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TESTIMONY

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"Small Business Administration: Is the 7(a) Program Achieving Measurable Outcomes"

[1] The views expressed in this testimony are solely my own and are not official positions of the Mercatus Center or of George Mason University.

Section 1: Introduction

The promotion of small business is a cornerstone of U.S. economic policy. Policymakers constantly point to small businesses as important sources of employment and economic growth.[i] There are about 25 million small firms in the U.S., employing almost 50 percent of all workers. Hence, even when politicians find little else to agree on, there is strong bipartisan support for government intervention aimed at promoting small business in the U.S.

A particular area of concern for policymakers is whether, in a free market, small businesses can access sufficient credit. The imperfections of credit markets, particularly for small businesses, are often used as the quintessential illustration of a market failure that necessitates government intervention.

Growing firms need resources, but many small firms may have a hard time obtaining loans because they are young and have little credit history. Lenders may also be reluctant to lend to small firms with innovative products because it might be difficult to collect enough reliable information to correctly estimate the risk of such products. If it's true that the lending process leaves worthy projects unfunded, some suggest that it would be good to fix this "market failure" with government programs aimed at improving small businesses' access to credit.

Encouraging lending to small businesses is one of the primary purposes of the Small Business Administration (SBA). Established as a tiny lending agency in 1953, the SBA has mushroomed into a multibillion dollar financial institution with a significant presence in the credit market. By the 1990s, the SBA had become a conglomerate agency pursuing multiple policy objectives. New programs were established to provide venture capital to growth-oriented companies, assist minority entrepreneurs, and lend management assistance to firms struggling to compete.

According to the SBA's Office of Advocacy, nearly 20 million small businesses have received assistance from one of the SBA's many programs since 1953. In particular, the SBA's flagship loan guarantee program, the 7(a) program, has grown significantly over the past decade. In FY2008, the SBA will guarantee $28 billion in loans alone, promising repayment of up to 85 percent if the borrower defaults. With a guaranteed and direct loan portfolio approaching $90 billion, SBA has an critical role as a steward of taxpayers' dollars.

My testimony is devoted to an important issue: the measurement of of the SBA's 7(A) Loan Program's performance. So far, the SBA has done very little to measure the performance of its loan guarantee programs. And to the extent that it has, it has done a very poor job. A recent GAO report finds that the SBA only measures outputs and not outcomes.[ii] In other words, the agency has focused its attention mainly on measuring how much it spends on the program rather than measuring the value added to the economy through the program and whether the value added from the program is worth the cost to taxpayers or the underlying financial risk associated with the loan programs. GAO also noted that while the agency is looking into creating outcome based performance measures, there is no timeline for when they will be introduced or how they might work.

Measuring the performance of the loan program is important as it will help the SBA decide whether it should remain in the banking, credit allocation, and subsidy

business or whether it should terminate these activities. However, measuring the performance of the SBA loan program is only useful to the extent that it triggers consequences if the program is found to under perform or to be useless.

Section 2: How Does the SBA Work?

The SBA's 7(a) loan program, its largest lending program, is intended to serve small business borrowers who cannot otherwise obtain financing from the private sector.[iii] The SBA does not provide loans directly. Instead, after proving that it couldn't get a loan under *suitable* terms and conditions, a small business applies to an SBA-certified bank.[iv] The bank then performs a complete analysis of the application. The SBA then reviews the application to decide whether the business should receive a loan.

In order to induce banks to lend money to credit-risky small businesses, the SBA guarantees the loan. If the borrower defaults, the SBA reimburses the lender up to 85% of the loss that the lender would otherwise sustain. With such a guaranty, lenders are often willing to accept a greater credit risk and grant more favorable terms than they might otherwise.[v] To offset the costs of the SBA's loan programs to the taxpayer, the SBA charges lenders a guaranty fee and a servicing fee for each loan approved and disbursed. While these fees are higher than commercial loan fees, SBA loans have easier credit terms and longer repayment periods than most commercial loans.

Section 3: What Should We Measure?

Like every other program, the SBA lending programs are supposed to achieve certain goals. Often, the programs' goals are based on the idea that there is a need somewhere that must be met and/or that the market is not delivering a specific good or service that we, as a society, believe should be delivered.

When thinking about measuring the performances of SBA loan programs, several questions must be asked.

Does SBA have a clear idea of what its goal is?
Do we really have a need for SBA lending programs today?
If a market failure exists, what is its scope and consequences?
Are SBA programs in fact achieving their stated goals?
What is the economic value added of SBA loan programs?
How do you measure that value?
Is the value added worth the cost to taxpayers?

Section 4: Does SBA Have an Outcome Oriented Goal?

The Government Performance and Results Act of 1993 requires agencies to produce strategic plans, annual performance plans, and annual performance reports. Performance reporting started in fiscal 1999. Researchers at the Mercatus Center at George Mason University initiated a Scorecard in fiscal 1999 to foster continuous improvement in the

quality of disclosure in agencies' annual performance reports. The scoring process evaluates (1) how transparently an agency discloses its successes and failures; (2) how well an agency documents the tangible public benefits it claims to have produced; and (3) whether an agency demonstrates leadership that uses annual performance information to devise strategies for improvement. An expert team evaluated each report on 12 criteria—four each for transparency, public benefits, and leadership.

One of the many important things the scorecard measures is whether or not an agency understands its purpose or even has a clear understanding of what outcome it is trying to achieve. This year scorecard concludes that in fact the SBA lacks outcome-oriented goals. And if that's the case then they are unable to measure how they achieve that outcome.[vi]

SBA's FY06 annual report describes the agency's four strategic goals and 12 strategic (long-term) objectives.[vii] The first three strategic goals are programmatic and stated as outcomes, but at such high levels that measurement is challenging. For example, the first strategic goal is: "Improve the economic environment for small businesses." While this is an outcome, it depends on many more factors than just the SBA. Utilizing this as a performance measure is not necessarily indicative of the success or failures of SBA.

Of the seven strategic objectives under the programmatic strategic goals, two are too general to be categorized as outcome-oriented (1.2 "Simplify the interaction between small businesses and the Federal Government through the use of the Internet and information technology" and 2.1 "Increase the positive impact of SBA assistance upon the number and success of small business start-ups"). The fourth strategic goal is management-related and has five strategic objectives ("Ensure that all the SBA programs operate at maximum efficiency and effectiveness by providing them with high quality executive leadership and support services"). While this goal and its objectives are not stated as outcomes, they do cover some areas that focus on enhancing the agency's capacity to accomplish its mission outcomes. The agency does not have a distinct set of annual performance goals, which makes it nearly impossible to track the annual progress towards these larger outcomes.

