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POLICY BRIEF
SPECIAL EDITION

A Government-Backed Line of Credit Would Help Small Businesses More Than Current Relief Efforts

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April 22, 2020

A recent survey reveals that, since January 2020, 43 percent of businesses have temporarily closed, and on average businesses have reduced their employee counts by 40 percent.[1] The survey reveals that 75 percent of small businesses have enough cash on hand to survive for two months, but millions of them have less than two weeks' worth of cash at their disposal. Roughly 99.9 percent of American firms, or 30 million, fit the definition of small business used by the Small Business Administration (SBA),[2] and together these firms employ roughly 65 percent of American workers.[3] The devastation of the small-business sector could therefore be disastrous for American families.

In an effort to provide relief, Congress charged the SBA with the task of administering a variety of credit programs, in part with the help and guidance of the US Department of the Treasury. Unfortunately, not only is the SBA too small to manage such a huge responsibility, it also has a long record of poor performance in times of emergency. There is no reason to believe that this effort will be different; the program as administered through the SBA will predictably serve small businesses poorly. To better help small businesses, Congress should create a government-backed line of credit. This would allow businesses to survive by giving funds—without red tape—to businesses that are facing increased demand right now.

Government grants and loans as provided through the Coronavirus Aid, Relief, and Economic Security (CARES) Act are meant to keep businesses solvent and to encourage them to retain their employees. While such programs will be needed when the economy gets ready to reopen, they should not be the focus for now. Because many businesses are on such thin margins, they might be insolvent now, but most can survive for a month or longer provided that they have liquidity. Any business that cannot last for a month or two is probably not a business that can be saved in the long term.

The bottom line is that the government's current approach for relieving small businesses is problematic not only in theory but also in practice. We suggest an alternative that is more likely to prove helpful: a government-backed line of credit—one neither extravagant nor insignificant—for every American.

SMALL BUSINESS RELIEF IN THE CARES ACT

Under the CARES Act, Congress established two main small business relief programs to provide a total of $349 billion for small business loans to cover qualified payroll costs, rent, utilities, and interest on mortgages and other debt obligations.[4] The loans will be forgiven in full, essentially making them grants from the government, if 75 percent of the loan is used to cover the borrower's payroll costs and if the firm keeps most workers on its payroll for an eight-week period after the loan is granted. Congress will soon add $300 billion to that original amount.

Unfortunately, the small business rescue programs are hobbled by the inability of the SBA and banks to process loans quickly—and, in many instances, to process them at all. The SBA has not met a mandate to deliver funding within three days of a disaster-loan application. Problems with the relief programs' execution include poor design, a notable lack of clarity about the rules, various changes in the programs dictated by the Treasury and the SBA, and poor coordination efforts.

The relief programs were never a good approach, anyway, even in theory. Rather than throwing money at firms in the hope that they might continue business as usual, the government's response should have been focusing on providing businesses with access to liquidity to survive until economic activity could safely resume. In the next section, we spell out a better alternative.

HOW A GOVERNMENT-BACKED LINE OF CREDIT WOULD WORK

The COVID-19 pandemic has brought on a massive liquidity crisis as a result of consumers staying home for fear of getting and spreading the coronavirus, of additional restrictions imposed by government, and of an inability of consumers who are out of work to pay rent and other bills. This liquidity crisis is quite different from the one that the country faced because of the 2008 financial crisis. At the center of that economic meltdown was the financial sector. Today, in contrast, the liquidity crisis originated in the nonfinancial sector, as small businesses saw revenues shrink drastically, resulting in a massive increase in unemployment. All of this is the consequence of an external shock—the pandemic.

Without financial assistance, individuals will not be able to pay mortgages and small businesses will not be able repay bank loans. This will in turn cause banks financial difficulty. Our proposal seeks to forestall this by giving individuals and small businesses the wherewithal to meet their short-term obligations.

As medical efforts are focused on "flattening the curve," government should also consider ways to minimize the damage to the economy, businesses, and American workers. Extending a government-backed line of credit to everyone with a checking account—individuals and businesses alike—would help small businesses from two separate angles.[5]

First, 81 percent of small businesses are sole proprietorships with no employees, no Federal Employer Identification Number, and no corporate tax return.[6] (It is also worth noting explicitly: many landlords are not corporations but small entities without employees.) The owners of these businesses file individual income tax returns, and these businesses are invisible *as businesses* to the federal government, thus making other forms of business relief harder for these small enterprises to access. Second, by helping individuals and households pay their bills, including their mortgages, this proposal will also help small businesses by buoying consumer demand for small business outputs and services.

