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THE EFFECTIVENESS OF THE SMALL BUSINESS ADMINISTRATION

HEARING

BEFORE THE

FEDERAL FINANCIAL MANAGEMENT, GOVERNMENT INFORMATION, AND INTERNATIONAL SECURITY SUBCOMMITTEE

OF THE

COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS UNITED STATES SENATE

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THE EFFECTIVENESS OF THE SMALL BUSINESS ADMINISTRATION

THURSDAY, APRIL 6, 2006

U.S. SENATE,
SUBCOMMITTEE ON FEDERAL FINANCIAL MANAGEMENT,
GOVERNMENT INFORMATION, AND INTERNATIONAL SECURITY,
OF THE COMMITTEE ON HOMELAND SECURITY
AND GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:30 p.m., in room SD–342, Dirksen Senate Office Building, Hon. Tom Coburn, Chairman of the Subcommittee, presiding.

Present: Senators Coburn and Carper.

OPENING STATEMENT OF SENATOR COBURN

Senator COBURN. The hearing of the Federal Financial Management Subcommittee of the Homeland Security and Governmental Affairs Committee will come to order. This is the 31st hearing that we have had on government agencies looking at spending, waste, and every other area that we can, to try to make the government more efficient, to make sure we are good stewards of the money that has been transferred to our care.

Before I get to the substance of the hearing, I would like to take a moment to just address the events leading up to our consideration of the Small Business Administration. I have not only been surprised, but profoundly disappointed by the negative reaction that some people have had to the mere mention of a subcommittee holding an oversight hearing on the efficiency of a government agency and particularly the Small Business Administration. Before the hearing was publicly announced, I heard from countless numbers of people asking what business this Subcommittee had to look at the SBA, worse yet, demanding that we not hold a hearing at all.

I just returned from China. You can't criticize your government in China without going to jail. The fact that people who may have a different point of view should not have the ability to express their point of view in this country not only harms our future, but does not bode well for freedom in this country.

Unfortunately, it has also come to my attention that some of this, and not with the knowledge of the Director or his staff within the Small Business Administration, of which e-mails that I have in my possession that came from SBA offices were involved in that. That type of illegal lobbying is unacceptable. It will be dealt with accordingly, and I have already had a discussion with Administrator

Barreto on those areas and I know that this was not from the Director or his office. It was done not under the direction of anybody in charge of the SBA.

Contrary to what has been said, I believe it is Congress' duty to do more oversight, not less, and this certainly includes the SBA. There is a perception out there that to be for the SBA is to be for small business and to be against the SBA is to be against small business. While the SBA's charge is to help small business, the interest of small business and the interest of SBA are only synonymous if and when the SBA is achieving its mission effectively and efficiently. That is why there is no group that should be more interested in the effectiveness of the SBA than small businesses, and advocating for that effectiveness is advocating for their interests.

If we find out that agencies don't cooperate effectively, then we take actions to try to fix those. That is where the authorizers come in and the appropriate subcommittee that deals with the authorization of the SBA. The only constituencies that could be affected would be those who profit from business as usual at the SBA. If the SBA has areas that are not running efficiently, it is certainly not the small business sector that benefits from maintaining the status quo, but rather those who tend to profit from what the SBA does.

Like every hearing this Subcommittee holds, this one will be fair, which means we will be tough on everybody. We will ask appropriate questions. Congressional hearings should not be pep rallies for business as usual. Small business deserves better. Free enterprise deserves better.

Now, more than ever, it is urgent to discharge our oversight duties in light of the fact that in 2007 this country will spend more money on government than at any time in our 230-year history. When all receipts are totaled, we will have spent nearly $3 trillion on everything from national defense and health care to sculpture gardens and countless other earmarked projects amounting to more than $9,000 per man, woman, and child in this country. Last year, after raiding Social Security, the Federal Government borrowed $538 billion. This year, we again expect to borrow another $500 billion to pay for all Federal programs. All of this will be paid for, with interest, not by us but by our children and our grandchildren.

There is almost no area of life left untouched by Federal dollars and Federal intrusion. Behind all of this out-of-control spending is the not-so-subtle notion that government never met a problem it couldn't solve. So when faced with a problem, Congress always does what it does best, spend your money.

Today, the Subcommittee will look at the SBA, which portions are set to expire this year until reauthorized by Congress. SBA has a surprisingly large impact on the national economy as well as the Federal fiscal outlook. Its budget for 2007 is $624 million, yet it oversees a loan portfolio of $70 billion. Even to Congress, $70 billion is a big amount.

More strikingly, though, is SBA's impact on the budget is quite often much larger than its initial estimates. You will see from this chart what the initial estimates were and then what they actual were.[1] Much of that is related to emergency and disasters, but nevertheless, it is a large component of the Federal budget.

The SBA was established primarily to help small business, but it is its disaster relief functions that have made the news lately. Unlike many of SBA's critics in this area, I want to commend SBA on the job they have done. We have never seen such a disaster in our country, and the fact that they geared up—nobody could have anticipated this. Even though they have taken criticism for not anticipating enough, the fact is they did get down there, they did hundreds of thousands of loans and are continuing to do it. Even though the waiting period might be longer than what we want, the fact that they responded in a way that met people's needs is amazing to me. It is not good enough, we know that. But the fact that they went from where they were to what they got accomplished should be noted as exemplary in terms of responding.

SBA was also established as the agency to which small business can turn if they are unable to make it on their own. Small businesses can turn to SBA for getting loans, getting government contracts, or help getting access to capital. SBA is also instrumental in representing the interests of small business throughout the process of issuing Federal regulations.

One particular area of concern for me, though, is that the Federal agency created to help small business only helps some small business, not all. The unfortunate result is that small businesses that do not have the benefit of SBA assistance are left to compete on their own against those that do. Injustice is bound to occur when government picks winners and losers in the marketplace. Advocates may ask, what is the harm in helping a few businesses down on their luck? After all, isn't it good for our economy and for a compassionate government to help failing businesses stay afloat?

We are not here to ask the existential questions of whether the government should be intervening in the marketplace. We already have an agency that we have established for that. But we will have and continue to have hearings on the role of the Federal Government.

SBA does exist to fulfill a mission and it utilizes taxpayer dollars to do that. We want to examine the evidence today of whether that mission is being achieved.

The problem: The 7(a) loan program is designed to guarantee loans for businesses with such bad credit that no private lender will give them a loan. A business in this situation can turn to the Federal Government for a low-interest loan courtesy of the American taxpayer. While a small fraction of businesses and private lending institutions profit, these loans help the few at the expense of many who don't get them.

The question today, though, is not whether we should help those companies with bad credit, it is whether intervention results in a measurable impact on the small business sector of the economy that wouldn't have been realized without taxpayer help. In other words, is SBA intervention in the marketplace making a measurable difference in that marketplace, and if so, is it better for those they help and those they don't?

[1] The chart appears in the Appendix on page 51.

The most fundamental mission of the SBA, though, for me is to help small business, and that is through regulation reform and the cost of regulation reform. The fact is, if you are a business with 20 employees or fewer in this country, it costs you almost $7,600 a year per employee, based on the footprint of the Federal Government's regulations. That number has increased, although the rate of increase is decreasing, and that is in real dollar terms. So to me, one of the biggest jobs for the SBA is decreasing the burden of the Federal Government on small businesses so that they can become competitive.

We will also ask several other questions relating to the granting of contracts and whether or not we actually see that those are going to small businesses, and I look forward to talking about the definition of small business, because as we have looked at this, what we have found is several large businesses with billions of dollars in sales and billions of dollars in profits are actually getting help from the SBA, which I believe is not the direction in which the Congress intended.

[The prepared statement of Senator Coburn follows:]

PREPARED STATEMENT OF SENATOR COBURN

Before I get to the substance of this hearing, I would like to take a moment to address the events leading up to our consideration of the Small Business Administration. I have been not only surprised, but profoundly disappointed, by the negative reaction of some of the mere mention of this Subcommittee holding a hearing on the Small business Administration. Before the hearing was publicly announced, I had heard from countless numbers of people asking what business we had looking at the SBA, or worse yet demanding that we not hold the hearing at all.

Unfortunately, it has come to my attention that some of this may have originated within the Small Business Administration itself. I have seen emails from SBA employees to organizations sent seemingly for the purpose of undermining our hearing before it even began. This type of illegal lobbying is unacceptable and will be dealt with accordingly.

I would like to state for the record that I do not believe Administrator Barreto, here with us today, had anything to do with these lobbying efforts. But, now that he is aware of these incidents, I will be following up with him to resolve the matter once and for all.

Contrary to what has been said, I believe that it is Congress' duty to do *more* oversight, not less, and this certainly includes the Small business Administration. There is a perception out there that to be for the SBA is to be for small business, and to be against the SBA is to be against small business. While the SBA is supposed to help small business, the interests of small business and the interests of SBA are only synonymous if and when the SBA is achieving its mission effectively and efficiently. That's why there is no group that should be more interested in the effectiveness of SBA than small businesses, and advocating for that effectiveness is advocating for their interests.

If we find out that the agency isn't operating effectively and we take action to try to fix the problem, which is, of course, our Constitutional duty, it's certainly not small business that would be hurt. The only constituencies that could be affected would be those who profit from business-as-usual at SBA. If SBA is broken, it's certainly not the small business sector that benefits from maintaining the status quo at the agency, but rather the bankers and big corporations who are currently profiting from SBA, among others.

Like every hearing this Subcommittee holds, this one will be fair, which means we are tough on everybody. Congressional hearings should not be pep rallies for business-as-usual. Small businesses deserve better.