There is also an issue with the measures being used. The SBA annual report lists 11 agency-wide performance measures and classifies all of them as "outcomes."[viii] However, it appears that only about half of these are truly outcome measures. For example, the four measures SBA has used to evaluate the goal of "Increas[ing] small business success by bridging competitive opportunity gaps faces entrepreneurs" all seem to deal with levels of assistance rather than outcomes.[ix] Most of the program or component-specific measures covered in the performance section of the report are activity, output, or efficiency measures rather than outcomes. For example, measure 3.1.2 is a useful outcome measure: "Percentage of businesses sustaining physical damage restored within six months after final disbursement of a disaster loan."[x] By contrast, it is difficult to see what impact towards an outcome is demonstrated by a measure for number of research publications issued.[xi]

The SBA annual report also lacks inclusiveness by disclosing only a select few measures in its annual report. This hinders the ability to get a clear picture of SBA's success as much as any of the other problems noted. To the extent they are disclosed in the report, the agency's performance metrics are fairly weak overall. The few agency-wide measures described under strategic goals 1 and 3 are good. However, the rest of the measures described in the report lack outcome-orientation. As noted previously, the report does not disclose the rest of the agency's measures and their results. The narratives accompanying the specific descriptions of performance results also are generally weak and provide the reader with little perspective to assist in assessing the agency's performance.

Section 5: Are the SBA's Loan Guarantee Programs Justified Economically?

The SBA's 7(a) loan guarantee program rests on the premise that small businesses are denied adequate credit in the free market because of a market failure. A common assumption is that the main obstacle to new business formation is the inability of would-be entrepreneurs to acquire the capital necessary to start a business. As a result, the assumption underlying the SBA loan guarantee program is that creditors do not lend to small businesses because they are too risky. In a perfect market, creditors would increase their prices to adjust for the higher risk, and in equilibrium, no small businesses would be left without the loans they wanted. The argument is that capital markets are not perfect, however, and as a result, small businesses cannot always get the capital they need to get started or to expand. But when the SBA guarantees a portion of a small business loan, it takes on some of the risk. In this way, the SBA gives lenders an incentive to offer loans to individuals who would otherwise be too great a risk.

In this model, SBA loan guarantees for small businesses are justified as a way to correct financial market inefficiencies that make it difficult for small firms to access capital. But do small businesses really have a hard time accessing capital and getting loans from banks?

Market Failure?

SBA loan guarantee programs stem from the premise that in a free market system some type of market failure denies small businesses credit. The most-cited source of such a failure is the asymmetry of information between lenders and borrowers—potential borrowers know their own financial situation and likelihood of repayment far better than lenders.

In their seminal 1981 paper "Credit Rationing in Markets with Imperfect Information," Joseph Stiglitz and Andrew Weiss explore the effect that asymmetry of information between lenders and borrowers has on the capital market and commercial lenders.[xii] According to them, because banks cannot distinguish between high and low-risk borrowers, the demand for credit may exceed the supply. To respond to this situation, banks should increase the price of loans by increasing interest rates. These higher interest rates would then decrease the borrowers' demand for credit. But because of inefficiencies in the capital market, banks do not do this.[xiii] Instead of increasing interest rates, banks simply ration credit, denying loans to worthy projects.

The SBA and its supporters argue that by guaranteeing a portion of a small business loan, the government takes on some of the risk of the loan. Reducing the risk in this way gives lenders an incentive to offer loans to businesses that they would otherwise deem risky. In this model, SBA justifies loan guarantees for small businesses as a way to correct financial market inefficiencies to reduce the deadweight losses associated with not funding all worthy projects.

The Not-So-Rationed Credit Market

A growing body of research also challenges the belief that credit rationing makes it difficult for small businesses to obtain capital. The academic literature gives no indication that private capital markets do not give credit, at the right price, to the businesses that deserve it at that price. Economists David de Meza and David Webb, for example, have published many articles since the 1980s in various academic journals showing that banks are not reluctant to lend money to small businesses outside the SBA program.[xiv]

Empirical research confirms this fact. The Federal Reserve Board's 2002 *Report to Congress on the Availability of Credit to Small Businesses* showed that the demand for small business financing closely tracked the pattern of debt growth from 1997 to 2002, which suggests a healthy correlation between the demand and supply of financing.[xv]

The Census Bureau's 1992 *Characteristics of Business Owners* survey shows that low sales are a much more important factor in small business failures than a lack of access to financing (see table 1). Of all the unsuccessful businesses in the survey, 71.7 percent of owners cited inadequate cash flow or low sales as a reason for failure; only 8.2 percent said a lack of access to business loans/credit contributed to the end of their businesses.[xvi]

According to the 2007 GAO report, the studies they reviewed did note some disparities among different groups in their ability to access credit.[xvii] However, there was no evidence for the reason of the differences and doesn't necessarily implies discrimination.

This is not to say that all potential entrepreneurs have unlimited access to affordable credit. They do not. But it is to say that while some people who want to start small businesses may not have access to affordable credit, a lack of access to affordable credit is not preventing small business formation overall in the United States.[xviii] Plenty of other small businesses have sufficient access to affordable credit.

This is not surprising. First, banks have a strong incentive to lend money to small businesses: profit. As even the SBA Office of Advocacy admits, "banks that concentrate on a small business niche can realize significant profits and increase their overall market value."[xix]

Second, bank loans are only one of many ways to acquire credit. Table 2 shows that while more than 80 percent of small businesses surveyed used some kind of credit, approximately 71 percent used non-commercial bank sources of financing, of which personal credit cards were the most prevalent.[xx]

Market Responses to Information Problems

Let's even assume that there is a market failure and that the asymmetry in information between lenders and borrowers leaves many credit worthy small businesses

unable to get credit and generate economic growth. This is not scarcity of capital problem it is an information problem. Distributing loans to borrowers on the grounds that they do not have access to credit does nothing to solve the information problem, and it isn't doing to much to identify which of the small businesses rejected by conventional banks could produce real growth either. What's more, the SBA underlying assumption is that only government intervention can address an asymmetry of information, but evidence from the market indicates that such asymmetry is not actually a market failure as financial markets have developed effective private solutions to such information problems.

Lending Relationships

One of the mechanisms that have emerged to address the information problem in capital markets is the development of "lending relationships." In lending relationships, familiarity does not breed contempt; it breeds appreciation. Banks are less likely to ration borrowers that have a history with the bank, larger accounts, and greater expected account growth. When evaluating longtime clients, banks will consider not only the clients' immediate creditworthiness, but also the banks' potential lost profits from damaging good relationships.

Lending relationships are also about gaining information. Repeated interactions with clients for different purposes give lenders information about the clients' creditworthiness—either specific financial information or "soft information" about the clients' characters. This greater information lowers the cost of lending and thus increases the availability of credit.

Credit Scoring

By taking information—such as monthly incomes, outstanding debts, financial assets, length of time at current job, previous loan records, and home ownership—from credit applicants and using statistical methods to generate numeric scores, credit scoring can predict the applicants' propensities to default or become delinquent. Credit scoring not only reduces greatly the cost of information-gathering, but, by improving a bank's ability to predict default, it also helps banks lend funds to borrowers more accurately.

