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HELPING SMALL BUSINESS BY ABOLISHING THE SMALL BUSINESS ADMINISTRATION

INTRODUCTION

Ronald Reagan is marking the Small Business Administration for extinction. If he succeeds, abolishing the 31-year-old SBA not only will cut $1.5 billion from the budget deficit but, much more important, actively will help small U.S. businesses. The President is taking this action, which predictably is stirring controversy, because he has uncovered one of Washington's best kept secrets: being for the SBA is not equivalent to being for small business. The more closely SBA is examined, the clearer the picture emerges that the SBA serves so few small businesses that the health of the small business sector actually demands SBA's immediate termination.

The arguments against this agency are compelling. SBA helps less than 1 percent of America's small businesses. Its default rate is staggeringly high. Those new sunrise and high-tech companies that create a large proportion of new jobs receive only a miniscule amount of aid from SBA. Yet doctors and lawyers borrow from SBA to subsidize their highly profitable professions.

The argument that the SBA is needed to capitalize American small business is spurious. Government-provided or subsidized loans, in fact, are not a significant source of small business capital. For those businesses that do seek loans, SBA merely diverts funds from more worthy to less worthy businesses; it does not "create" new credit. Nor does the SBA generally help industries hurt by imports or create net new employment. SBA disaster loans duplicate the programs of other government agencies, and under the heading of "non-physical" disasters, the agency bails out many companies that have simply made bad business judgments. The SBA Management Assistance program, meantime, duplicates services offered by the private sector.

On the other hand, the Office of Advocacy in SBA performs a useful service by studying the impact of proposed federal regulations on small businesses. As such, the Administration's plan to retain this office is wise. But the value of this tiny section of the SBA provides no reason for saving the entire, costly agency. The remainder of SBA wastes taxpayers' money and should be eliminated.

SBA HELPS FEW BUSINESSES

SBA supporters insist that the Agency's primary function, providing loan guarantees and direct loans, is essential to the small business sector--especially to start up companies in need of capital. But in FY 1984, the $3.65 billion in SBA loan commitments went to less than two-tenths of 1 percent of the nation's small businesses, a mere 21,461 of over 14 million. Over 99.8 percent of American small businesses received no direct SBA aid. A survey by the National Federation of Independent Business (NFIB), moreover, reveals that, of those businesses receiving SBA loans, fewer than half rely on the loans as a primary source of capital.

SBA wins only tepid support, even from the small business community. NFIB found that half of the firms it surveyed oppose direct government loans;[1] two-thirds of these businesses have had no contact with SBA at all. This evidence refutes those who claim that the strength of America's small business sector is the result of SBA programs. Only a tiny fraction of small business has been aided by SBA.

If Congress really wishes to assist small business, it should tackle the real problems faced by entrepreneurs--government red tape, a confusing and burdensome tax system, and other barriers to business creation--rather than wasting the tax dollars of would-be and existing small businessmen on an agency that provides them with little or no real help.

SBA'S POOR LOAN RECORD

The High Default Rate

Some advocates of SBA argue that it plays a key role in identifying promising new firms, presumably overlooked by private sector funders, and nurturing them to maturity. There is little evidence, however, that SBA picks promising small businesses.

The default rate on SBA loan assistance has been high. In 1984, for instance, 18 percent of firms receiving guaranteed

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1 "Small Business Evaluates SBA," National Federation of Independent Business, June 1984.

loans had to be bailed out by the government; this costs taxpayers $544 million. In 1983 the default rate was 26.8 percent, and in 1982 it was 39.9 percent. There is little justification for gambling tax money on a program that picks such a high percentage of losers. Yet if qualifications for loans are so tightened that only "safe" businesses can obtain them, as the SBA is attempting to do, then surely such businesses, with a little persistence, could obtain loans from private sources.