Introduction

Now, more than ever, it is urgent to discharge our oversight duties in light of the fact that in 2007, this nation will spend more money on its Federal Government than at any time in our 230 year history. When all receipts are totaled, we will have spent nearly 3 trillion dollars on everything from national defense and healthcare to sculpture gardens and countless other earmarked projects—amounting to more than $9,000 per person. Last year, after raiding Social Security, the Federal Government $538 billion in borrowed money. This year, we again expect to borrow another $500 billion to pay for all Federal programs. All of this will be paid for, with interest, by our children and grandchildren.

There is almost no area of life left untouched by Federal dollars and Federal intrusion. Behind all of this out-of-control spending is the not-so-subtle notion that government never met a problem it couldn't solve. And so, when faced with a problem, Congress always does what it does best: Spends your money.

Fiscal Impact of SBA

Today, the Subcommittee will take a look at the Small Business Administration, of which portions are set to expire this year unless reauthorized by the Congress. SBA has a surprisingly large impact on the national economy as well as the Federal fiscal outlook. Its budget for 2007 is $624 million,yet it oversees a loan portfolio of nearly $70 billion. Even for Congress $70 billion is not pocket change, and it is even less so to taxpayers whoa re on the hook for that money should the bill come due.

More strikingly, though, SBA's impact on the budget is quite often much larger than its initial estimates to Congress. Between 2002–2006, SBA's beginning-of-year spending estimates have amounted to $3.5 billion. But, after all receipts were totaled, SBA spent more than $9.8 billion—nearly three times more than was initially estimated. And so, like every hearing we have on any agency, this hearing is intended to ask a very simple set of questions regarding what taxpayers are getting in return for SBA spending.

Mission of SBA

The SBA was established primarily to help small businesses, but it is its disaster relief functions that have made the news recently. Unlike many of SBA's critics in this area, I would like to commend SBA for a job well done in many respects following the hurricanes in the Gulf Coast. They were on the ground making many more loans than anyone thought they could do in a short period of time.

But SBA was also established as the agency to which small businesses can turn if they are unable to make it on their own. Small businesses can turn to the SBA for help getting loans, help getting government contracts or help getting access to capital. SBA is also instrumental in representing the interests of small business throughout the process of issuing Federal regulations. One particular area of concern for me, though, is that the Federal agency created to help small businesses only helps *some* small businesses, not all. The unfortunate result is that small businesses that do not have the benefit SBA assistance are left to compete on their own against those that do. Injustice is bound to occur when the government picks winners and losers in the marketplace.

Advocates for the Small Administration may ask, "What's the harm in helping a few businesses down on their luck? After all, isn't it good for our economy and for a compassionate government to help failing businesses stay afloat?"

We're not here today to examine the existential questions of whether the government should be intervening in the already crowded marketplace. This subcommittee has had, and will continue to have, hearings on the role of the Federal Government. The fact is, SBA *does* exist to fulfill a mission, and it utilizes taxpayer dollars to do it. We're simply here to examine the evidence for whether that mission is being achieved.

The Problem

For example, the 7(a) program is designed to guarantee loans for businesses with such bad credit that no private lender will give them a loan. A business in this situation can turn to the Federal Government for a low-interest loan, courtesy of the American taxpayer. While a small fraction of businesses and private lending institutions reap the profits, these loans help the few at the expense of the many that don't get them.

The question today, tough, is not whether we should help those companies with bad credit. Its whether our intervention results in a measurable impact on the small business sector of the economy that wouldn't have been realized without taxpayer help. In other words—is SBA intervention in the marketplace making a measurable difference in that marketplace, and if so, is it better for those they help and those they don't?

The most fundamental mission of the SBA, though, is to help *small* business. Unfortunately, though, small businesses are not only the only ones that get helped—big businesses are getting rich by taking advantage of SBA programs. In February of 2005, the SBA Inspector General reported that government contracts set aside for small businesses are actually going to *large* businesses with some frequency. For example, in 2002, the following companies all received millions of dollars each in small business awards.

- Northrop Grumman
- Hewlett-Packard
- General Dynamics
- Oracle

These are all great companies that are helping our vibrant economy and are doing billions of dollars of work for the Federal Government. But no one would argue that they are *small*. It is doubtful to me, though, that any of them are in great need of government help, especially an agency that helps *small business*. How does the $2 billion spent in FY2002 on these and other large companies help SBA achieve its mission?

Finally, I am deeply concerned about the high costs facing small business in complying with Federal regulations. As a small business owner myself, I know first hand how hard it is to afford paying for all kinds of regulations saddles on small businesses. SBA reports that small business owners pay on average more than $2,000 per employee every year than large companies for regulatory compliance. Each year the burden of regulation increases for small businesses.

Yet, this year, SBA plans to use less than 2 percent of its budget on regulatory assistance for small businesses. In fiscal year 2007, SBA plans to spend 15 times as much money on program administration than on regulatory assistance. I am concerned that this program gets far too little attention from the SBA, yet this is the one thing SBA does that truly effects *all* small business owners.

Conclusion

All of these examples bring me back to the central purpose of this hearing, which is to take a look at the effectiveness of the Small Business Administration at achieving its stated mission. By the end of this hearing, I hope to have answers to some important questions, such as:

- Does SBA intervention in the loan market improve outcomes for small businesses?
- Is the SBA rigorously evaluating its programs against measurable outcomes and reporting those results to Congress?
- How do SBA programs affect businesses not helped by the SBA?
- Is that impact positive, negative or neutral?

I look forward to getting answers to these and other questions during today's hearing.

Senator COBURN. I am very pleased to welcome to our Subcommittee a friend of mine, somebody I have known for 12 years, and I value her insight. It is Representative Sue Kelly from New York. We asked her to testify based on her experience and background in this area.

Congresswoman Sue, thank you for being here. Your complete testimony will be made part of the record and please let us hear from you.

TESTIMONY OF HON. SUE KELLY,[1] A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Ms. KELLY. Thank you. First, Senator, let me associate myself with great approval of your concern and interest of making sure that every single taxpayer dollar that comes to Washington, DC, is carefully shepherded in a way that we get the maximum use of those precious tax dollars that we take from the American public. So thank you for your concern there.

I thank you for the opportunity to testify here today. The success of our local economy in New York's Hudson Valley, where I represent, is especially dependent on the success of small businesses.

[1] The prepared statement of Ms. Kelly appears in the Appendix on page 53.

Let me begin by telling you a story about a small business owner in my Congressional district named Mandy Villodas. Mandy operates the English Rose Day School in Washingtonville, New York. It is located in Orange County. She began her child care business in her home. Later, she rented space from a church and she operated her child care business from there for a few years. Then she began working with the Small Business Administration to expand her small business and build a permanent child care center. With the help of an SBA-guaranteed loan, Mandy was not only able to expand her child care services, she preserved 15 existing jobs and created five new jobs for local residents. The English Rose Day School has been operating very successfully ever since.

Without the help of the SBA, Mandy wouldn't be where she is today. Her small business would not be having such a profound impact on the lives throughout our local area. Let me give you a couple of examples.

Mandy's success in getting the construction money through SBA resources helped provide additional work for local contractors. Remember that many of them are small businesses. Her school is a happy, safe environment for parents to leave their children in good care while they go out and work hard in both large and small businesses. Those parents earn money that they turn around and spend in many aspects in our local communities in our small businesses.

Successful small businesses have a very positive ripple effect through so many aspects of our local communities. This is the ideal example of the importance of government's investment in small businesses to boost job creation. The resources that Congress and the SBA devote to help small businesses grow and succeed are imperative to the growth and success of our economy.

When times are tough, small businesses revitalize our workforce and our communities. For instance, IBM operates a very large facility in southern Dutchess County, where I represent. While IBM had to downsize, particularly during the 1990s, New York's industries, governments, unions, nonprofits, worked together to rebuild the employment infrastructure in Dutchess County through small business growth. It has diversified where it was mostly based on IBM economy.

Dutchess County economic development records show that 33 new firms opened their doors in Dutchess County between February 1994 and February 1996. This alone created more than 3,000 new local jobs at a very critical time when IBM was cutting them.

That trend continues today, not only in Dutchess County, but in every other county in New York's Hudson Valley. Increasing numbers of new small businesses are creating increasing numbers of new local jobs. The numbers show that without the help of the SBA funding and resources that were relied on by the Small Business Development Center in mid-Hudson, small businesses in our area would not have made it. The lack of support for our small businesses translates back into jobs for residents in our local communities.

The SBDC Mid-Hudson has worked directly with 12,338 businesses, helping them invest $363 million in the local area economy. These efforts created and saved 10,429 jobs.

Small businesses in Orange County tell me that the 504 loan product available through the SBA has been absolutely critical in meeting their needs. These small businesses say that banks are simply unwilling to do business with them often. So when a bank shuts its doors on a small business, it leaves them with no other source of any financial assistance. The SBA programs then provide them with the millions of dollars in financing to preserve the business, to grow the business and preserve local jobs. SBA programs like the 504 loan program have enabled lenders and borrowers to have a dialogue that never would exist otherwise.

In ways like these, the SBA can play a critical role in the livelihood of our local communities. Here in Washington, we need to give them more than lip service because they create seven out of every 10 new jobs. We can't pat small businesses on the back for supplying the new jobs and then stifle their access to capital. The effective SBA programs that are working need to have our continued support here in Congress, just as much as small businesses need continued support provided through those programs.

In fact, there are some additional steps that the SBA and Congress really ought to be taking to encourage small business growth. One group that particularly needs our attention in the next few years is America's veteran population.

New York is one of the States with the largest deployment of reservists to Iraq and Afghanistan. Every month, reservists are coming back to New York and other States and their previous jobs are not always waiting for them when they return. Some are returning to find that the small businesses that they owned or the small firm where they worked has suffered dramatically in their absence. Some of those doors have closed. But there are doors that have opened. It leaves our veterans, though, hard-pressed to make ends meet and in dire need of capital if they want to start their own business or they need other forms of assistance.