In fact, the evidence suggests that credit scoring has increased the availability of credit to small firms. For instance, research by Allen Berger, Scott Frame, and Nathan Miller (2005) suggests that small business credit scoring is associated with increased small business lending, higher loan prices, and greater average loan risk.[xxi] They find that credit scoring increases credit availability for relatively risky borrowers. Credit lender will simply have these risky borrowers pay relatively higher interest rates for their loans in order to compensate for the risk they represent. "The result" says Dr. Chad Moutray, Chief Economist for the Office of Advocacy at the SBA, "is a financial market that tends to efficiently allocate capital to small businesses."[xxii]

Section 6. Is the SBA Doing What It Says It Does?

The economic justification for any government-sponsored lending or loan guarantee program must rest on a well-established failure of the private sector to allocate loans efficiently. Absent such a private sector deficiency, the SBA's activities would simply be

a wasteful, politically-motivated subsidy to this sector of the economy. As demonstrated in the previous section, the private sector does not seem to suffer from such deficiencies, which suggests that there is no economic justification for SBA loans.

Yet many argue that some public policy objectives require the sacrifice of marketplace efficiency. It is an accepted feature of modern American government that some public interests or social policy gains can outweigh economic losses and hence are worth selected override of our free-market values. In the case of the SBA, its lending programs could fulfill specific public policy objectives that the marketplace on its own would not otherwise serve or would supply at suboptimal levels. But does it?

In describing its role in the economy, the SBA proclaims that small is beautiful: "Small business is where the innovations take place. Swifter, more flexible and often more daring than big businesses, small firms produce the items that line the shelves of America's museums, shops, and homes. They keep intact the heritage of ingenuity and enterprise and they help keep the 'American Dream' within the reach of millions of Americans. Every step of the way, SBA is there to help them." From this belief, it naturally follows that we need more small businesses around and should implement policies that will increase the number of small businesses. Glorifying small businesses also leads to the idea that small business owners deserve assistance because they are morally admirable and more deserving than big business owners. They create more jobs and economic growth than larger firms while facing what some consider to be unfair competition from big business. Along the same lines, the SBA points to racial and gender disparities as a justification for assistance to disadvantaged groups in particular.

SBA can thus be judged based on its ability to meet these public policy goals—namely, to fill the gap between supply and demand of small business loans, particularly for women- and minority-owned small businesses. To measure the SBA's results, I have analyzed the flow of SBA credits to evaluate who receives them and whether the SBA is meeting its stated policy objectives to promote new startups, to encourage female and minority business owners, and to help small businesses become big ones.

A close examination demonstrates that neither stated SBA policies nor its actual lending patterns provide evidence that SBA loan guarantees serve any focused or rigorously defined public policy purpose at all.

SBA Lending Profile

In the recent AEI working paper, I looked at the flow of SBA credit in order to identify how well the SBA is serving its stated objectives, such as promoting new startups, helping small business compete with big business, and stimulating high tech investment, economic growth, and job creation.

Seven main conclusions could be drawn from the data.[xxiii] One, no more than 1 percent of small businesses loans are SBA loans each year. This makes it hard to argue, as the SBA does, that it is helping solve a credit rationing problem and that without SBA loans small businesses would have a hard time accessing credit. The private sector finances most loans and hence, the SBA is largely irrelevant in the capital market.

Two, 75 percent of SBA 7(a) loans go to helping a very small fraction of small businesses in mainstream service, retail, and wholesale sectors. Even in those sectors most likely to receive SBA loans, only about 1 percent of all firms do.

Three, the SBA is helping a minuscule fraction of small businesses in each sector compete against other small businesses in the same market. In the 25 sectors receiving the largest share of SBA 7(a) loan guarantees, less than 0.5 percent of the small businesses received the guarantees.

Four, there is no shortage of firms or new startups or services in America. Looking at the data, there is no compelling reason to suggest that new businesses would not be started without the SBA's 7(a) loan program since less than 3 percent of start-ups received SBA loans between 1998 and 2002.

Five, in 2004, 29 percent of 7(a) loan guarantees went to minority business owners but SBA distributed loans to only 3 percent of all minority owned firms. This makes it hard to argue that SBA loans programs have a significant impact on minority owned small businesses. The same trend is true for women-owned firms.

Six, markets are functioning well in the sectors that account for 75 percent of SBA lending. There are an overwhelming number of firms, a large amount of competition, and no empirical evidence that the market is being underserved in these areas.

Seven, most of the restaurants, car repair shops, grocery stores, dry-cleaning stores, and daycares that compete with SBA borrowers paid the market rate to meet their credit needs. By giving a credit market advantage to some small businesses, the SBA ends up harming the competing small businesses.

In short, it appears that no unique policy objectives are served by extending subsidized credit to less than 1 percent of the firms that supply basic economic services.

Using FY2005 numbers, the GAO recently confirmed these finding. The GAO report finds that 7(a) program guaranteed 90,000 loans valued at $14 billion in FY 2006. It notes that 7(a) represents about 4% of all outstanding small business loan dollars and 1.3% of the number of outstanding small business loans in 2005.[xxiv]

GAO also notes that from 2001 through 2004, more than a quarter of 7(a) loans went to small businesses with minority ownership and about a quarter to start-ups, compared to about 10 and 5 percent of conventional loans that went to minority-owned business and start-ups. For female-owned small businesses and small businesses located in economically distressed neighborhoods, the proportions of 7(a) and conventional loans were more similar (22 percent versus 16 percent for female-owned and 14 percent versus 10 percent for distressed neighborhoods.

However, even though this data is interesting it doesn't say much about the relevance of SBA loans. The true question is really, of all the loans going to women or minority owned small businesses, how many were SBA loans. Using the GAO data, we find that even though a large share of SBA loans went to women and minority owned businesses, less than 5 percent of all loans going to women and minority owned businesses were SBA loans.

Responding to the Argument that SBA's Relevance Rests on Long Term Lending

In response to the argument that 7(a) loans represent 1.3% of the number of outstanding small business loans in 2005, we often hear that what really matters is that 7(a) loans represent 40 percent of long term loans (defined as loans that last for 3 or more years). In the word of David Bartram—chairman of the National Association of Government Guaranteed Lenders (NAGGL), a national trade organization comprised primarily of lenders participating in the 7(a) guaranteed loan program, and president of the SBA Division of US Bancorp, the nation's sixth-largest financial services company—" [long term borrowers are] the real targets that SBA hits upon. Not every small business out there, but companies that need long term financing."[xxv]

Everyone understands the value of being able to have access to longer term loans. However, there is a sound reason why banks usually do not extend long term loans to small businesses. It's not that they are mean or want to hurt small businesses. They're simply reducing the risk of lending money to small businesses.

Loans to small firms, firms with low ratings, and firms with little cash available to service debt, for example, are more likely to be small, secured by collateral, and have a short contractual maturity. Larger and more profitable firms are able to borrow on better terms across all three of these non-price dimensions. However, economist Philip Strahan (1999) explains, the price and non-price terms of loans are jointly determined to help solve information problems; pricing, collateral, maturity and loan size are used as complementary tools to deal with borrower risk.[xxvi]

Banks put smaller, less profitable and more opaque borrowers (as measured by the market-to book ratio) on a shorter leash. These borrowers must go back to the bank more often than larger, better established firms to prove that their prospects remain bright. It doesn't mean that they do not ultimately have access to long term lending. It just means that they have to go back to the bank more often to extend their loan. This is the price of having access to capital at suitable terms rather than not having access to capital or having access to it at extremely high rate.