The SBA claims that the true rate of dollar loss on investments is only 6 percent. This is nothing to be proud of. But these SBA figures do not accurately reflect the true dollar loss rate. The SBA's 6 percent figure uses as a base the value of loans that have reached maturity plus outstanding loans, and to calculate the loss from defaults, the outstanding loans are all treated as "good loans," even though they might, and often do, default. An examination of only those SBA loans that have reached maturity yields a different picture. For example, the loans made between 1971-1974, when examined at maturity, showed a loss rate of over 10 percent. The Office of Management and Budget projects the loss rate on loans made between 1978-1981 to be 12 percent, twice the rate SBA asserts.[2]

Shunning Sunrise and High-Tech Industries

Some proponents of SBA loan assistance argue that, even though assistance reaches just a tiny fraction of risk-prone businesses, these firms, such as computer manufacturers and electronics firms, are vital to the U.S. economy. The facts do not support this argument.

Of the 600,000 new businesses formed in 1983, less than 2 percent received any SBA assistance.[3] Few of these are important new high-tech companies that otherwise would not have been able to obtain funds in the open market. Of the start-up businesses receiving SBA assistance in 1983, less than 1 percent were involved in new technologies. Between 1976 and 1982, the number of sunrise firms in such fields as computer equipment, software, telecommunications, office equipment, and medical instruments, soared by over 26,000. Of these, barely 600 received SBA loans.

Scrutiny of SBA loans reveals that nearly 60 percent go to various retail and service businesses. Example: 16 percent of SBA assistance in 1984 was channeled into restaurants, bars, liquor stores, bowling alleys, pool halls, golf courses, tennis clubs, and other entertainment businesses. While such enterprises provide useful goods and services for the consumer, there is no

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2 David Stockman, Testimony before the Senate Committee on Small Business, February 21, 1985.

3 "Rathole and Rabbit Hole," The Wall Street Journal, February 28, 1985, p. 28.

shortage of such businesses or of private funds to finance them. There is no evidence that these business sectors need federal money. Viable new firms in such areas can easily obtain private capital.

Doctors, dentists, lawyers, accountants, and other professionals obtained nearly 7 percent of SBA loan assistance in 1984. With the average salary of a U.S. physician now over $100,000, and the salaries of these other professionals also well above the national average, there is no justification for their receiving federal funds to start their businesses.

Many SBA loans are highly questionable by any standard. Example: Show World Center, Inc. acquired two loans from New York investment companies, guaranteed by SBA, for operations that included the sale of X-rated books, movies and magazines, live sex acts, and performances by nude dancers.[4] Example: Glen's for Men, a Southern California chain of homosexually oriented bathhouses, was backed by the SBA. Another business used $200,000 of its $1,000,000 SBA-assisted loan to purchase a 42-foot yacht.[5] Even Senator Lowell Weicker (R-CT), one of SBA's strongest supporters, admits that "SBA is letting itself be ripped off, and the taxpayer is footing the bill."[6]

It would be one thing if SBA's losses and poor investments were the result of the agency's having taken legitimate chances with innovative entrepreneurs. But this is not the case. The SBA shuns firms producing goods or services that are pathbreaking. There are countless examples of innovative firms, trying to market new products, that were turned down by the SBA for no apparent reason, while coin-operated laundries obtained loans. Last year Inc. Magazine reported the trials of a firm which had developed a promising anti-cancer device but was nearly ruined by SBA's nine-month-long bureaucratic process.[7] The firm never did get the loan despite meeting countless special requirements. Ex-SBA offical, Jere Glover, confirms that this is in no way atypical: "They [the SBA] have a problem with high technology loans, and they know it. If this had been a car wash or a restaurant, it would have sailed right through."[8]

The pattern of SBA loan commitments points to the inherent flaws in the agency. While its loss rate is high, the SBA is, in many ways, too cautious, shunning high-tech and new sunrise industries in favor of more conventional retail businesses. This