We need the SBA to be increasingly pushing veterans' business opportunities. At one time, the SBA used to offer veterans lending assistance at a discount, but currently, other than some procurement programs, there are very few areas where the SBA can give our veterans any preference at all.

At a time when new veterans are coming back to our country after serving us in the war on terror, we need to provide the SBA with the support that it needs to work with our veterans and to do them proud when they return.

I feel that we need to equip the SBA and its affiliates with the resources that they need to work with reserve offices, to visit veterans who are hospitalized on their return, and to provide veterans every opportunity to start a small business on their own.

In other words, the SBA should be even more of a resource for our local residents and communities in the future instead of less of a one. Our economy needs small businesses. Small businesses need the SBA. We need for the SBA to be with us for our small businesses in a continuingly increasing way at the very local level.

I thank you very much. It is a great pleasure to be able to testify before you, Mr. Chairman. I appreciate your giving me the opportunity here today. I would be glad to answer any questions.

Senator COBURN. Thank you.

Senator COBURN. My Ranking Member is here, Senator Carper, and I will give him an opportunity for an opening statement and then we will go to questions for the Congresswoman.

OPENING STATEMENT OF SENATOR CARPER

Senator CARPER. I look forward to having a chance to ask a question or two of Representative Kelly. I don't think we have ever met before. Welcome. We are glad you are here. Thank you.

Senator COBURN. Thank you.

Representative Kelly, in your statement, you said that evidence shows abundantly that without SBA in Dutchess County, that you wouldn't have seen that. What is the evidence that shows that? Is there an economic study that showed there was a shortage of capital? What is the evidence that showed that the SBA was needed to supply capital for that, or the evidence shows that there was not available capital for small business in Dutchess County?

Ms. KELLY. When I took office, IBM had canceled 14,700 jobs. GM had moved a factory that resulted in 7,000 more jobs being lost. So there was a huge job loss during the time period that I quoted in my testimony. If the SBA had not been able to insure loans by our local banks—because of the enormity of the job loss, the banks themselves were feeling some loss—without the SBA stepping in to ensure that small businesses could get those loans, the small business diversity that we have would never have occurred because the banks were unwilling to issue loans.

In many instances, the people who were furloughed out of those jobs, in fact, picked up pieces of the IBM, the old system that was there and created small businesses with ideas that they had for making that particular piece of the former IBM business better, doing it more economically and so on. They absolutely had to have loans and the loans that they were able to receive are, I believe—I don't know if I can tell you for sure that the SBA has absolute documentation that they produced the jobs, but I can tell you that working with the Chambers of Commerce and the NFIB and NAM, they can tell you that we moved along in a much more diversified and much better economic situation than we ever would have been and we did it much more rapidly because the SBA was there to help.

Senator COBURN. OK. My question wasn't meant to dispute that. I was looking for the evidence of the shortage of capital. You have addressed that somewhat because of the fear of the increased risk of the capital market to supply that, and what you are saying is this was all advanced on a faster pace because of the guarantees of the SBA.

Ms. KELLY. Exactly, because the SBA was willing to make those very small loans.

Senator COBURN. OK.

Ms. KELLY. It takes an employee just as much time to process a large loan as it does a small loan. In this instance, the SBA was there and they were willing to process the smaller loans and do it on a fairly rapid ramp-up, so we got the businesses up and going.

Senator COBURN. You have recently put out a call for a five-point plan to help small business with an emphasis upon lower regulation and taxes as a centerpiece. Would you comment for the record on that for us?

Ms. KELLY. Well, for one thing, small businesses—I will just take the tax piece alone—small businesses pay more taxes in many ways than large businesses do and the cost per employee for small businesses is greater than it is for a large business. Large businesses have banks of people in the back room that do all of their economic form filling out. A small business owner who employs one to ten people has to do that themselves. They do it on their kitchen table.

Someone who is slightly large, a mid-size business, they, too, are working to try—most of these people will have maybe one accountant, maybe two, but it costs them money. The large businesses, if you are selling stock in your business, you figure all of that in. If you are a small business, you can't figure it in because you are the only owner of that stock. So it is your bottom line that it affects when you have to hire people to fill out all these tax forms.

We need to lower the taxes on small businesses. We need to make sure that people who are the sole owner of a business—those people who have small businesses should not be double-taxed. In some instances, they take their salary from the small business and then the business itself is also taxed. These double-taxation structures are very difficult.

So there are a lot of different pieces of the tax burden alone that need to be addressed to help small businesses. They will and they want to pay their fair share, but they cannot do it if it is a constant outreach from the Federal Government reaching into their pockets for more taxes.

As far as some of the other things that I am proposing, I believe very strongly that our small businesses need to have some of the other tax structures fixed. Our small businesses can't plan. Many small businesses don't get through the third generation. My family owns a small business. We are in our third generation and I hope my children can inherit the blood, sweat, and tears my husband and I and his father and his mother put into the business, but it often happens that the tax man comes in and takes the small business and the farms because the families can't afford to pay all the taxes because we have not made the death tax permanent.

Senator COBURN. Let me ask you one other question. One of my concerns about SBA is less than 2.5 percent of its budget goes to regulation reform, the very thing that you are talking about in terms of such a burden. Is it your feeling that more of their budget ought to go to regulation reform?

Ms. KELLY. I would not tell the SBA how to do that, but I do think that regulation reform, cutting red tape, I have had a bill that was signed into law. I never could get the money. Perhaps you can help me get the money to put an office in the GAO to take a look——

Senator COBURN. I am trying not to spend any money anywhere. It is a hard sell with me, but maybe——

Ms. KELLY. Maybe we can work together to do that, but we need to absolutely stop this red tape that is harming the small businesses of this Nation. Our small businesses are subject to so many rules and regulations that they—and there is so much redundancy and overlap, we need to have the SBA's help in helping us stand down some of that, and if the SBA can do that by removing regulations of their own, so be it. We need to get the regulations off the back of small business. They must be allowed to grow.

Senator COBURN. Senator Carper.

Senator CARPER. Thanks, Mr. Chairman, and welcome. It is great of you to come. And you are from New York, correct?

Ms. KELLY. Yes.

Senator CARPER. When were you elected to the House?

Senator COBURN. Nineteen-ninety-four.

Ms. KELLY. Nineteen-ninety-four. Dr. Coburn and I are classmates.

Senator CARPER. No kidding. It is a scary thought, isn't it? [Laughter.]

Ms. KELLY. We have also worked together on a number of issues, so——

Senator CARPER. Where is the 19th District?

Ms. KELLY. Just north of New York City, Hudson River Valley.

Senator CARPER. I think you probably said this in your statement. Do you serve on the Small Business Committee?

Ms. KELLY. Yes, I do. I have for 12 years.

Senator CARPER. You must be pretty senior. Are you one of the most senior members now?

Ms. KELLY. Yes.

Senator CARPER. Are you chair yet?

Ms. KELLY. No.

Senator CARPER. Someday?

Ms. KELLY. Hopefully.

Senator CARPER. Soon?

Ms. KELLY. I hope. [Laughter.]

Senator CARPER. All right. I left the House 2 years before you got there. Mike Castle filled my shoes more than ably and I have tried to fill his as governor back in Delaware.

SBA does a real nice job in Delaware, and I think one of the reasons why is because we have some very good people that are involved in working with our businesses in our State. A friend of mine likes to say that programs don't change people, people change people. I think, really, the same is true with respect to the effectiveness of whether it is a Federal program or it is SBA. The programs are oftentimes only as good as the people that are there administering and running the programs. We are blessed in Delaware with some very able people.

Do you all have Small Business Development Centers in your State?

Ms. KELLY. We do have Small Business Development Centers.

Senator CARPER. We have them in each of our counties. We only have three counties. We have, in some cases, more than one in each county, but we are big believers in SBDCs. The idea that somebody can walk into really kind of a storefront operation, if they need help on finding access to capital, you would help them figure out how to incorporate, pay taxes, do a business plan, do a marketing plan. We have our SCORE people right there so they are able to hook up. We have sometimes folks from some of our banks that are there. It is really kind of a one-stop shop for helping small businesses. I just want to ask, how do the SBDCs work in your State?

Ms. KELLY. The SBDCs work fairly well. I represent five counties and in those five counties, we do not have an office in every one of the counties, but there is an availability for anyone from any of the surrounding counties to get to the offices that we do have, and the SBA has been working very well. It is extremely important when a small business needs a loan to enlarge their business. When you are moving up a step, those 504 loans are critical to so many small businesses.

I had a small business owner come to me and say, "I am trying to get a 504 loan. I need a piece of equipment. It is a million-dollar piece of equipment, but I think I can really pay this back." We helped him. He was able to get this equipment and he has now more than paid his business back for it. He could not have done it without that loan because he is in a tiny little area where the local bank was able to do it and they knew him, but from what their bank regulations demanded, it was too big a loan for them to handle without some kind of assurance. The SBA came in and gave them the assurance.

Senator CARPER. I arrived just as you were wrapping up your testimony. Let me just ask you if you would just repeat for me, and I apologize for getting here after you had started, just repeat for me some of the one or two major thoughts you would have us take away from your comments.

Ms. KELLY. One or two major things?

Senator CARPER. Yes. If you don't remember anything else, what would you have us remember?

Ms. KELLY. If you don't remember anything else, stay focused on helping the SBA make the smaller loans to the small and mid-sized corporations. Those are the ones that truly need the help. Larger corporations most often have other places where they can go. It is extremely important that we help those small businesses get those loans because that is where our job growth is.

Senator CARPER. Do you have anyone in your district who is doing these micro-loans, maybe under $1,000, not so much SBA or commercial banks, but do you have anyone who is doing that kind of thing?

Ms. KELLY. We very well may have, but I don't know about it if we do.

Senator CARPER. We have some faith-based organizations working, a program called Nehemiah Gateway and they are doing a really nice job with micro-loans and they are doing a nice job with helping folks with their taxes to figure out whether people are truly eligible for an income tax credit. It is something that we commend to you.