Another set of tools that financial institutions use in debt contracts to solve the informational opacity problems of small businesses include restrictive covenants and choice of maturity. The debt contracts issued by commercial banks, finance companies, and other financial institutions are often covenant-rich, requiring the borrower to return to the institution to renegotiate these covenants when strategic opportunities to enhance value arise or when the financial condition of the firm changes (Berlin and Loeys 1988, Carey et al. 1993). In part, these covenants and their renegotiations are intended to give the lending institution more control and prevent borrowers from engaging in risk-shifting behavior. By using specific financial ratio and activity restrictions linked to periodic submission of financial information, covenants limit the firm's ability to change its financial condition or strategy. Thus, covenants can force a borrower to obtain permission from its lender before embarking on significant strategic changes. One theoretical result is that the strictest covenants are expected to be placed on the firms with the most credit risk and greatest moral hazard incentives (Berlin and Mester 1993). Interestingly the data show that these restrictions benefit small firms because these firms end up using an experienced banker or financial institution that can guide them through difficult business choices.[xxvii]

In the long run, the length of the loan doesn't matter. Small businesses that want/need long term loans, but are risky and have difficulty getting access to capital,

are likely to have loans with shorter maturity and then renegotiate those loans. So a firm that is getting a conventional short term loan and a firm that is receiving a SBA long term loan could both be undertaking similar long term projects. If both ways can provide the same result--the firm getting financed--then why does it matter if the loans are successive short term ones or a single long term loan? It doesn't. Moreover, even in this artificially defined market of "long term loans", the private sector provides 60 percent of the loans without the federal guarantee.

Finally, there is an important fairness question attached to this issue. If long term financing is such an important factor in the success of small firms, why should some borrowers benefit from it while others don't? In particular, why should small businesses owners who haven't been able to get credit through traditional means and prove themselves worthy of the trust of a commercial bank benefit from terms to which most creditworthy borrowers don't have access Why should not being able to get credit in the first place payoff in the end?

Section 7. Measuring the Value of SBA Loans

The evidence presented above points in one direction: the SBA's 7(a) loan guarantee program is unlikely to have a significant positive effect on the market. But you would never know this from the SBA's evaluations of its programs. The SBA does not publish or even try to measure the gains, whether economic or social, of its programs. In fact, the SBA's only measure of success amounts to stating how many loans have been guaranteed in a given year and how much it has spent on small businesses, rather than measuring the return on its efforts.

As noted by the GAO in July 2007, the SBA does not collect any information to determine how well firms perform after receiving 7(a) loans. So there is no way of knowing if the program is reaching its strategic goal to "increase small business success by bridging competitive opportunity gaps facing entrepreneurs."[xxviii]

Remember that the theory behind SBA lending programs is that lenders overlook borrowers that if given access to credit would generate economic growth. As such, measuring the performance of SBA loans should include their effect on economic growth. It is possible, for instance, that even though a large share of SBA borrowers default on their loans, the economic growth triggered by the other borrowers compensates for the losses. In addition, the Office of Management and Budget doesn't publish the details of its actuarial analysis of the proper level for the SBA program fees. In other words we are left in the dark about the performance and economic impact of SBA loans.

Job Creation is Not an Appropriate Outcome Performance Measure

One mistake that is often made by agencies when talking about their achievements is to try to account for the number of jobs created. However, the mere creation of jobs is not an appropriate economic policy objective. You can add jobs to an economy yet create no economic value. For example, imagine hiring someone to dig a hole every morning and someone to fill it in every afternoon: you create two jobs, but nothing of economic value. A striking real-life example is the former Soviet Union,

where unemployment was low because the government gave a job to everyone, and yet the economy was stagnant.

Economic policy is appropriately directed towards economic growth whether it takes the form of additional jobs or a productivity increase in existing jobs. There is no reason to base our policies on the idea that new jobs are creating more economic value than existing jobs, or that small business jobs are more valuable than jobs at large firms.

It important to remember that targeted policies—whether they take the form of direct subsidy, tax credit, loan guarantee—have often proven to be bad policy. Here are three reasons.

(1) Special treatment creates special interest groups that tend to undermine the application of economic efficiency criteria. Preferential government policies have inspired small businesses to join together to protect their benefits and lobby for more. Thus joined together, they have lobbied for policies that benefit all small businesses equally, which draws resources to those who do not deserve it. While the powerful small business lobby has won some targeted policies that are consistent with promoting general economic growth, such as cutting marginal tax rates and red tape, these worthwhile policies have been accompanied by many inefficient programs. The great majority of SBA activities are wasteful and unnecessary.

(2) Special treatments are bound to be inefficient. For one thing, they never go away, even if conditions change to make them no longer necessary. Government officials are reluctant to acknowledge policy failure and the targeted group has a strong incentive to want the policies to be made permanent.

(3) The practical implementation of special treatment for small businesses has perverse side effects. If regulations and tax laws favor small firms over large ones, it will make it more profitable to stay small rather than grow. This perverse incentive will lead to a misallocation of resources away from their most productive uses and will interfere with the natural growth and evolution of firms.

For the typical small business benefit, firms will lose the targeted benefit when their employment, assets, or receipts surpass a certain limit specified by law. This hidden cost has been described as the "notch problem," and it is an unavoidable byproduct of the design of many programs targeted at small firms. Such a design creates a disincentive to grow beyond that limit. For instance, if a firm doesn't hire more than 49 employees, it avoids mandatory family and medical leave; or if an employer does not hire more than 10 employees, he is exempt from most OSHA requirements for recording and reporting occupational injuries and illnesses.

What is the Value of the SBA's Loan Programs?

In his 1985 Congressional testimony, former director of the Office of Management and Budget David Stockman wrote of the 7(a) loan program, "SBA conducts a $3-4 billion annual lending program which indiscriminately sprays a faint mist of subsidized credit into the weakest and most prosaic nooks and crannies of the nation's $4 trillion economy. In the process it serves no rigorously defined public policy purpose objective."

Twenty years later, it seems that very little has changed. Now, the SBA runs a $28 billion loan program and we have a $12.8 trillion economy. However, SBA credit volumes are still inconsequential in the market as a whole since they reach such a tiny fraction of small firms. Most SBA loans still go to helping small businesses in service, retail, and wholesale sectors, but even in these industry sectors most likely to receive 7(a) loans, no more than 1 percent of small businesses receive the loans in any given year. Similarly, the evidence suggests that the SBA's loan guarantees are not targeted to helping small businesses compete with big businesses.

But why does this matter? The SBA may not be having a large effect in a macro sense, but it does have some impact in a micro sense. The U.S. economy may not be better off because of SBA loan guarantees, but the individual recipients are certainly helped. In fact, advocates of the SBA's lending programs remind us that few of the beneficiaries will become tremendous success stories like FedEx; most will stay small. The problems with this scenario are twofold: one, anecdotes about the program's success are not enough to make the case that it creates value because the costs to taxpayers may far exceed the benefits; and two, the program creates an unlevel playing field that in some cases ends up hurting other small businesses.