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4 "Small Business Loans Aid 'Minority' Whites, the Rich, A Porn Film," The Wall Street Journal, June 8, 1982, p. 1.
5 Ibid.
6 As quoted in "S.B.A.: A Ripe Target for Big Ripoffs," U.S. News and World Report, March 22, 1982, p. 11.
7 Bo Burlingham, "Let Them Make Mud Pies," Inc., July 1983, pp. 65-74.
8 Ibid., p. 66.

is not surprising since the qualities that make a good business entrepreneur are not those that make a good public sector bureaucrat.[9] The entrepreneur breaks rules and takes risks. The bureaucrat must adhere to agency rules and policies and take care not to risk needlessly the public's tax money. The bureaucrat also is susceptible to political pressures and likely to make politically expedient but economically unwise decisions.

Local bankers and other private institutions are clearly better suited to make loan decisions concerning small businesses. SBA does not promote innovation, nor does it do a good job at promoting more pedestrian enterprises. The SBA loan program is inherently flawed. It is not an issue of tightening loan requirements. The only responsible action is to scrap the loan assistance program.

Diverting Credit to Less Worthy Businesses

Currently, the fraction of 1 percent of businesses that do receive SBA loan assistance diverts resources from more worthy businesses. To qualify for SBA aid, a business must be turned down at least twice by a private lending institution. If such a business wins an SBA loan guarantee, any bank lending to that business is guaranteed payment of 90 percent of the value of the loan in case of default. The business then seeks a private sector loan and will clearly be given first chance at loan money by banks that understandably welcome such federally insured, low-risk investments.[10] Thus the guarantee encourages the bank to divert funds from businesses that are sounder firms but have no SBA protection. The result: many small and potentially successful businesses are locked out of the credit market by SBA loan guarantees that favor other, probably less successful, small firms.

HOW SMALL FIRMS OBTAIN CAPITAL

Even if the SBA improved its lending practices, it would not be the best vehicle to help America's budding entrepreneurs. Institutional loans, whether guaranteed by SBA or directed from banks and other lending agencies, are simply not the primary source of capital for small businesses. A National Federation of Independent Business (NFIB) survey reveals that fewer than half of the 3 percent of existing small businesses that have ever received government aid relied on it as the primary source of

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9 See Ludwig von Mises, Bureaucracy (Westport: Arlington House, 1969).

10 While the SBA loan program is of little benefit to small businesses, banks have profited handsomely. Since 90 percent of any given SBA loan is insured against default by the government, banks can earn a return of up to 40 percent on the typical SBA guaranteed loan. See: Harold Bergan, "The Maverick Moneylender," The New Republic, February 10, 1982, p. 21.

their capital. For nearly 60 percent of America's small businesses, start-up funds come from savings of the owners or those of their friends and family.

This suggests that the best way to help new firms is to encourage risk taking and to enable Americans to retain and save a greater portion of their earnings. The further reduction or elimination of capital gains taxes, for instance, would increase savings greatly, while improving the return on investments in new firms. This would make more capital available for both large and small companies. And cutting personal taxes would allow individuals to keep more money to invest in new business enterprises. By making private capital more available, these measures would do far more to help small businesses than is accomplished by the SBA.

SBA supporters maintain that those small businesses that require loans often run into special problems that are alleviated by SBA, including scarce credit going mainly to large conglomerates, difficulty in acquiring long-term credit, and higher interest rates on their loans. Yet the Interagency Task Force on Small Business Finance, formed by the Federal Reserve Board in 1982 to investigate lending practices to small businesses, contradicts these statements. Loan approval rates for established small firms, the Task Force discovered, were virtually the same as for large businesses over the survey period. Moreover, the interest rates charged to small businesses were generally no higher than those charged to large businesses.[11]

These findings were later corroborated by a National Federation of Independent Business study, which concludes that it was very rare for small businesses to pay interest rates of more than 2 points over prime.[12] Even more important, the NFIB members--all of whom are small businesses--did not cite long-term credit financing as a particularly burdensome problem; of 72 factors impinging upon a firm's business, unavailability of long-term credit was not even ranked in the top half. This directly contradicts the rationale for the SBA.

