The Examiner

Time to abolish the SBA

Veronique de Rugy
March 28, 2012

In his second term, President Reagan supported an effort by his budget director, David Stockman, to abolish the Small Business Administration. Stockman referred to the SBA as a "billion-dollar waste" that benefited few small businesses, while distorting credit markets.

SBA advocates always argue that the agency is very economical. With the exception of the last few years, budget requests for the SBA have been consistently lower than $1 billion.

Yet budget requests don't tell you much about the final cost of a program. First, based on SBA data, taxpayers are already on the hook for more than $90 billion in outstanding loans guaranteed. As the years go by, taxpayers' exposure increases.

Second, data from past budgets show there is often a wide gap between the requested spending and the actual amount spent by the agency.

For instance, if you take data from fiscal years 2006 to 2012, actual spending exceeds requested amounts nearly every year. Between 2006 and 2011, this overrun grew from $100 million to $5 billion. And SBA's actual spending in that period has grown more than 600 percent, from $905 million to $6.2 billion.

This is mainly the product of large losses, because of higher default by borrowers in SBA guaranteed loan programs. In regular times, the agency's default rates are already quite high, but they increase dramatically in times of recession.

This is important because it undermines a foundational premise of the SBA loan program, that some small businesses are wrongly denied adequate credit by lenders. The theory is that lenders misjudge their viability or mistake low-risk applicants for high-risk ones, and these poor judgments hinder economic growth. Private lenders have developed many techniques, such as credit scoring, to improve their information about borrowers. The SBA, by contrast, operates with a "no credit elsewhere" criterion that fails to address the information gap.

The SBA gives loans to small businesses that can't get capital; therefore it effectively subsidizes high-risk borrowers. The SBA wrongly assumes that every high-risk borrower has the potential to succeed, but in fact, the SBA default rates demonstrate that this isn't true.

Unfortunately, the SBA doesn't attempt to measure the effectiveness of its loans. If it did, it would have to confront a large body of research that refutes the belief that credit rationing makes it difficult for small businesses to obtain capital.

Empirical evidence confirms this point. The Cato Institute's Tad DeHaven and I have shown that in any given year, small-business loans backed by the SBA represent only a very small share of total commercial loans to small businesses. Of the top 15 industries receiving the most SBA-guaranteed loans over the past 10 years, only 0.5 percent of the small businesses in these industries received loans backed by the SBA.

Take the top industry receiving SBA loans: the full-service restaurant industry. It is has a large number of firms and robust competition. There is no obvious market failure, and 98.3 percent of restaurants get credit without SBA subsidies. By creating a credit market advantage for a small, favored subset of businesses, the SBA is unfairly and needlessly meddling in the economy. It also costs taxpayers, since 23.3 percent of the SBA loan borrowers in this industry default.

Small businesses with sound business plans and solid prospects are able to raise debt and equity capital through private means. If a small business has shaky finances and questionable prospects, it likely won't get private capital. The high failure rates on SBA-backed loans illustrate that the government's credit market interventions often misallocate capital toward wasteful ends and in an unfair manner. Stockman was correct 30 years ago. It is time to abolish the SBA.

Examiner Contributor Veronique de Rugy is a senior research fellow of the Mercatus Center at George Mason University.