The Cost to Taxpayers

Congress determines the total amount of loans the SBA is able to guarantee. In its FY 2007 budget request, SBA asked to be allowed to guarantee $28 billion in loans, of which $17.5 billion would be for 7(a) loans.[xxix] However, there was no money appropriated for it.

Traditionally, to effectively manage a loan program, fees are charged to the borrowers for the loans. In the case of SBA loans, the fees are charged to both the borrower and the lender for each 7(a) loan. Additionally, in order to compensate for anticipated defaults on 7(a) loans, funds are set aside to cover expected losses: a "subsidy rate" is used to calculate how much needs to be set aside. The Office of Management and Budget (OMB) has been responsible for setting the final subsidy rate calculation.

In 2005, Congress agreed with the Bush administration's plan to eliminate the subsidy for the 7(a) loan program. Instead of paying off loan defaults with taxpayer dollars, users of the 7(a) loans would be required to pay sufficient fees to cover the costs.[xxx] The cost of running the program and oversight are still paid for with taxpayers' dollars.

The difficulty is this: Over the years, there has been much dissension on how to effectively calculate the subsidy rate—whether this rate be zero or not. Until recently, studies of the loan program showed a profound inability to establish a subsidy rate that would cover projected loan defaults or to establish the proper level of fees to make the rate zero. For instance, in 2001, the Government Accountability Office (GAO) released a report showing that the SBA's approach of averaging historical data was causing large overestimates in subsidies.[xxxi] However, the report mentioned that SBA was currently working on an econometric model to address the problem.

In FY2003, SBA began using the new econometric model, and it seems to be working well so far. In 2004, the GAO analyzed the new model and concluded that the model was reasonable.[xxxii] The GAO did suggest that SBA: 1) update the model over

time, 2) decide whether it might be appropriate to include additional variables in the model, and 3) release how exactly they constructed the model so that the model could be examined in more detail by outside sources. According to the SBA's 2005 annual report, the most recent reestimates of expected 7(a) losses were the "smallest in the program's history." They attributed this improved accuracy to the stability of the ongoing loan performance as well as the consistency of the credit subsidy model.[xxxiii] The SBA may not be the most objective judge of its own program, but it does seem that progress has been made in the last 3 years.

Whether the accuracy of the model can continue, however, is still an open—and crucially important—question. Neither the OMB nor the SBA publishes estimates of the size of the subsidy or its economic impact, but according to an estimate from the Congressional Budget Office, in FY2003 the subsidy was on track to be more than $1 billion over ten years.[xxxiv] Since then, the SBA has raised its loan fees, which should have achieved breakeven levels, yet the SBA has required taxpayers to pay for unexpected losses, suggesting that fees are still too low and there remains a subsidy.

What's more, if the economy suddenly takes a turn for the worse, for instance, and small businesses become much more likely to default on their loans, does the SBA's model account for such events? If not will the agency be prepared to cover the increased costs? Or will taxpayers have to bail out the SBA? In addition, the SBA's Office of Inspector General has repeatedly warned that the SBA needs to improve its oversight of lenders to minimize the risk of default, waste, and fraud.[xxxv] As long as the SBA guarantees such a high percentage of the loan amount, banks have very little incentive to thoroughly evaluate loan applicants. Can the model accurately predict the costs of loans made by minimally-supervised lenders?

The threat of high default costs is very real. The default rate for the SBA's loan programs is higher than in the private sector. Glennon and Nigro (2005), for instance, look at a sample of seven-year maturity SBA 7(a) loans disbursed from 1983 to 1998.[xxxvi] They analyze the riskiness of SBA loans by measuring the cumulative default probabilities. Using the same methods that Moody's and Standard & Poor's use to evaluate corporate bonds, they find that SBA loans rate between Moody's B and Ba ratings and between Standard & Poor's BB and B ratings. This is the upper end of speculative grade; i.e., "SBA loans are concentrated in the relatively more risky segment of the loan market." However, they note that earlier research shows that, at the end of 1997, nearly half of the rated assets of commercial banks were comparably risky.

They then measure the default rate. Approximately two-thirds of the loans in their sample went to existing firms and one-third to start-ups, with a vast majority to firms with 25 employees or less. They find that default rates vary by industry sector and by firm size. Across all the different categories, the default rate is generally around 15 percent. This number is higher than the GAO's 2003 estimate that the default rate on 7(a) preferred lender loans has averaged about 14 percent in recent years.[xxxvii]

Glennon and Nigro then refine their data and measure the default by cohort. They look at loans by year of disbursement, which controls for "the impact of changes in program guidelines, the aging (or seasoning) of the loans, and the censoring of observations in 1998 [i.e., the data stops in 1998, and not all of the loans have reached maturity by that time]".

They find that the average annual default rate, which adjusts for the shorter exposure time of the censored loans, declines after 1987, reaching a low of 2.6 percent, and then rises after 1993, reaching a high of 4.6 percent in 1995. The cumulative default rate for the non-censored cohorts falls over time, from almost 30 percent in 1983 to less than 20 percent in 1991. The censored cohorts show that the risk of default is time-dependent: the rate of default increases over the first few years after disbursements, then declines as the loan matures further.

According to the SBA's own data, for its 2005 cohort of 7(a) loan guarantees, the cumulative default rate was 7.4 percent, and it is 7.21 for the 2006 cohort so far. This is outstandingly high compared to the private sector. For all business loans ("commercial and industrial" or "C&I" loans) from all FDIC-insured banks, the annual net charge-off rate—i.e. loans that the lender no longer expects to be repaid—is very low, typically less than 1.5 percent.[xxxviii] But this includes both small and large businesses. Default rates for small businesses alone are expected to be significantly higher because of their riskier nature.

The FDIC does not collect data on default rates for small businesses specifically, so it is difficult to compare SBA-guaranteed loans to small business loans in general. A rough comparison is the charge-off rate for credit cards, since credit cards tend to be used for higher-risk borrowing. If small business owners get turned down for traditional bank loans, they might turn to non-traditional credit sources, like credit card borrowing. Charge-off rates for credit card lenders are a lot higher, but still lower than SBA loan default rates. For instance, in 2005, the annual net charge-off rate for credit card lenders was 4.64 percent, while the default rate for SBA-guaranteed loans disbursed in 2005 was 7.4 percent.[xxxix]

Of course, this disparity is understandable. To qualify for an SBA loan, one must first be rejected at least once by a private funding source. However, it doesn't mean that it makes economic sense. Edwards (2004) explains that "If a small business has a sound business plan with solid prospects, it should be able to raise debt and equity capital in private markets. If a small business has shaky finances and poor prospects, it will be denied private capital, which is a good thing because such loans would be economically wasteful."[xl] Yet these "shaky" small businesses are exactly whom the SBA lends to: the SBA's mission is to lend money to those rejected by the private banking sector because they were perceived as too risky and unlikely to make money.