It is true that most studies have found a slight difference in the rates charged to small and large businesses (anywhere from 1 to 2.75 percentage points). This alone, however, is no reason for the SBA to exist. Such differential treatment of small and large businesses, after all, is consistent with sound lending practices and does not signal any market imperfection requiring fine-tuning by government bureaucrats. Large businesses are the beneficiaries of preferential interest rates because they are

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11 Cynthia Glassman and Peter Strulk, "Survey of Commercial Bank Lending to Small Business," The Interagency Task Force on Small Business Finance, Federal Reserve System Studies on Small Business Finance, 1982, p. 8.

12 As quoted by Michael Abrahams, "Fall Review for the Director of OMB--1983," 1983, p. 2.

proved successes in the marketplace, with demonstrated managerial skills, and the ability to write off losses through diversification. In short, they pose less risk for the lender. By contrast, small business ventures, though vital to a growing economy, are inherently more risky; 99 percent of all business failures are firms of less than 100 employees.[13] And risk is a central determinant of the cost of a loan. The SBA's own data reveal that during the 1976-1980 period (the most recent data available) the four-year survival rate for large firms was over 20 percent higher than the rate for firms of 0-20 employees.[14] The differences in interest rates charged to small and large businesses, therefore, reflect a rational response to risk, not a market imperfection.

OTHER SBA MYTHS

In addition to SBA's poor record in stimulating the creation of small businesses in America, proponents of the agency cite supposed benefits accruing from SBA that turn out to be myths. Among them:

1) SBA loans help "import-impacted" industries.

Amid recent speculation over the effect of the strong dollar on domestic production and the more general fear of imports flooding U.S. markets, some claim that SBA loans cushion foreign competition. This argument is without merit. For one thing, the federal government already has at least three programs designed to shield industries from "harmful" foreign competition. For another thing, there is little evidence that SBA assistance has actually been targeted toward "import-impacted" industries. Over three-quarters of SBA loans in 1984 went to firms in industries whose activities have nothing to do with international trade. And when the Office of Management and Budget (OMB) identified the twelve industries hardest hit by international competition in 1984, it found that they received less than one-half of 1 percent of SBA's loan portfolio.[15]

2) SBA loans generate employment.

Proponents of the SBA claim that as many as 350,000 new jobs have been generated by firms receiving SBA assistance.[16] This ignores two key aspects of the job generation process. First, in the aggregate, the net effect of public spending and guarantees on job generation almost always has been found to be negative.

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13 The State of Small Business, A Report of the President, Government Printing Office, March 1984, p. 36.

14 Ibid., pp. 70-71.

15 Stockman, op. cit., p. 16.

16 Senator Lowell Weicker, Congressional Record, 99th Congress, First Session, Vol. 131, No. 27, Part II, March 7, 1985.

Public spending typically eliminates at least as many jobs as it creates, since it can only help one group of firms by imposing job-destroying taxes on another group. Private credit diverted to SBA otherwise would have gone to more credit-worthy businesses generating at least an equal number of jobs. Second, the 350,000 job creation figure assumes that none of the firms that received SBA assistance would have gone into business had it not been for the availability of the government's aid. This is demonstrably erroneous, since a large number of firms turned down for SBA loans eventually received financing elsewhere and thus went into business anyway.

There are employment generation policies, such as reducing regulation, business taxes, and government spending, which are far more efficient for the government to pursue than is a selective loan program.

3) SBA disaster loans help the economy.