Ms. KELLY. That is something that I have been actually talking with some local people about. I have been looking at bridging loans because these 504s sometimes are—you can't qualify and there are other reasons. If you can get a loan to bridge you over into a larger—into expanding your business, it is a good way to go. I applaud you if you have micro-loans. Micro-loans are wonderful, especially for women.

When I went into the bank to get my first loan for my first small business, the bank officer—and I had enough money in the bank actually to cover the loan, I just was trying to be as economical as I could be about the way I was doing business—the bank officer said, "Of course, we will give you the loan. Come back with your husband."

Senator CARPER. Is that how you met your husband?

Ms. KELLY. No. [Laughter.]

He was already my husband when I asked him to go——

Senator CARPER. You walked up the street. You were looking for a guy. No, I am just kidding. [Laughter.]

All right. There is a gentleman right over your right shoulder who handed you a note or something. Does he work for you?

Ms. KELLY. Yes, he does.

Senator CARPER. You might just want to note, Nehemiah Gateway and a woman named Mary Dupont in Wilmington, Delaware, who runs, among other things, their ITC program and their microloan program. We always steal good ideas from New York, and maybe this is one you all could steal from us.

Thanks. Welcome. Nice to have met you.

Ms. KELLY. Thank you.

Senator COBURN. Congresswoman, thank you for your testimony. We may have a few other questions for you that we might submit for the record. If you would be so kind as to respond to those, I would appreciate it.

Ms. KELLY. Of course, I will. Thank you so much for letting me testify.

Senator COBURN. It is a pleasure. Thank you.

Before our next panel comes up, I just want to make a couple of comments. Some of the questions that need to be asked, and the reason I asked Congresswoman Kelly, is evidence of lack of capital is an important question in SBA. We also have heard and we will hear about job growth, and there is some significant economic dispute over where job growth creation comes from. We should not be afraid to have that debate in Congress, because policy based on the truth of where job growth comes on should be directed so that we incentivize the best job growth and we incentivize the capital markets in the best way.

Let me welcome Hector Barreto. He is the Administrator of the SBA. He has been in that position since 2001. He recently led his agency through the unprecedented disaster in the Gulf Coast. Prior to his work in government, Mr. Barreto was a business owner and served as Chairman of the Board of the Latin Business Association in Los Angeles.

Administrator, thank you so much for being here.

Senator CARPER. Mr. Chairman, before he speaks, you were good enough to offer me a chance to make an opening statement——

Senator COBURN. Sure.

Senator CARPER [continuing]. And I passed up on it. Let me just say, welcome, Mr. Barreto. It is nice to see you again.

Mr. BARRETO. Thank you, Senator.

Senator CARPER. One of the things that you probably heard me say before, and I would just like to say it here on the record, government has many roles. I like what Lincoln used to say, "The role of government is to do for people what they cannot do for themselves." I thought that summed it up pretty well.

The role of government is not to be a lap dog for business, for big businesses or small businesses, but I think a major role of government is to provide a nurturing environment for job creation and job preservation. We do that in a variety of ways with respect to making sure that we have a world class workforce, that the people who are coming out of our high schools and colleges have the kind of skills that our employers are looking for to try to make sure that the health care costs are not as outrageously expensive as they are today, to try to make sure we have decent transportation systems, a measure of safety in our communities and our workplaces and our homes. Those are just some of the things that—access to decisionmakers, reasonable regulation, bearable tax and that kind of thing, but also access to capital is real important. And frankly, for businesses, especially small businesses, access to good advice, to good counsel.

I applaud the work that many of the folks who work with you and are part of your team. We are really blessed in Delaware with the folks who serve on your team in our state and we are grateful for all that they do. They really see themselves as servants and their job is to help nurture particularly small businesses and folks who are trying to make a go of it and we are grateful for their help. We like partnering with them and I just want to say that for the record.

Mr. BARRETO. Thank you, Senator.

Senator COBURN. Welcome, Administrator. Your complete written testimony will be made part of the record and you are free to testify. We would like for you to limit it to 5 minutes, but you don't necessarily have to. We want you to get your message out.

TESTIMONY OF HON. HECTOR BARRETO,[1] ADMINISTRATOR, U.S. SMALL BUSINESS ADMINISTRATION

Mr. BARRETO. I will talk as fast as I can. Thank you, Senator. Chairman Coburn, Ranking Member Carper, Members of the Subcommittee, thank you for inviting me to testify about the U.S. Small Business Administration and its programs. At the risk of repeating information, let me mention some small business facts.

The U.S. Census Bureau reports that 98 percent of businesses have less than 100 employees. Economists from the SBA's Office of Advocacy report that America's more than 24 million small businesses employ over half of all Americans and create more than 50 percent of American non-farm GDP. The most recent report from the Bureau of Labor Statistics states that from September 1992 through March 2005, firms with fewer than 500 employees accounted on average for about 65 percent of quarterly net employment growth, representing 13.5 out of 20.6 million net jobs created by the private sector.

Nobody is more supportive of small business than President Bush. The President asked me to do this job because I know from personal experiences the challenges they face as well as the opportunities they create and the contributions they make. My task was

[1] The prepared statement of Mr. Barreto appears in the Appendix on page 55.

and is to make SBA a more relevant, more productive, more efficient and effective organization, one we are proud to tell you about today.

The role of the SBA is to counsel and assist entrepreneurs and small businesses by providing tools that will help them to survive and thrive.

When I became Administrator in 2001, SBA guaranteed roughly $14 billion in loans to 42,000 small businesses at a cost of over $110 million in subsidy. Four years later, in fiscal year 2005, SBA guaranteed over $19 billion at no subsidy cost to the American taxpayer, and over 98,000 small businesses received financing at terms they could not have found otherwise.

At that time, small businesses were awarded only about $50 billion in Federal contracts. Now, for two consecutive years, the Federal Government reached its 23 percent contracting goal for small business with nearly $70 billion in Federal contract awards in fiscal year 2004. That is a 40 percent increase.

Finally, our technical assistance partners trained or counseled over 1.1 million small businesses in fiscal year 2005.

By restructuring key operations and reengineering loan programs, the SBA has achieved record program growth while operating more efficiently. SBA's fiscal year 2007 budget request is more than 30 percent less than its regular fiscal year 2001 appropriation, but that fiscal year 2007 budget request allows us to offer $28 billion in financial assistance and maintain the zero subsidy. That is a record in loan-making authority. Moving to zero subsidy allowed the agency to continue to meet the financing demands of small businesses without a taxpayer subsidy. For the first time in several years, the SBA stabilized the 7(a) loan program and offered financing without loan caps or temporary suspensions of program availability. In addition, it focuses agency resources on enhanced oversight of the portfolio in order to maintain a zero subsidy rate.

With improved efficiencies and technological enhancements, Federal procurement dollars going to small businesses have grown, as well. In fiscal year 2004, small businesses received contracts totaling over $69 billion of the approximately $300 billion in Federal contracts, $20 billion more than in fiscal year 2000, supporting an estimated 156,000 jobs. Additionally, there were an estimated $45 billion in subcontracts awarded to small businesses.

SBA's Office of Entrepreneurial Development offers assistance in various aspects of business planning through our resource partners, those Small Business Development Centers, the Women Business Centers, and SCORE, who trained and counseled over 1.1 million clients in fiscal year 2005. Additionally, 311,000 clients registered for our 23 online courses, and one million accessed the SBA website.

Let me give you an example of how SBA programs work together. Last year, Bob Layton and James Gardner, both veterans and experts in the oil field business from Oklahoma, went to our resource partner, the Small Business Development Centers, looking for assistance to launch their business. After being turned down for commercial lending options, they received financing through our 7(a) loan guarantee programs. In September 2005, 3 months after they started HOFSS—that stands for Horizontal Oil Field Supply

Systems—they won a FEMA contract to apply their oil field technology to pump 169 million gallons of water out of New Orleans, something that would have taken much longer without taxpayers' initial support. What a great story.

In conclusion, Chairman Coburn, Ranking Member Carper, and Senators, SBA is today assisting more small businesses at less cost to the taxpayer. I am proud of our achievements and the efforts by SBA's employees to make this possible. There is still more work to do, but we are committed to delivering greater results for the American taxpayer.

However, SBA programs alone cannot drive small business growth. President Bush's small business agenda making enacted tax cuts permanent, eliminating unneeded regulation, passing an association health plan bill, and opening international markets to American goods and services are vital.

Mr. Chairman, I thank you again for the opportunity to testify in front of your Subcommittee and I look forward to answering your questions.

Senator COBURN. Thank you, Administrator.

A couple of things, let us get out of the way. What is the SBA's definition of small?

Mr. BARRETO. Well, there are a couple of definitions that are very well known. If you are trying to do business with the government, in other words, going for Federal procurement, it is a revenue size standard depending on your industry, and different industries have different size standards, but an average is $5 to $6 million in revenue a year. If you are a manufacturing firm, it could be companies that have 500 or less employees.

The reality is that more than 90 percent of businesses aren't anywhere close to that. Most small businesses are very small.

Senator COBURN. But should a firm that has $8, $9, $10, or $20 million in revenues or profits and 500 employees—you are calling that small. I think that is big.

Mr. BARRETO. Again, it depends on what you are referring to——

Senator COBURN. Well, if you look at the distribution of the number of employees in facilities, a manufacturing facility with 500 is in the upper range of what we see in this country.

Mr. BARRETO. Right.

Senator COBURN. So that is not small by any definition in terms relative to the mix of what we have.

Mr. BARRETO. It depends on how you define it.

Senator COBURN. That is why I asked the question.

Mr. BARRETO. And the reason is that most manufacturing companies, as you know, most of the revenue that they make goes right back into the company. If you have 500 employees and you are a manufacturer, depending on what industry, that may not be a very profitable company. There is a lot of money that goes into capital expenditures, infrastructure, and those employees, and that is why we have two definitions.