The implicit assumption is that bringing a small business to life that would not have existed without the SBA is worth the cost. But if that's the case, the SBA needs to demonstrate that claim. We know that the agency doesn't give a loan to every small business owner who applies for a loan. It rejects many applicants. Yet the SBA does not provide a model explaining how it, unlike the private sector, is capable of identifying the winners among the losers—those previously rejected. If the SBA really could pick winners, its value would be clearer. Its lending programs could be justified by its ability to identify those who would become the next Amazon.com among the small businesses rejected by commercial banks, thus allowing economic value to be created where it would not have been otherwise. Of course, even if the SBA had a way to identify future winners in a way that the private sector cannot, it would still have to make the case that these winners are worth the cost to the taxpayers.

Unfortunately, that's hardly the case. A recent report by the Office of Inspector General (IG) for the SBA details several programs and activities by the SBA that are particularly vulnerable to fraud, waste, and other inefficiencies.[xli] Posed as a series of "challenges," the report includes an assessment of the SBA's progress in improving the areas of concern. Among other concerns, the report examines the 7(a) loans and notes that the program, as well as SBA loan programs generally, requires better oversight and monitoring to improve control and reduce fraud risk. In addition, the report mentions the SBA's difficulty in identifying viable businesses.

Almost every local SBA office has its own web page with numerous "success stories." Even though some of these stories are impressive examples of entrepreneurship, most are about businesses basically managing to stay afloat, rather than maturing into fast growing businesses. Also, these are nothing more than anecdotes, which is hardly a basis for sound cost-benefit analysis.

What's more, the two main SBA success stories seem to be Outback Steakhouse and Staples.[xlii] In 1990, Outback Steakhouse received $151,000 in working capital, with which, according to the SBA, the restaurant obtained the size it needed to go public. Of course, the rest is history, and now Outback receives about $3.6 billion in sales. Staples received about $1.5 million in 1987 so that it could expand from just a single store to five stores. It went public in 1989 and now has about $16 billion in sales.

Those two examples regularly trumpeted by the SBA hardly make the case for the legitimacy and productivity of SBA loans. First, SBA's success stories are at least 16 years old. Does it mean that since 1990 no SBA loan has resulted in such a successful business story? But even if SBA loans resulted in one such success story every year, it is not obvious, without proper empirical evidence, that it would justify the cost to taxpayers of defaulted SBA loans. And again, it is surprising that the SBA is not concerned about measuring the return on the taxpayers' dollars that it spends.

Second, those two success stories were not funded with the SBA's flagship 7(a) loan program but with its Small Business Investment Company (SBIC) program. Established in 1958, the program was meant to be a unique tool that provides risk capital in the form of debt and equity financing to small businesses for their growth, modernization, or expansion. There are currently over 400 SBICs nationwide, with a capital base of more than $23 billion. SBICs are privately owned and privately managed investment firms, licensed and regulated by the SBA, that use their own capital, plus funds borrowed with SBA guarantees, to make venture capital investments in small businesses.

However, this program has frequently been criticized for being inefficient and wasteful. The IG report cited above also examines concerns pertaining to the SBIC and charges that with $12.5 billion in the form of guaranteed debt and equity interest, the program places too much risk on taxpayer funds. In other words, the return on taxpayers' dollars is negative. While the report does document progress made in addressing these challenges, it concludes that much remains to be done.

In response to an editorial in the Wall Street Journal listing major flaws with the SBIC programs, the Ranking Member on the Small Business Committee, Representative Nydia Velazquez (D-NY), wrote that "four years later, under the Bush administration, there has been $1.1 billion in losses."[xliii] In other words, SBA's two business stories were

founded by a program that clearly has negative return to taxpayers' dollars and should be shut down.

SBA Loan Guarantees Hurt Other Small Businesses

Since this small distribution in highly competitive sectors is unlikely to greatly improve the prices and products available to consumers or significantly bolster economic growth, the primary effect of the loan guarantees is to create an unlevel playing field. Small business owners must be denied traditional credit before they are eligible for 7(a) loans. Because they, by definition, do not qualify for loans at market rates, the 7(a) loan program allows them one, to receive money that they might have never received and two, to receive funds a lower rate than they otherwise would have. All other small businesses, however, pay the market rate that reflects the actual risk they represent.

For the most part, the SBA helps a very small fraction of small businesses that are not creditworthy compete with unsubsidized firms in naturally competitive healthy markets. Hence, the SBA is hurting a large portion of small businesses in the name of helping very few others.

Section 8: Banking on the SBA

The SBA's loan guarantee programs benefit a few at the expense of the many. One major beneficiary is SBA lenders. The SBA does not provide loans directly; rather, borrowers have to apply to an SBA-certified bank.

How Do Banks Benefit?

Banks benefit from the SBA program in several ways. First, when a small business defaults on its obligation to repay an SBA loan, the bank does not bear most of the cost.[xliv] Thus, even though SBA borrowers are riskier than others, the downside risk to the bank is at most 25 percent of what it would be were the loan not guaranteed by the government. In some cases, the loan guarantee even makes the risk for banks lower for SBA loans than for traditional loans.

Second, under normal circumstances, banks would not issue loans to the small businesses in the 7(a) program, because the high risk of default on the loans means that banks would not profit on the loans.[xlv] But with the government guarantee of these loans, banks now can make a profit of SBA loans. According to David Bartram—chairman of the National Association of Government Guaranteed Lenders (NAGGL), a national trade organization comprised primarily of lenders participating in the 7(a) guaranteed loan program, and president of the SBA Division of US Bancorp, the nation's sixth-largest financial services company—"we can be as profitable in a 7(a) loan program as we are in our conventional lending if done correctly." [xlvi]

Third, through the SBA's Secondary Market Program, lenders have another way to reduce their risk even further and also to increase their lending capability.[xlvii] Lenders pool the guaranteed portions of SBA loans and then sell to investors trust certificates that represent claims to the cash flows. In other words, the guaranteed portions of the loans are turned into tradable securities or "securitized."

Generally, securitization involves grouping assets—such as residential mortgages or car loans—into large pools that are sold as securities to investors. The originator of the security will often offer loss protection to enhance the credit rating of the security. Lenders benefit from the increased liquidity and asset diversity; borrowers may benefit from lower financing costs; and investors benefit from greater liquidity and lower risk than if they had invested in the loans directly.[xlviii]

To encourage a secondary market, Congress passed a law in 1984—the Small Business Secondary Market Improvement Act—that reduced regulatory barriers for the securitization of small business loans.[xlix] Under this law, SBA provides a secondary guarantee of the trust certificates—guaranteeing timely payments on the certificates if the borrowers' payments are late. According to the Congressional Budget Office, through the Secondary Market Guarantee Program, SBA is taking on risk in addition to the initial guarantee of payment of the principal and interest in the event that borrowers default and the agency purchases the loans.[l] That additional guarantee makes the securities more valuable to investors, who are, as a result, willing to pay more for them.

