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A GUARANTEED SUCCESS? Why the SBA should not guarantee loans

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Encouraging lending to small business is one of the primary purposes of the Small Business Administration (SBA). In order to accomplish this purpose, the SBA will guarantee $28 billion in loans in FY2008 alone, promising repayment of up to 85 percent if the borrower defaults. Taxpayers on the hook for a total of $83 billion in guaranteed loans might ask whether the SBA should be in the business of guaranteeing loans.[1] The evidence says it should not.

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.[2] 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.[3] 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.

MARKET RESPONSES TO INFORMATION PROBLEMS

The SBA argues that the asymmetry in information between lenders and borrowers is a market failure that only government intervention can correct. 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.

> . . . 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.

LENDING RELATIONSHIPS

One of the mechanisms that has 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.[4] 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."[5]

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

Table 1

REASON THE DISCONTINUED BUSINESS IS NO LONGER OPERATING BY EMPLOYMENT SIZE OF FIRM, 1992

	If the businesses is no longer operating because it was unsuccessful, the reason why the business was unsuccessful*				
	INADEQUATE CASH FLOW OR LOW SALES	LACK OF ACCESS TO BUSINESS LOANS/CREDIT	LACK OF ACCESS TO PERSONAL LOANS/CREDIT	OTHER REASON	NOT REPORTED
ALL BUSINESSES	71.7	8.2	3.3	71.7	1.3
HISPANIC-OWNED BUSINESSES	67.1	8.8	5.8	68.3	3.2
BLACK-OWNED BUSINESSES	63.4	15.5	8.4	69.3	4.3
OTHER MINORITY-OWNED BUSINESSES	67.6	6.1	6.4	75.9	2.6
WOMEN-OWNED BUSINESSES	70.2	9.3	3.3	75.8	2.8

*Data represent percentage of owners reporting in the designated categories.

Source: 1992 Economic Census, Characteristics of Business Owners.

Table 2

PERCENTAGE OF ALL SMALL, MINORITY-OWNED, AND WOMEN-OWNED FIRMS THAT USED CREDIT, 1998

	ALL SMALL FIRMS		SMALL MINORITY-OWNED FIRMS		SMALL WOMEN- OWNED FIRMS	
	% OF FIRMS	% OF CRED-IT USERS	% OF FIRMS	% OF CREDIT USERS	% OF FIRMS	% OF CREDIT USERS
ANY CREDIT	82.5	100.0	76.9	100.0	78.2	100.0
ANY TRADITIONAL CREDIT	55.0	66.7	49.4	64.2	46.1	59.0
Commercial Bank	38.2	46.3	27.3	35.5	28.4	36.3
ANY NON-FINANCIAL INSTITUTION	9.6	11.6	12.0	15.6	8.9	11.4
ANY NON-TRADITIONAL CREDIT	70.7	85.7	54.9	71.4	68.8	88.0
Owner Loans	14.2	17.2	12.5	16.3	12.9	16.5
Personal Credit Card	46.0	55.8	45.5	59.2	47.5	60.7
Business Credit Card	34.0	41.2	28.6	37.2	28.9	36.8

Source: SBA (2003), "Financing Patterns of Small Firms: Findings from the 1998 Survey of Small Business Finance," Table C.2.

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.[6]

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.[7]

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.[8]

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.[9] 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."[10]

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.[11]

DOES THE SBA DO WHAT IT CLAIMS IT DOES?

If the private sector allocates loans efficiently, is there no justification for SBA loans? Not necessarily. While there may be no economic justification, there could be public policy goals important enough to justify its meddling in a well-functioning market. In other words, SBA can thus be judged based on its ability to meet these 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 in this area, I analyzed the flow of SBA credits from its flagship loan guarantee program, the 7(a) program, to evaluate to whom they go and whether the SBA meets its stated policy objectives.[12]

I found the following:

- The 7(a) loans represent about one percent of the number of outstanding small business loans. As the private sector finances most loans without government guarantee, the SBA is largely irrelevant in the capital market.
- The United States has no shortage of firms or new startups. The data suggest that entrepreneurs would start new businesses at the same rate in the absence of the SBA's 7(a) loan program.
- While 29 percent of 7(a) loan guarantees went to minority business owners, SBA distributed loans to

only three percent of all minority-owned firms. The same trend is true for women-owned firms.

- In the sectors that account for 75 percent of SBA lending, there are an overwhelming number of firms, healthy competition, and no empirical indications of an underserved market.

- Since the small distribution of SBA loans in these highly competitive sectors is unlikely to improve prices or products greatly or bolster economic growth significantly, the loan guarantees' primary effect is the creation of an unlevel playing field that hurts non-SBA supported firms. 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.

Even though SBA loans tend to flow to riskier borrowers—as its mission intends—it is unlikely that they promote economic growth.[13] SBA loan guarantees go primarily to businesses that conventional providers of financing have rejected. Objectively, these SBA guaranteed firms are the least likely to create stable employment, improve technology, or enhance national productivity. Also default rates on SBA loans are extremely high. According to the GAO, the long-term default rate over the life of loans is roughly 14 percent as opposed to 1.5 percent for FDIC-insured banks or 4.3 percent for credit cards.[14]

Finally, the SBA rests its case for loan programs mainly on anecdotes of small firms staying afloat thanks to its programs. The SBA cannot point to success stories that would compensate taxpayers for the costs of the programs. Moreover, for each SBA success story, there are thousands of small firms that prospered without the SBA loans.

CONCLUSION

Supporters of the SBA's loan programs argue that the federal government's assistance aids small businesses by filling a gap in financing when banks do not provide loans for the purposes, in the amounts, and with the terms required by small business borrowers. However, a large part of the economic literature dismisses this argument, demonstrating no failure of the private sector to allocate loans efficiently, thereby discrediting the economic justification for the loan guarantee program. In addition, the data demonstrate that even if credit were a serious problem for small firms, SBA loans would not help them much. The SBA's 7(a) loan guarantees serve only a tiny fraction of the nation's small businesses. However, these loans face a significant risk of default, which would cost taxpayers large amounts of money. For these reasons, Congress should abolish the SBA loan programs.

ENDNOTES

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