If you are trying to go after a government contract, you may only have a few employees, but if you exceed the revenue size standard in that area, you are considered large by our definition.

Senator COBURN. OK. Well, look at this chart over here that I have up.[1] General Dynamics, net income was $1 billion——

Mr. BARRETO. We don't consider that small.

Senator COBURN [continuing]. And $13 billion in revenues, and they have $30 million worth of contracts under the restricted contracting program. Titan Corp., they obviously aren't making much money, but their revenues are greater than $1 billion, they have 10,000 employees, and they have $540 million in restricted access contracts. Raytheon, everybody around Washington knows Raytheon, a $16 billion company, 76,000 employees, and $126 million in contracts. I am asking that question——

Mr. BARRETO. Sir——

Senator COBURN [continuing]. Because I know you can't screen all of this out, and that isn't my point. My point is we know what the statute says in terms of your direction——

Mr. BARRETO. Right.

Senator COBURN [continuing]. And what you are trying to do in terms of the 23 percent. One of my questions on the data—and what was the name of the ombudsman or the advocacy office of the firm they hired? Eagle Eye. They talked about that it is really not 23 percent because there are some contracts that are so big that they are taken out of the mix, and since the denominator is made smaller, it raises the percentage.

So is the 23 percent number accurate as far as you are concerned, and has the denominator been lowered because some contracts aren't available to SBA-eligible firms?

Mr. BARRETO. We think the 23 percent is pretty accurate. Look, there are some things, for example, the Department of Defense is the largest procurement agency in government and if they are buying an aircraft carrier or the new jet fighter, there is probably not a small business that is going to be able to provide that to them. So there are some things that are going to be taken out of the mix.

But also, I want to refer to your chart. I think there is a misunderstanding, and the Eagle Eye study tried to clarify that misunderstanding. We don't have an incidence where we have these large companies that are going in there, taking contracts away from small businesses. What we do have is that sometimes a small business will get a contract when they are small and then they will outgrow the size standard. Now, they still have that contract, but they didn't get the contract when they were large.

And sometimes a small business will grow and become successful after they have gotten small business procurements and they will be purchased by a larger company—a Raytheon, a General Dynamics. But Raytheon and General Dynamics didn't go after a small business contract. What they did is they purchased a small business who had a small business procurement in their portfolio.

Senator COBURN. Which probably explains most of this, is that correct?

Mr. BARRETO. We believe it does explain most of it.

Senator COBURN. So when they are buying, they are buying an advantaged position in contracting with the Federal Government.

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[1] The chart appears in the Appendix on page 52.

Mr. BARRETO. Usually, that is not why they are buying the company. Usually, they are buying the company because they are trying to acquire some kind of technology or some kind of patent. Large companies have discovered that it is much more cost effective for them to let a small business develop the innovation, the technology, and then purchase that. I think you see that every day from some very large companies. There are announcements in the paper every day about that.

Senator COBURN. I don't doubt their motivation, but the fact still remains that they have bought an advantage over somebody else who now would be a small competitor and now they own it. So the question is, what happens? Is there any attempt to change those rules so that you go out and you can knock off a market——

Mr. BARRETO. Right.

Senator COBURN [continuing]. You are keeping another small business from competing for that same thing because it is now owned by a giant.

Mr. BARRETO. Yes. That is a good point. Before the Eagle Eye study came out, the SBA put forward a regulation that requires a small business that is selling their company and selling those small business procurements to a larger company to certify that they are going to a larger company. That is very important. I think that will mitigate a lot of what you are referring to.

Senator COBURN. Has anybody done a study that would compare capital market availability without the 7(a) program?

Mr. BARRETO. Sure. There are lots of studies out there. There are organizations, for example, like the Greenlining Coalition. You may have heard of them before. They have done a lot of work in this area, and they claim that without SBA programs, without SBA filling that gap, many communities, especially the emerging markets, the fastest-growing segments of small business in the United States, which are minority businesses, 40 percent of all businesses are owned by women, would be prevented from accessing a lot of this procurement.

You don't have to go very far. You can go anywhere in the country and if you ask small businesses, what is one of their biggest challenges, they are going to tell you it is accessing capital. This is a common complaint from small businesses.

Senator COBURN. I am just going to take another 30 seconds. Is there a point in time when a small business shouldn't have capital and some other small business should and one of them fail and one of them succeed?

Mr. BARRETO. I am not sure I completely understand that question. What I will tell you is that small businesses are pretty savvy consumers. Oftentimes, they are getting an SBA loan because there is no way for them to get the loan without the guarantee. It doesn't mean they are a bad business. It doesn't mean that they won't be successful. It may mean that they don't have a long track record. It may mean that they need a loan for a longer term than a lender can offer them. But when that business becomes——

Senator COBURN. It may mean that they can get a lower rate if they have got an SBA——

Mr. BARRETO. They don't get a lower rate. They get competitive interest rates, and after they pay the fees that the lenders pay, they get a larger—it costs them more to get an SBA loan.

Senator COBURN. But your comparison is against an unknown sample. You are saying they can't get capital.

Mr. BARRETO. I am saying——

Senator COBURN. So how can you contrast against the very premise that says somebody cannot get capital and saying that they are not getting the rate? If you cannot get capital, there is an infinite interest rate.

Mr. BARRETO. They can get capital, but they are not going to get capital at those rates.

Senator COBURN. That is right. That is exactly my point.

Mr. BARRETO. They can get capital through a factor. They can get capital from a credit card company. They can get capital from some unsavory sources who are going to ask for a huge, onerous——

Senator COBURN. I am talking about legitimate——

Mr. BARRETO. Yes, apples-to-apples comparison, a lot of times, the only chance that they get, the only chance they are going to get is if they get that loan guarantee, because in a lot of those cases, that borrower is very close, but that lender might say, look, I want to do the deal, I believe in your company, but if we could get the guarantee from the SBA, I think we can do this deal, and I think that is what happens in a lot of the cases.

Senator COBURN. OK. I want to cover one last point, the President's PART Management System.

Mr. BARRETO. Yes.

Senator COBURN. You all are still in the red on financial performance.

Mr. BARRETO. Well, we have actually made significant progress over the last few years. We got a clean opinion on our audit last year. We have a tremendous amount of controls that have been put in over the last couple of years. We have a loan monitoring system for the first time in a long time.

So I agree with you. We are not totally satisfied we are there yet, but, of course, we have worked very closely with GAO. We have taken a lot of their recommendations. In fact, they have told us, and I believe that you are going to have some testimony, that they like the direction that we are going on the implementation of a lot of those.

Senator COBURN. You are—and I want to give the President and his Administration credit. This is the first time ever in our history that good, transparent management systems have been installed, and even though you are not there yet, you are making progress. But it is still in the red, which means if you were an agency—anybody trading publicly in this company, you would be in hock with the SEC big time and you would not be traded right now.

Mr. BARRETO. Right. Well, I think one of the reasons we might be traded is the fact that even though our budget has gone down 35 to 40 percent, the production of the agency has doubled over the last 4 years. And also, we are very proud of the President's management agenda where we are currently green in three out of the five areas and green on progress on every one of those areas.

Senator COBURN. You are. One last thing, and you don't have to comment on it, but we are going to be submitting a lot of questions for the record on default rates——

Mr. BARRETO. Sure.

Senator COBURN. For example what the American people are actually exposed to, because that is not talked about often in terms of the SBA, and several other questions.

I will defer now to Senator Carper.

Senator CARPER. Thank you. Let me go back to a question that the Chairman asked about the two businesses trying to vie for credit, and one maybe has a more meritorious idea than the other and whether or not one could get credit maybe, or the company with the less meritorious idea or business plan or business model.

Sometimes if you or I are a company or small business and the administrator here is the banker and I know him because we went to high school together, or I know him because my wife and his wife are friends and there is a relationship that exists outside of the merits of the business, there are those kinds of advantages that come to bear here, as well. Personal relationships do matter. Sometimes good ideas don't get funded in the private sector simply because of those relationships. That is just kind of a fact of life.

You mentioned your budget is down, what did you say, 30 percent?

Mr. BARRETO. Approximately 35 percent over the last few years from where we were.

Senator CARPER. What is going on with the funding for Small Business Development Centers over the last 3 or 4 years?

Mr. BARRETO. Funding for SBDCs has been pretty level. I mean, that is pretty much—I think we put $90-plus million into it. With what they raise on their own—remember, it is a match. It is a dollar-for-dollar match. But oftentimes, they exceed that match. That is really close to a $200 million program.

Senator CARPER. Where does the match have to come from?

Mr. BARRETO. Well, it comes from a variety of different sources. As you know, Senator, many of those SBDCs are located at universities and community colleges, so oftentimes the partner is that educational institution. But they are not always there. Sometimes they are sponsored by a State agency. Sometimes there are nonprofits that contribute to it. They may be getting money from the private sector. But most of the time, you are going to see it come from a university system or a State budget.

Senator CARPER. When you look at the Administration's request for SBDCs, say in 2006 or 2007 compared to, say, 2001 or 2002, what does it look like?

Mr. BARRETO. Well, it has been pretty flat.

Senator CARPER. I know that is where we have ended up in terms of appropriations, but I am asking about requests.

Mr. BARRETO. Well, every year we work together with the SBDC organization. In fact, this year, they met with the Office of Management and Budget directly, which we were very glad that we could facilitate that, because it is important for them also to be able to state their case. As what has already been said, every dollar that goes——

Senator CARPER. Would you try and answer my question? It is not a trick question or anything like that. My recollection is the Administration comes in each year and asks for less and less for SBDCs——

Mr. BARRETO. No.