The SBA disaster loan program is designed to provide emergency loans to small businesses damaged by physical or non-physical disasters. The physical disaster component is a $500 million program covering floods, windstorms, and similar catastrophes. This hardly seems a federal government responsibility. The prudent businessman should secure private insurance to protect his investment. In fact, the vast majority do so. The disaster loan program merely allows firms to avoid insurance costs. The SBA disaster loan program, moreover, duplicates the services offered by other government agencies, such as the Federal Emergency Management Administration.

Some may argue that federal physical disaster assistance is justified under certain circumstances. This surely is not the case with the reasons for non-physical disaster aid, such as changing market conditions. Example: A sporting goods stores experiencing declining sales of ski equipment due to a lack of snow qualified for an SBA loan. Example: Gift shops, boat chartering companies, and hot tub emporiums in South Florida have received aid when they claimed that the tourist industry had been harmed by the sudden influx of Cuban refugees. Example: The devaluation of the Mexican peso qualified U.S. businesses near the border for SBA loans.[17]

Such loans are disguised subsidies that force the U.S. taxpayers to underwrite business losses resulting from normal business risks and, in many cases, poor business judgment. Since "non-physical disaster" is such a vague category, and since the SBA cannot possibly assist every firm harmed by such "disasters,"

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[17] "SBA Entrenched as Petty Cash Drawer," The Washington Post, February 11, 1985, p. 1.

the standards for selecting recipients are often arbitrary and political.

One particularly curious form of "non-physical disaster" assistance is for small businesses that suffer losses due to "direct government action." This has included suppliers of farm equipment who suffer losses thanks to government programs paying farmers not to grow food. While it may be fitting for such government programs to be officially recognized as "disasters," a more sensible approach would be to eliminate such damaging programs, rather than compensate businesses for the problems they cause.

SBA also provides low-interest loans to cover farm disasters. These overlap with the Department of Agriculture's Farmers Home Administration assistance programs. This duplication allows farmers to shop around for the lower interest rate, usually selecting the SBA. Terminating SBA farm disaster loans would eliminate interest inequities and consolidate farm relief programs in the Department of Agriculture, where they belong.

4) <u>SBA management assistance is essential to the health of American small business</u>.

The SBA Management Assistance Program of SBA operates 36 development centers in 33 states at a cost of $28.5 million annually. These centers are supposed to offer information and assistance to small businesses. An NFIB survey, however, found that only 10 percent of small businesses said they would go first to the SBA for such advice. Most prefer to check with other businessmen or private consultants. Further, the services provided by these SBA centers are available in abundance from private consultants, colleges, universities, and business schools. This SBA program is still another example of a service provided quite adequately by the market--yet duplicated by the federal government and not even extensively utilized by the constituency it is meant to serve.

THE CASE FOR SBA'S OFFICE OF ADVOCACY

The Office of Advocacy researches the impact of federal government policies on small business and speaks inside government for the interests of small business. This function should be retained and could be by transferring the office to the Department of Commerce. Many government policies benefit one sector of American business at the expense of others. Small entrepreneurs understandably have less political clout than huge corporations. Without an institutionalized voice speaking for small business within the government, the burden of unwise federal programs could easily fall disproportionately on the shoulders of small companies.

CONCLUSION

The SBA helps so few businesses that its elimination would have no effect on America's small business sector. Some 99.8 percent of all small U.S. businesses get along well without SBA financial assistance. The Reagan budget proposal calls for complete elimination of SBA. Some advocates have suggested that SBA merely be reformed or that funding be reduced but not eliminated. This approach ignores three vital points: (1) SBA has been claiming for the last four years that it is cleaning house; today it is as bad as ever. (2) Since SBA is conceptually flawed--it diverts credit from more worthy businesses to a handful of risky enterprises that find favor with federal bureaucrats--no reform short of termination will serve the public interest. (3) If SBA funding is cut back but not eliminated, it will not be long before legislators, seeking pork barrel favors for their business friends, will manage to restore the cut funds.

The SBA is not vital to small business and is a waste of billions of taxpayers' dollars. The sooner SBA is eliminated, the better it will be for American small business.

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