The data confirms that point. Small business loans are typically not good candidates for securitization. Because the loans' terms vary so much, their underwriting tends not to be standardized, and their risk requires such a high degree of credit enhancement, securitization becomes unprofitable. But SBA-guaranteed loans do not have these problems, and most of the small business loans that have been securitized are SBA 7(a) guaranteed loans. From 1994 to 2001, over 40 percent of the guaranteed part of all 7(a) loans was securitized. By contrast, slightly less than 10 percent of the unguaranteed portion of 7(a) loans was securitized. The advantage of the SBA guaranteed loans is clear: between 1994 and 2001, almost $22 billion of SBA guaranteed loans was securitized, while only about $4 billion of conventional small business loans was securitized.[li]

And this is done at low cost to lenders since under current law, the SBA charges no fee for the 100 percent secondary market guarantee. Only if the loan is sold for more than 110 percent of the outstanding principal balance is half of the excess paid to SBA.[lii]

How Profitable Are 7(a) Loans to Banks and Lending Institutions?

The NAGGL website, a member-only site, states that "return on assets of SBA loans can easily exceed 5 percent, and return on equity can exceed 70 percent."[liii] While return on assets is a poor measure of profitability, return on equity is not. Return on equity (RoE) reveals how much profit a company earned in comparison to the total amount of shareholder equity found on the balance sheet. A 70 percent RoE is remarkably high. As of January 8, 2007, the RoEs for the two biggest banks in America—Citigroup and Bank of America—were 18.36 percent and 16.56 percent respectively.[liv] Even the credit card company American Express, which enjoys a higher return because it requires fewer assets than commercial bank to conduct its business, doesn't show such incredible return on equity. In January 2007, its RoE was 34.2 percent.[lv]

In a Congressional hearing, NAGGL's chairman explained that "if you were to sell the SBA guarantee portion, now you have only 25 percent of direct exposure on your bank's books […] so that is the reason why there is a leveraging power there. That is the

reason why the loan can be profitable." He also concluded that because of the federal guarantee, SBA loan business is a higher-end business to lenders.[lvi]

Who are the recipients of these sky-high returns? Reviewing a representative sample of 2,267 7(a) loan lenders, the FY2006 data shows that the sample 7(a) lenders issued 97,290 loans,[lvii] for a total of $14.5 billion of which SBA guaranteed $10.2 billion or approximately 70 percent. The top ten banks in the United States issued 51 percent of the 7(a) loans. Expand the list to the top twenty banks in the United States and the percentage rises to 65 percent.[lviii] Bank of America leads the list of institutions. Others on the list are J.P. Morgan Chase, Wells Fargo & Co., and Capital Financial. The biggest banks in America are the ones benefiting the most from the SBA loans programs.

If SBA Loans Are So Profitable, Why Doesn't Entry Dissipate the Rents?

Economic theory tells us that if excess profits exist in a given market, new firms enter until profits are normal. If SBA loans produce high returns, more lenders should enter the resulting competition should eliminate the exceptional returns. But if the return on equity remains high and there are no legal barriers to entry, profits must not be high enough to make entry cost effective for new banks.

There are about 6,000 banks and BHCs' serving millions of small businesses in the US.[lix] According to the office of lender's oversight, in 2006 there were 4959 SBA lenders. It means that it is not hard to become an SBA lender. However, according to the National Small Business Association, only 2,751 of them originated at least one loan in 2006. And the SBA data presented above shows that only 10 of them issued over half of the SBA loans meaning that the other 2,741 issued very few of the loans.

According to SBA lenders, SBA compliance requirements are complex and costly. Often, it is not cost effective for most banks to issue SBA loans even when they are SBA lenders. For instance, large banks have enough resources to train and devote several fulltime employees to SBA loan practices. Smaller banks can't afford it and never develop the required expertise. Also, large banks have automated systems to meet SBA compliance requirements and have better and lower cost credit scoring mechanisms in place. Smaller banks hence never or rarely issue SBA loans. The high cost of issuing SBA loans serves as a barrier to entry to the SBA lending market and shelter big banks from competition which explains the recurring and high profit they make on SBA loans.

Private Profits, Public Losses

Banks benefit, but the taxpayer pays. Because the SBA guarantees such a high percentage of the loan amount, banks have little incentive to evaluate loan applicants thoroughly, and the SBA applies little oversight. The SBA's Office of the Inspector General (OIG) has repeatedly warned that the SBA needs to improve its oversight of lenders to minimize the risk of default, waste, and fraud. [lx] The OIG recently found that during the first half of FY 2006, 43 percent of SBA purchased guarantees were made inadequately. As a result of this data, the OIG projects that SBA erroneously distributed $36 million in loans, a rate of about 17 percent.[lxi]

The Government Accountability Office echoes these concerns, pointing out that if the economy were to plunge suddenly, 7(a) loans borrowers would increasingly default on their loans, forcing taxpayers to send large sums of money to SBA banks. As of last year, these guarantees represent some $83 billion in potential taxpayer liabilities, a risk that banks would otherwise assume.[lxii]

Lawmakers sell the SBA loan program as a program that helps small business, an important and popular institution in the United States. In reality though, the SBA loan program is actually a form of corporate welfare for America's biggest banks. The banks reap profits from this program, but the taxpayers have much to lose.

Section 9: Conclusion

Supporters of the SBA's loan programs argue that the government's assistance aids small businesses by filling a gap in financing when banks and other traditional sources do not provide loans for the purposes, in the amounts, and with the terms required by small business borrowers. However, a large economic literature dismisses this argument and demonstrates no failure of the private sector to allocate loans efficiently, thus discrediting the economic justification for any government-sponsored small business lending or loan guarantee program. Absent such a clearly identified problem, the SBA's activities are simply a wasteful, politically-motivated subsidy to this sector.

Moreover, even if to some extent the private sector fails to allocate loans efficiently, it remains to be proven that government intervention is a more desirable alternative. In fact, the data demonstrates that even if credit were a serious problem for small firms, SBA loans wouldn't be of much help to them. The SBA's 7(a) loan guarantees serve only a tiny fraction of the nation's small businesses, and most of the program's borrowers could obtain financing without the SBA's help.

In the end, the burden of the proof is on the SBA who needs to demonstrate that its loan program generates economic growth. It should measure what the benefits of the program are and also what the costs are.

To conclude, most of the nation's 25 million small businesses are funded and grow without government subsidies. Entrepreneurship is definitely one thing that Americans know how to do without government help. The SBA loan guarantee program doesn't seem to help deserving small businesses and should be terminated.

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[i] For a discussion on whether small businesses are the fountainhead of job creation see Veronique de Rugy (2005), "Are Small Businesses the Engine of Growth," AEI Working Paper, http://www.aei.org/publications/filter.all,pubID.23537/pub_detail.asp

[ii] GAO (2007), Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program's Performance GAO-07-769 July 13.