Senator CARPER [continuing]. And we end up going ahead and restoring the funding——

Mr. BARRETO. We pretty much ask for the same amount every year. What happens, though, is the SBDCs come in and ask for more every year and we feel that the amount of money that we are already investing in that program and the amount of money that is leveraged against that should also go into the equation.

Senator CARPER. OK. Let us talk about New Orleans. The Chairman and I are going to go down to New Orleans and have a field hearing on Monday and we will be talking with folks from businesses large and small there and the folks that are trying to rebuild levees and all. Just take just one minute and talk to us about New Orleans and what you all are doing down there, what we need to be mindful of as we go down.

Mr. BARRETO. One minute. Seven-and-a-half billion dollars so far. That is almost twice as much as ever has been guaranteed in U.S. history. We processed pretty close to 400,000 applications. We are dealing with an area that is 90,000 square miles wide. We are dealing with five States, millions of people. And I just tell you this——

Senator CARPER. Do you have any posters or any visuals? It looks like there might be something right here.

Mr. BARRETO. Well, these are the average days to a billion. It took us 88 days to do a billion dollars. We did the second billion in 28 days. We did the third billion in 17 days. We did the fourth in 16 days. We did the fifth in 21 days. And the last billion, we did in 13 days, and that is pretty much what we are running right now.

I think the key that people need to understand is it truly has been an unprecedented disaster. I am glad that you are going to be down there. I have been down there five times——

Senator CARPER. But what should we be looking for?

Mr. BARRETO. Well, I think we should be realistic on the conditions on the ground and what it is going to take for these folks to get back on their feet. I mean, it is just—it is truly devastating. I mean, two-thirds of the people are still gone. There are parts of the city that still haven't been decided about if they are going to rebuild. The customer base is gone. The worker base is gone. There are huge difficulties to rebuilding that the small businesses and the homeowners are still facing down there.

In fact, I think there was an article this week in either *The Washington Post* or *The New York Times* that was talking about people who have already got loans who are saying, "I don't even know with the loan if I am going to be able to rebuild."

Senator CARPER. OK. You mentioned in your testimony, you talked about association health plans.

Mr. BARRETO. Yes.

Senator CARPER. I think I mentioned in my comments the access to affordable health care and that the rising cost of health care in this country is killing us.

Mr. BARRETO. Yes.

Senator CARPER. And whether you happen to be businesses large or small, and we look at the government itself and the funding for Medicare and Medicaid, it is killing us as taxpayers, as well, because we end up borrowing all that money from overseas to help fund programs like Medicare and Medicaid.

Our friends Senator Enzi and Ben Nelson have tried to get together and improve, if you will, the association health plan legislation. They are offering that, I think, when we maybe come back in a couple of weeks. We are going to have a chance to take up and debate on the floor AHPs with a real focus on what they are doing.

Senator Blanche Lincoln of Arkansas has proposed, along with several of us, a different kind of idea, and I just want to mention it to you. I think it is one with merit. You know how we have the Federal Employee Health Benefit Program, where we sort of allow all of our Federal agencies, little ones and big ones, to kind of pool their purchasing powers to ask insurers to come in and offer us health care plans, and given that kind of massive purchasing power, we get pretty good rates and fairly good variety of plans. What we are trying to do is to get the Office of Personnel Management to play a similar function for small businesses and allow a little business where you have 10 employees or 100 employees to act almost as Federal agencies, small Federal agencies, and to pool together their purchasing power.

I think that is an idea that has merit, as well. You have probably heard about it, and I just wanted to——

Mr. BARRETO. I have definitely heard about it.

Senator CARPER [continuing]. Lay it on the table.

Mr. BARRETO. Well, that is the whole concept between association health plans. We want small businesses to be able to pool together across State lines, develop their own pools, decide what kind of insurance they want, and be able to negotiate better rates and better benefits from the private sector.

Senator CARPER. If you could just sort of critique for me, if you will, the plan put forth by Senator Lincoln. What do you like about it? Any reservations about it?

Mr. BARRETO. Well, I think that small businesses get really concerned when we start talking about a government-wide program, a government-wide health program. They start thinking about some of the other large bureaucracies in government and how those work and what the customer service is and what the flexibility is and I think they get nervous about it. They get worried about it.

What they would rather have is they would rather be empowered themselves. What they can't understand is why they are the only group in America that doesn't have access to affordable health care. If you work for a large corporation, you have it. If you are a member of a union, you have it. If you are a government employee like I am now, you have it. But if you are a small business owner, good luck. You are going to get double-digit increases on your health insurance every year whether you use it or not. There is less choice now. I remember when I——

Senator CARPER. I don't mean to be rude, but my time has expired and I am just going to——

Mr. BARRETO. Oh, you said one minute, I am sorry.

Senator CARPER [continuing]. Interrupt you, if I may. What we are trying to do with Senator Lincoln's proposal is to give the small businesses, frankly, the opportunity to get the kind of health care that we do. You mentioned a reluctance on the part of small businesses having these country-wide or nation-wide programs.

Mr. BARRETO. Yes.

Senator CARPER. You actually administer several of those——

Mr. BARRETO. Yes, I do.

Senator CARPER [continuing]. And they are, for the most part, I think, a good thing for small businesses.

Mr. BARRETO. Yes.

Senator CARPER. The last thing I want to bring up, my staff is good enough to hand me this question. It says, a question for SBA and/or GAO, and since I am not going to be here when our friends from GAO testify, I just want to take a moment and share it with you.

I am told that we will hear testimony from another witness later in the afternoon, Ms. de Rugy, that small business, including minority and female-owned businesses, may not have as much of a problem accessing credit as most people might believe. I believe this witness will note at one point that 80 percent of small businesses in a recent survey used some kind of credit and more than 71 percent, she says, use non-traditional forms of credit, much of it credit cards.

Here is my question. Have you seen any research comparing the success of businesses that can get bank loans and those that might depend on some of these non-traditional forms of credit?

Mr. BARRETO. Well, there have been a lot of different research. I don't know if it has been specific to that. You know, we have an Office of Advocacy that does a lot of research on it. One of the things they are going to tell you is that 50 percent of small businesses don't make it past 5 years. They go out of business. They don't go out of business because they want to. They don't go out of business because they didn't work hard. They don't go out of business because they are not creative and innovative. They go out of business because they don't have the tools that they need to succeed. At the top of the list is access to capital.

But they also need other things that we provide. They need technical assistance. A lot of times, they don't know what they don't know. It is not their fault. They are good at one thing and they may not be good at something else. They need access to opportunities. They need access to Federal contracts, to contracts with the private sector.

In all of those areas, SBA provides a critical role. I will tell you that the fastest growing segment of small business are those minority businesses. All you have got to do is pick up the newspaper. Last week, the Census Bureau reported that Hispanic business, for example, is growing three times the national average. Women are the fastest overall group.

And if you listen to them, they will tell you a very different story. When I was in business, I learned a long time ago, if you listen to your customers, they will tell you everything you need to know about what they need to be successful, and these groups are very vocal and adamant that there is not a level playing field yet, they are not there yet, they still need assistance. They are not asking for a handout, they want a hand up. They want an opportunity to get in the game and they will do the rest.

I think that is one of the things that has made our country the greatest country in the world. I will tell you that we get countries coming into our agency every day asking us to please help them duplicate the programs of the SBA, and we are proud to do that.

Senator CARPER. All right. Good. Thanks very much for being with us today and for your leadership.

Mr. BARRETO. Thank you, Senator.

Senator CARPER. Thanks.

Senator COBURN. We will be submitting multiple questions for the record for you, Administrator. Just to give you a heads up, right now, your testimony is that 7(a) and 504 operate without a subsidy, but that is kind of Washington-speak because your numbers are $675,000. Subsidy rate is zero percent, but the number is $675,000. It doesn't fit into a percentage, but there actually is money——

Mr. BARRETO. Right. The cost of producing the loans, it doesn't cost the U.S. taxpayer any money. But does money go into our capital access program for employees and for office? Yes, we have money that goes into that.

Senator COBURN. So there is a cost?

Mr. BARRETO. Well, there is a cost to oversee the program and to be able to interface with the 6,000 lenders that we have as part of our delivery system.

Senator COBURN. Why wouldn't we want the cost of those programs to pay for that, as well, since we are going to be in a declining budget? I mean, if we say there is zero subsidy, we ought to say there is zero subsidy.

Mr. BARRETO. Well, what I am saying is that when a loan defaults, the U.S. taxpayer doesn't, as before, used to put up $110 million to cover those. They don't put up that $110 million anymore. So the fees that——

Senator COBURN. So no subsidy for the loan default risk?

Mr. BARRETO. That is right.

Senator COBURN. But there is still a subsidy for the loans.

Mr. BARRETO. Well, there is an appropriation that goes to the SBA to run our programs, yes.

Senator COBURN. And so the point is the SEC, their appropriation is part of what they collect. All I am trying to do is make a point——

Mr. BARRETO. Right.

Senator COBURN. Could the SBA be like the SEC and not take any taxpayer dollars?

Mr. BARRETO. Of course, we do a lot more than just do loans, but I hear your point.

Senator COBURN. OK. The other thing we will be talking about is if at any point in time you find this is not to be the case or you are amenable to changing your rates, to make sure it stays that way.

Mr. BARRETO. You are talking about the zero subsidy?

Senator COBURN. Yes.

Mr. BARRETO. Absolutely. I mean, we are committed to it. It is one of the reasons that every year that we have been there—well, the last couple of years, we have broken every record in SBA history.

Senator COBURN. Yes.

Mr. BARRETO. So a zero subsidy works and we are committed to it.

Senator COBURN. And we are going to give you a great opportunity to directly refute Ms. De Rugy's testimony——

Mr. BARRETO. Great.

Senator COBURN [continuing]. And that will be one of the questions we will ask you.

Mr. BARRETO. Wonderful.

Senator COBURN. OK.