Here's how the lines of credit will work. For each checking account, banks will be instructed to calculate the revenue stream that went into the account as deposits for the months of January and February 2020. The owners of the bank accounts will then become eligible for a credit line allowing them to overdraft their accounts by the amount of the January and February deposits, at an annual interest rate of 1 percent, to be assessed each month on the amount of the outstanding overdraft. For instance, an individual who got four paychecks of $2,500 each over those two months would now be eligible for a line of credit of $10,000. Likewise, a small business with $200,000 in receipts deposited over those two months would be eligible for a $200,000 line of credit.

For a while, at least, this should not create any reserve shortage, since the banking system was flooded with excess reserves because the Federal Reserve (Fed) is paying interest on reserves. If a shortage of reserves develops, the Fed can address it by lending additional reserves to the banking system.

The government will guarantee this credit line for each account. Repayment to the banks by individuals and small businesses of these credit lines would be due in June 2022. Beyond that point, the Treasury will remit any unpaid balance to the bank and take over collection from the holders of the delinquent account.

Regulators, including the Federal Deposit Insurance Corporation, could require every bank to participate. The compliance cost would be relatively low, since banks would only have to write computer code to calculate the size of the credit line to which each checking account is entitled, to track the overdrafts and interest accruals, to report to borrowers on bank statements, and to report to the Treasury on accounts that default in June 2022.

Individuals and businesses will be able to draw on their lines of credit if needed without any questions asked. There will be no forms for individuals or businesses to fill out. Many people and businesses will not need this financial help, and hence will not borrow against their line of credit. The repayment requirement allows this solution to be both simple in its design and implementation *and* flexible. However, use of this credit should be augmented with a strong incentive to repay, such as the loss of some future government benefits for individuals and businesses that do not fully repay their loans.

Some small business owners will decide that, without relief in addition to this line of credit, they cannot continue, so they will prudently refrain from incurring additional debt. Other persons may turn to different sources of financing, such as charitable organizations, family members, or private investors. A policy of credit-line-extension, therefore, might actually increase incentives for private lending in times of emergency, options often crowded out by more conventional means of government relief and intervention.

Because the line of credit is made available to each small business to use based on its own need and expected timeline, business owners won't have to rush to get a government loan. This contrasts with the SBA loan program, where borrowers apply for funds before they need them out of fear that the funds will be exhausted by the time they actually need liquidity.

This approach has many advantages. First, the use of the credit lines will limit the adverse feedback effects of a few weeks of reduced economic activity. Although in theory government might add to the credit line if the public health crisis were to require that economic activity be curtailed for a longer period, in practice this cure won't work if the economy is kept in a coma for months. This fact, however, is no reason to discard this proposal because in reality there exist *no* good solutions for very long shutdowns.

Second, this solution is extremely simple. It does not require government to write rules about forbearance for all types of contracts. People can use their credit lines to pay their bills, their mortgages, their car payments, their employees, or whatever they choose. This solution involves the creation of no new government program or agency or the expansion of any existing ones—meaning, of course, that there is no need with this proposal to rely on proven-inefficient government agencies such as the SBA. As people are witnessing right now, all these more conventional options lead chiefly to chaos without providing much relief to businesses. Another advantage is that the cost to the future taxpayers will be low. The government is not obligated to bail out every single person or every single business. Taxpayers only have to make good on the loans that go into default. But if incentives to repay are strong enough, the default rate would be quite low and, hence, taxpayer costs would be minimal compared to the costs of programs put in place under the CARES Act.

Yet another advantage is that it contemplates a flexible economy that adapts to new circumstances, rather than only rewarding individuals and businesses that remain as they were before the crisis. Some businesses are trying to ramp up hiring even while others are laying off workers, and policy should allow individuals to respond to market incentives, rather than condition aid to businesses on their retention of workers regardless of how much those workers are needed.

CONCLUSION

The government's current approach for relieving economic dislocation in the small business sector is unworkable, both in theory and especially in practice. It also represents significant expense for taxpayers without providing small businesses the help they actually need. We suggest an alternative that is more likely to prove helpful.

ABOUT THE AUTHORS

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NOTES

1. Alexander W. Bartik et al., "How Are Small Businesses Adjusting to COVID-19? Early Evidence from a Survey" (NBER Working Paper No. 26989, National Bureau of Economic Research, Cambridge, MA, April 2020).
2. Office of Advocacy, "'What's New' Infographic Lets You See Answers to Top Small Business Questions," Frequently Asked Questions, Small Business Administration, September 24, 2019, https://advocacy.sba.gov/2019/09/24/whats-new-infographic-lets-you-see-the-answers-to-top-small-business-faqs/.
3. Office of Advocacy, "'What's New' Infographic."
4. Arnold Kling, "Nonbank Liquidity Now, Solvency Later," *askblog*, March 23, 2020.
5. Kling, "Nonbank Liquidity Now, Solvency Later."
6. Office of Advocacy, "'What's New' Infographic."