[iii] The SBA criteria for a 7(a) loan are very broad. An applicant must be a for-profit enterprise without the internal resources necessary to finance its activities. It must be able to demonstrate capacity to repay the loan, and it must be considered a small business by the SBA. As the SBA defines a small business as a firm with less than 500 employees, almost all U.S. firms are "small." (A comprehensive definition of small businesses across industries can be found at www.sba.gov.) According to the SBA's Office of Advocacy, small businesses represent 99.7 percent of all employer firms in the United States. SBA Office of Advocacy, "Frequently Asked Questions," http://app1.sba.gov/faqs/faqindex.cfm?areaID=24.

[iv] "Suitable terms" is a subjective assessment by the SBA lender. Even if it could get capital from a private lender, a small business can get a SBA loan so long as the SBA lender (which may even be the same bank to which the business applied for a private loan) assesses that the conditions of the private loan would be "burdensome." Because of the high probability of failure, most risky projects are likely to have private loans offered at "burdensome" terms.

[v] See Small Business Administration, "SBA's Role—Guaranty Percents," http://www.sba.gov/services/financialassistance/basics/sbarole/serv_7a_guarantyperc.html.

[vi] Maurice McTigue, Henry Wray and Jerry Ellig (2007), "8th Annual Performance Report Scorecard: Which Federal Agencies Best Inform the Public?" The Mercatus Center at George Mason University, April.

[vii] Small Business Administration, Congressional Submission FY2006, http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_abt_budget_2.pdf

[viii] Ibid, p. 20, 24, 35.

[ix] Ibid, p. 24.

[x] Ibid, p. 35.

[xi] Ibid, p. 68.

[xii] Joseph Stiglitz and Andrew Weiss (1981). "Credit rationing in Markets with Imperfect Information," American Economic review, Vol 71, n. 3, June.

[xiii] These inefficiencies include moral hazard and adverse selection.

[xiv] See e.g., De Meza, David and David Webb (1999). "Wealth, Enterprise, and Credit Policy," 109(455): 153-163, De Meza, David and David Webb (2000). "Does Credit Rationing Imply Insufficient Lending?," Journal of Public Economics 78(3): 215-234 and De Meza, David (2002). "Overlending?," Economic Journal 112(477): F17-F31

[xv] Federal Reserve (2002), "Report to Congress on the Availability of Credit to Small Businesses"; September, pp. 57-62. http://www.federalreserve.gov/boarddocs/RptCongress/sbfreport2002.pdf

[xv] Thomas McCool (1998), "Small Business Administration: Secondary Market for Guaranteed Portions of 7(a) Loans," Government Accountability Office, GAO/TGGD-98-184, September. http://www.gao.gov/archive/1998/gg98184t.pdf.

[xvi] Bureau of the Census (1992), "Characteristics of Business Owners," Department of Commerce, Economic and Statistics Administration, CBO – 92 1.

[xvii] GAO (2007), Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program's Performance GAO-07-769 July 13.

[xviii] Levenson, Alec R. and Kristen L. Willard (2000). "Do Firms Get the Financing They Want? Measuring Credit Rationing Experienced by Small Businesses in the U.S." Small Business Economics 14(2): 83-94.

[xix] Chad Moutray (2007). "Small Business Lenders Find a Profitable Niche," The Small Business Advocate, June, Vol 26, n. 6, p. 3.

[xx] Small Business Administration (2003). "Financing Patterns of Small Firms: Findings from the 1998 Survey of Small Business Finance," September. http://www.smallbusinessnotes.com/pdf/ssbf_98.pdf

[xxi] Berger, Allen N., W. Scott Frame, and Nathan H. Miller (2005). "Credit Scoring and the Availability, Price, and Risk of Small Business Credit," Journal of Money, Credit, and Banking 37(2): 191-222.

[xxii] Office of Advocacy (2007), "Relationship And Standardized Lending Practices Work Together To Provide Small Business Access To Credit," Press Release, June 15.

[xxiii] For details about this data see Veronique de Rugy (2006), "The SBA Lending Program Needs to be Abolished," AEI Working Paper, April.

[xxiv] GAO (2007), Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program's Performance GAO-07-769 July 13

[xxv] David Bartram, Testimony before the Subcommittee on Federal Financial Management, Government Information, and International Security of the Senate Committee on Homeland Security and Governmental Affairs, Effectiveness of the Small Business Administration: Hearing before the Subcommittee on Federal Financial Management, Government Information, and International Security, 109th Cong., 2d sess., 2006, 38.

[xxvi] Philip E. Strahan (1999), "Borrower Risk and the Price and Nonprice Terms of Bank Loan," Banking Studies Function, October, http://www.newyorkfed.org/research/staff_reports/sr90.pdf

[xxvii] Allen N. Berger and Gregory F. Udell (1998), "The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle," Journal of Banking and Finance Volume 22, 1998
http://www.amciconsulting.com/Economics%20of%20Small%20Business%20Finance.pdf
[xxviii] GAO (2007), Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program's Performance GAO-07-769 July 13
[xxix] Small Business Administration (2006). "FY2007 Budget Request and Performance Plan," Table 7, http://www.sba.gov/cfo/2007_Budget_Request_and_Performance_Plan.pdf
[xxx] As evidence see http://www.sba.gov/cfo/2007_Budget_Request_and_Performance_Plan.pdf
[xxxi] Government Accountability Office (2001). "SBA's 7(a) Credit Subsidy Estimates," GAO-01-1095R.
[xxxii] Government Accountability Office (2004). "Small Business Administration: Model for 7(a) Program Subsidy Had Reasonable Equations, but Inadequate Documentation Hampered External Reviews," GAO-04-9.
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[xli] SBA Office of Inspector General (2005).
[xlii] "SBA Success Stories," http://www.sba.gov/successstories.html
[xliii] Wall Street Journal (2005). "Venture Capitol-ism," Review and Outlook, April 13; Nydia Velazquez (2005), "Letter to the Editor," Wall Street Journal.
[xliv] The SBA charges lender's fees and servicing fees to borrowers in order to cover the default cost of the program. However, analysts have expressed doubts about the effectiveness of the system and the lack of SBA performance outcome measurements makes it impossible to verify that claim. Also, the overhead cost of the program is not covered by these fees. See for instance GAO (2007), Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program's Performance GAO-07-769 July 13.
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[xlvi] Ibid., 37
[xlvii] Thomas McCool, Testimony before the Subcommittee of Government Programs and Oversight of the House Small Business Committee, Small Business Administration: Secondary Market for Guaranteed Portions of 7(a) Loans, (Washington, DC: Government Accountability Office, 1998), 5, http://www.gao.gov/archive/1998/gg98184t.pdf.
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[liii] Senator Tom Coburn, Subcommittee on Federal Financial Management, Government Information, and International Security of the Senate Committee on Homeland Security and Governmental Affairs, Effectiveness of the Small Business Administration: Hearing before the Subcommittee on Federal Financial Management, Government Information, and International Security, 109th Cong., 2d sess., 2006, 39.
[liv] Yahoo Finance, as of January 8, 2007
[lv] Yahoo Finance, as of January 8, 2007
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[lvii] According to the National Small Business Association, the number of SBA lenders was 2,751 in fiscal 2006.
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