Mr. BARRETO. Thank you, Senators. I appreciate it.

Senator COBURN. Thank you so much for being here.

Mr. BARRETO. Thanks a lot.

Senator COBURN. Our next panel is panel number three. First is William Shear, Director of Financial Markets and Community Investment at the Government Accountability Office. He received his doctorate in economics from the University of Chicago.

Veronique de Rugy is the Research Fellow at the American Enterprise Institute.

Third is Jonathan Bean, a professor at Southern Illinois University. He received his doctorate in business history from Ohio State University. He has been published extensively on issues relating to small business and the Small Business Administration.

David Bartram is the President of U.S. Bank's SBA Division, Chairman of the National Association of Guaranteed Lenders. His organization represents approximately 80 percent of lenders that issue SBA loans.

And then finally is John Pointer. He is a former NFL linebacker and small business owner. He received help through a SBA program and is here to share his experiences.

I would like to thank each of you for being here. Your full written testimony will be made a part of the record and you will be recognized in the order in which I introduced you. Mr. Shear, if you would start, please. Thank you.

TESTIMONY OF WILLIAM B. SHEAR,[1] DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. SHEAR. Thank you very much, Mr. Chairman, Senator Carper, and Members of the Committee. It is a pleasure to be here this afternoon to discuss the evaluations we have made at the Small Business Administration. My testimony is based on a number of reports that we have issued since 1998. These reports have focused on how well SBA has administered its programs in carrying out its mission.

[1] The prepared statement of Mr. Shear appears in the Appendix on page 62.

SBA's purpose is to promote small business development and entrepreneurship through business financing, government contracting, and technical assistance programs. In addition, SBA's Office of Disaster Assistance makes loans to households to repair or replace damaged homes and personal property and to businesses to help with physical damage and economic losses.

Significant changes in SBA's management of its loan programs, its information technology, human capital, and financial resources have occurred, and we have studied various aspects of these changes. Today, I will discuss, first, changes in SBA's oversight of the 7(a) business loan program; second, steps SBA has taken to improve its management of information technology, human capital, and financial reporting for its business loans; and third, SBA's administration of its disaster loan program after the September 11 terrorist attacks and the recent Gulf Coast hurricanes.

In summary, since the mid-1990s, when we found that SBA had virtually no oversight program for its 7(a) guaranteed loan program, SBA has, in response to our recommendations, established a program and developed some enhanced monitoring tools. The oversight program is led by its Office of Lender Oversight, which was established in 1999. Although we have not comprehensively reviewed the 7(a) program in some time, over the years, SBA has implemented many of our recommendations for lender oversight and continues to make improvements toward addressing others.

With respect to other management challenges since the late 1990s, SBA has experienced mixed success that affects its ability to manage the 7(a) program. While the agency was unsuccessful between 1997 and 2002 in developing its own information technology for a loan monitoring system, it awarded a contract in April 2003 to obtain loan monitoring services. This service allows SBA to carry out off-site monitoring of its 7(a) lenders to help evaluate risk and other loan characteristics. The agency has made good progress in response to our recommendations addressing financial management issues, but there are still some that remain. There are still challenges that remain in all these areas.

Now, I will turn to SBA's administration of its disaster loan program. After the 9/11 terrorist attacks, we found that SBA followed appropriate policies and procedures for disaster loan applications in providing approximately $1 billion in loans to businesses and individuals in the disaster area, as well as to businesses nationwide that suffered economic injury.

We are now evaluating the agency's response to the 2005 Gulf Coast hurricanes. Our preliminary findings indicate that SBA's workforce and new loan processing system were overwhelmed by the volume of loan applications. We have identified three factors that have affected SBA's ability to provide a timely response to the Gulf Coast disaster victims.

First, the volume of loan applications far exceeded any previous disaster.

Second, although SBA's new disaster loan processing system provides opportunities to streamline the loan origination process, it initially experienced numerous outages and slow response times in accessing information.

And third, SBA's planning efforts to address a disaster of this magnitude appear to have been inadequate.

In summarizing, I want to make one more statement about the Gulf Coast hurricanes and what has happened to our Gulf Coast residents based on our experience in visiting the region. Our hearts go out to the victims, and I think, Senator Coburn, as you have been in the region and all of us that have gone there, our hearts just have to go out to the victims of this and our hearts are with helping those victims get their lives back.

I will also say that there have been a number of people who have worked for the SBA in this region who have been very dedicated on a daily basis. We might have some questions about the leadership that has come in this effort, the planning efforts and other characteristics of the response of SBA, but we have certainly seen an awful lot of dedicated public servants really put out tremendous effort in trying to help these victims recover.

With that, I would be happy to answer any questions that you may have.

Senator COBURN. Well, you obviously, Ms. de Rugy, are the one that has raised all the stir and controversy over this hearing. People don't want to hear an opposite viewpoint from what has been expressed many times. I want to welcome you to our Subcommittee and tell you we value every opinion, especially learned opinions of people who actually study capital markets. The comments that have been made because you have written on this in the past would lead me to believe that there is something more in terms of problems with the SBA than what we have had because of the tremendous overreaction.

I just want to tell you, I welcome you here. I welcome your testimony. And anybody who truly supports the SBA ought to welcome any criticism there can be because that will hone it to be better and make us better. So I want to defend your right to say what you are going to say. I want to defend the excellence that I have seen that comes out of AEI and other research that you have done. I think it is great for us to hear from you and I welcome you. Take the time that you need.

TESTIMONY OF VERONIQUE DE RUGY,[1] RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Ms. DE RUGY. Thank you, Mr. Chairman. Chairman Coburn, Ranking Member Carper, who is gone, Members of the Committee, it is an honor to appear before you today to discuss the effectiveness of the Small Business Administration. The promotion of small business is a cornerstone of U.S. economic policy. There are about 25 million small business firms in the U.S. employing almost 50 percent of all workers.

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

[1] The prepared statement of Ms. de Rugy appears in the Appendix on page 85.

Encouraging lending to small businesses is one of the primary purposes of the Small Business Administration. Its main program to achieve that goal is the SBA's flagship loan guarantee program, the 7(a) loan. But are these SBA loan guarantees desirable? Is there, in fact, a market failure that justifies government intervention via the SBA? If there is a market failure, are the SBA programs well designed to address the problem, or if there is no market failure, does the SBA help achieve policy goals important enough to justify its meddling in a well-functioning market?

First, my work concludes that there seems to be no failure of the private sector to allocate loans efficiently. There might have been 53 years ago, but today, it is not true. A large and growing body of research has challenged the widely-held belief that credit rationing makes it difficult for small businesses to obtain capital. A series of papers by de Meza and Webb conclude that government intervention is not necessary and may actually be detrimental to entrepreneurship. The theoretical arguments are confirmed by an increasing number of empirical studies.

However, if for the sake of argument we assume that there is a market failure that prevents small businesses from receiving adequate credit, we can show that the SBA's loan programs are not an effective way to combat the problem. Basically, if there is a gap between the supply and demand of loans, the SBA is irrelevant in trying to fill it.

Looking at the flow of SBA's 7(a) loans, we find that, one, no more than 1 percent of all small business loans are SBA loans each year. The private sector finances most loans without government guarantee, and hence, the SBA is largely irrelevant in the capital market.

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

Three, each year, in the 25 sectors receiving the largest share of 7(a) loan guarantees, less than 0.5 percent of small businesses receive the guarantees.

Four, there is no shortage of firms or new start-ups in America. The data suggests that new businesses would be started at the same rate without SBA's 7(a) loan program.

Five, in 2004, 29 percent of 7(a) loan guarantees went to minority business owners, but the SBA accounted for only 3 percent of all loans to minority firms. The same trend is true for women-owned firms.

Six, the market is 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, since the small distribution of SBA loans is in highly competitive sectors, it is unlikely to greatly improve the prices and products available to consumers or significantly bolster economic growth. The primary effect of the SBA loan guarantees is to create an unlevel playing field and hurt non-SBA firms.

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

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, costing a lot of taxpayer money, the economic growth triggered by the other borrowers compensates for this loss, but you still have to measure it. And on that front, the results of my studies show that it is very unlikely that SBA loans create enough value to compensate for the risk taken by taxpayers.

First, there is the high level of default among SBA borrowers.

Second, the SBA cannot point out success stories, other than marginal examples, that would compensate for the costs to taxpayers. In addition, for each SBA success story, we can point out thousands of examples of firms that became great stories, great entrepreneurial American stories, and that did it without the help of the government.

The SBA's case rests mainly on anecdotes of small firms staying afloat thanks to its program, yet that is a very weak case for the program, especially considering the large literature showing that average weekly wages, which are highly correlated to productivity and economic growth, increase with the size of the establishment.

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 the help of the government.

Thank you, Mr. Chairman.

Senator COBURN. Mr. Bean, welcome.

TESTIMONY OF JONATHAN J. BEAN,[1] PROFESSOR OF HISTORY, SOUTHERN ILLINOIS UNIVERSITY

Mr. BEAN. Thank you, Chairman. I brought a book for you on the history of the Small Business Administration, and since the Ranking Member has left, I will have to send him his copy. Thank you for inviting me here to speak on a subject I have studied for some 15 years, which culminated in my book, "Big Government and Affirmative Action: The Scandalous History of the Small Business Administration."

I have a written statement for the record and I have also prepared a few brief words on the effectiveness of the Small Business Administration. I will offer a 5-minute assessment of the program, and then hopefully during questions and answers, I have six concrete ways to eliminate what you call waste, fraud, and abuse in SBA programs.

In a word, the SBA was and is unwanted, unknown, and unneeded. First, it was the unwanted orphan of the Reconstruction Finance Corporation, RFC, a huge government lending agency established during the Great Depression. In 1953, a new Republican

[1] The prepared statement of Mr. Bean appears in the Appendix on page 112.

