risk is the essence of doing business.

    b. **Access to Capital.** Small businesses must have adequate access to capital at reasonable costs. Where risks are too high for the private sector, government must develop programs to make capital available using other risk-reduction methods such as intensive consulting. No business should fail for the sole reason of lack of capital.

    c. **Access to Information.** In today's global economy, small businesses need access to critical information to a far greater extent than ever before. This need can only be fully satisfied through the use of professional researchers. Hawai`i has one library that will do customized research for small businesses statewide—the Hawai`i Business Research Library, a center of the Hawai`i SBDC Network.

    d. **Quality Understanding.** In order to successfully compete over time in today's global economy, small businesses must understand continuous quality improvement concepts.

    e. **Government-Imposed Burdens.** State and county governments must eliminate all unnecessary governmental burdens to businesses, whether those of taxation, regulation or bureaucratic obfuscation.

POLICY RECOMMENDATIONS

The findings of the Hawai`i SBDC Network survey, the Corporation for Enterprise Development state rankings, and the Progressive Policy Institute's state rankings support the following set of recommendations, which are consistent with the vision for a vibrant and sustainable economy:

The State of Hawai`i should actively promote a broad range of types of businesses across all industries. Entrepreneurial businesses that become fast-growth companies have a diversity far greater than just being involved with high technology. In 1999 and 2002, *The State New Economy Index*, in its study of the transformation from the traditional economy to the new economy, states that what defines the new economy can occur in all industries. The new economy is less high technology businesses than a way of doing business that incorporates new technology along with certain attitudes about the centrality of ideas, innovation, and technology. It is fast-growth companies–wherever they occur and of whatever type–that will grow and sustain Hawai`i's economy.

The State of Hawai`i should actively promote the availability of capital–both equity and loans–to a diverse group of businesses, growing businesses committed to Hawai`i. Programs should include loans to "unbankable" businesses that do not qualify for commercial loans because they are start-up businesses or have less than sterling credit or do not have sufficient collateral or are part of the new economy. Other programs should include venture capital for promising entrepreneurial companies with the potential for rapid growth and should include seed-capital, especially in the form of grants and/or equity, but also in the form of loans. Risk should be reduced where necessary through intensive consulting.

The State of Hawai`i, in addition to supporting education, should actively promote training activities in the form of consulting and workshops that lead to an increase among

business people in the knowledge of entrepreneurship and continuous quality improvement concepts. The new economy is based upon the concepts of entrepreneurship, and fast-growth companies are dependent upon those concepts. Also, if companies are to survive over time in the global marketplace, they must learn the concepts of continuous quality improvement. The ways of business are changing faster than the owners and managers of small businesses can learn without these programs. Much as the state supports education and workforce development, it should also support the training of small business owners and managers.

The State of Hawai`i should actively promote the availability of critical information to business people, including the availability of technology information. Businesses need information–whether it is demographics for market studies, competitive analyses for positioning within a market, new product identification, finding new suppliers or distributors to expand sales or a myriad of other possibilities. This specialized kind of information retrieval to be accurate, adequate, and not excessively time-consuming, requires expertise. Small businesses do not have the funds or time or knowledge to do this for themselves.

Endnotes

[1] Corporation for Enterprise Development. *Development Report Card for the States 2002*. December, 2002. http://www.drc.cfed.org/

[2] Progressive Policy Institute. *The 2002 State New Economy Index*. June, 2002. http://www.neweconomyindex.org/states/

[3] The definitions for what constitutes a small business are commonly derived from the U.S. Small Business Administration's extensive industry-by-industry definitions. See www.sba.gov/regulations/part121.txt for size regulations in 13 CFR 121.121.

[4] Hawai`i SBDC Network Survey of Small Businesses. January, 2002.

[5] Berney, Robert E., and Bruce D. Phillips, 1995. *Small Business and Job Creation: An Update*. Prepared for the Conference on "Dynamics of Employment and Industry Evolution," University of Mannheim, Germany, January 19-21, 1995.

[6] According to the National Commission on Entrepreneurship, "Entrepreneurs have been responsible for 67 percent of the inventions and 95 percent of the radical innovations made since World War II." See http://www.ncoe.org/toolkit/fasftacts.html.

[7] Approximately 97.5 percent of the businesses in the United States that export are, according to the U.S. Small Business Administration, small businesses. http://www.sba.gov/gils/SBA1998May27.144816.html.

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