President and Congress carried through on their pledge to eliminate the corrupt RFC, but created the SBA as a stop to small business advocates in Congress. Since then, however, nearly every President I studied sought to eliminate the ineffective, scandal-ridden SBA or merge it into another government agency, usually the Commerce Department. It has survived because it serves the interests of Congress, not the small business owner.

Second, the SBA is the, "great unknown" among small business owners. Very few ever come into contact with it, and any support is a football field wide and an inch deep. Congress and bankers are the prime constituencies keeping it alive. Indeed, the SBA has been called by more than one author, "a creature of Congress."

Third, the SBA is unneeded. Government reformers have proposed sunsets for legislation so that Congress will periodically revisit the effectiveness of laws that may have outlived their usefulness. The sun set on the SBA a long time ago, yet Congress has failed to follow through on decades of studies, many of them by the GAO, highly critical of the agency's various programs. There is little fear, however, about sunsetting the Small Business Administration. If the SBA fell dead in the economic forest, few people not on its door would hear it crash.

What are some of the problems with the SBA? And I do have solutions later, if you are interested. First, it represents an unstated back-door industrial policy, a notion discredited by the experience of the past quarter century. That is the notion of the government picking winners in the economy, or gazelles as they are called in small business literature, just as they did in Europe and Japan. The U.S. economy, proponents argued in the 1980s, was lagging behind Japan and Europe because government and business were not intertwined. Twenty years later, we see that the industrial policy model has failed in the long run, vindicating the American path of growth through deregulation and tax reform, so-called climate policies. Yet the latest rationale for the SBA is that it picks winners, though no evidence to back that up, helping small firms create jobs and spawning technological innovations.

Second, the SBA doesn't help the truly small or disadvantaged business. Those are groups that are never adequately defined by the agency. Moreover, when it did try, the SBA's efforts to wage war on poverty or create start-up businesses in high-unemployment areas failed miserably. There were additional policy failures in lending with taxpayers cosigning the loans and absorbing the risk bankers should themselves take, contracting preferences to small and not-so-small businesses, affirmative action originally targeted at African Americans which collided with immigration reform, making Asians and Hispanics the unintended beneficiaries of billions set aside for disadvantaged firms.

Last, the SBA's history is uniquely scandalous in the modern era. Neither party escapes blame. The Eisenhower Administration turned the SBA into a huge pay dirt plum, under Kennedy, an SBIC venture capitalist dealt in their own firms, minority programs have fostered unending scandals involving fronts, cronyism, and governmental corruption, the most spectacular examples being Wedtech under Reagan and Whitewater under President Bill Clinton.

I asked former SBA Administrator Bernie Boutin why scandals keep sticking to the SBA and he said, "Any time you have money, you will immediately find the mugs. It draws them like flies." I might add that it is other people's money.

I have one last short paragraph. Let me end with several quotes by Senator William Proxmire, longtime nemesis of the SBA, best known for his Golden Fleece Awards for government waste. In the 1960s and 1970s, Proxmire characterized the SBA as "a medium-sized or even a big business administration," not dedicated to the truly small businessman and one that only helped a minute number of businesses. He put the SBA on a short list of wasteful, useless agencies—his term—that should be abolished. Others included the Selective Service and the Interstate Commerce Commission, agencies that have passed away.

In 1979, this maverick Democrat, joined by a growing chorus of critics, stated, "The Federal Government is too big, spending is excessive, the SBA, which has lost its way and outlived its usefulness, is the place to start cutting." And later, in 1985, Proxmire labeled the SBA one of Washington's ten worst boondoggles.

This Congress has an opportunity to carry through on Proxmire's legacy and eliminate this distraction from the real problems facing small business.

Senator COBURN. Mr. Bartram.

TESTIMONY OF DAVID BARTRAM,[1] CHAIRMAN, NATIONAL ASSOCIATION OF GOVERNMENT GUARANTEED LENDERS

Mr. BARTRAM. Mr. Chairman, I appreciate the opportunity to testify today on the effectiveness of the SBA's 7(a) program, SBA's largest and oldest guaranteed loan program.

The SBA 7(a) program fills a critical gap for small businesses that need access to long-term loans. In fact, the SBA in partnership with private sector lenders who use the 7(a) and 504 loan programs account for about 40 percent of all long-term loans to small businessmen throughout this country.

This means SBA is the single largest provider of long-term loans to U.S. small businesses. Conventional sources, like conventional banks, typically make short-term loans to match short-term deposits, and this leaves small business with a credit gap for long-term loans. Therefore, the SBA loan programs are where small businesses and the private sector lenders turn to bridge this gap. This is especially true for new business start-up ventures and early or younger companies.

An important note is that the SBA's 7(a) loan program is self-funding. It receives no Federal appropriations for credit losses, to clarify your previous point. Instead, fees paid by the borrowers and lenders alike keep the 7(a) subsidy rate or net present value cost to the government at zero.

It is also important to note that according to the Administration's fiscal year 2007 budget submission, over the last 10 years, fees paid by the borrowers and lenders have been excessive. More than $800 million in excess fees have flowed back to the Treasury. This means that the SBA has collected far more than necessary to cover

[1] The prepared statement of Mr. Bartram appears in the Appendix on page 128.

predicted costs of the SBA's 7(a) program. In short, the SBA 7(a) program has been a profit-maker, not only through the fee income but also through tax revenues paid by small businesses, their owners, and their employees.

Small businesses benefit from a SBA loan in three ways. First, the SBA provides access to capital on reasonable, market-rate terms that these SBA borrowers cannot find conventionally. Many bank loan policies do not allow conventional financing of new start-up or early-stage companies—and this is true at my bank, U.S. Bank, we are the sixth-largest bank in the country—where our banks do not allow us to lend to a company that is 18 months old or less. The SBA loan program is the only option for many of these small businesses. So there are countless numbers of small businesses that simply would not be in business today if it were not for the SBA loan programs.

Next, the SBA guarantee allows a small business to appropriately finance long-term assets with long-term loans if they are going to buy commercial buildings, long-term equipment, and such. According to Federal statistics, the typical 7(a) loan has an average maturity of 12 years. A significant majority of conventional loans to small businesses made by commercial banks have an original maturity of 3 years or less, with the average being less than 1 year.

Because of the longer maturities, the third benefit is that the borrower has significantly lower monthly payments with an SBA loan than they would have with a conventional loan. Again, this is especially critical for new businesses or younger companies.

Over the past several years, the SBA loan program has experienced tremendous growth. Just for the last fiscal year, more than 100,000 small businesses received financing through both the 7(a) and the 504 program. These loans totaled $25 billion. For the current fiscal year, it is estimated that the combined programs will reach $30 billion. Again, no appropriations are provided for credit subsidies, meaning that the program users, the ones that actually use it, are lenders and small businesses actually cover the losses associated with this program.

Over the last several years, the SBA has also worked to streamline the program so the lending process for us, the lender, has been reduced, reducing our cost. It means that the red tape that the customer has to go through to get these loans is also less.

The results are clear. Record lending in both the 7(a) and 504 program, this public-private partnership has been and still is a shining example of what can be achieved when the private sector and the Federal Government work together.

I would certainly be glad to answer any questions that you might have. Thank you again.

Senator COBURN. Thank you so much for your testimony.

Mr. Pointer, I read with interest your testimony 3 or 4 days ago and the thought that shot through my mind is, if you had never seen the SBA and had a loan outside of the SBA, you would probably still have that business.

Mr. POINTER. That is correct.

Senator COBURN. So I am looking forward to your testimony.

TESTIMONY OF JOHN POINTER,[1] SMALL BUSINESS OWNER

Mr. POINTER. Thank you very much, Senator. I really appreciate this opportunity to come and speak to you as well as the Subcommittee Members.

Senator COBURN. Everybody should know you are an Oklahoman. I just want to make sure everybody knows that.

Mr. POINTER. Well, I am from Tennessee. [Laughter.]

I am very disappointed at this point in time. I want to go on record that Chief Administrator Barreto is not here to listen to my presentation today.

Again, it is truly an honor to be invited to give my testimony regarding my experiences with the Small Business Administration, the SBA. My presentation today will acknowledge my expertise in small and minority business development and full understanding of SBA's various programs. I have submitted today a written documentation for the record.

Most recently, I have been the liaison for Hurricane Katrina recovery for small and minority business development on behalf of the State of Mississippi under their agency, Mississippi Development Authority. Before I advise you today of my dealings with the SBA, I want to give you briefly, Chairman, just a little bit about who I am and why I am here today, thanks to you.

I would like to give you an insight of my background and my strong moral beliefs. My brother, Reggie, who is here today, we grew up in a small town in Tennessee, in Columbia, just 50 miles outside of Nashville. We were taught Christian values and we also were taught how to utilize the golden rule, treat people the way you would like for them to be treated and for you to be treated, as well. My mother was a schoolteacher prior to the segregation in the South as well as after. She taught school for 37 years. My father was the first African American store manager with Atlantic and Pacific. As we all recall, that was A&P Food Stores.

I stand here today before you with Washington insiders who have proclaimed me as the nation's largest minority whistleblower in the history of Federal programs designed by Congress and Senate to assist women and minority businesses and their development. Just as I am proud of my actions to stop waste, fraud, and abuse, Chairman, I still stand disillusioned after over a decade of fighting the SBA due to their misuse of Federal regulatory power, depravity of facts, and improper use of illegal maneuvers regarding the laws of Federal and State courts, all the while under the watch of Chief Administrator Barreto.

In 1989, as a small business owner to the State of Tennessee's No. 1-rated minority business, I alerted the SBA of criminal wrongdoing of their Specialized Small Business Investment Corporation, the SSBIC, and also my company was Pointer Oil Company. I was a petroleum distributor. There was blatant illegal acts such as illegal wire transfers, forgery of tax documents, and check fraud. For years, sir, the SBA denied my company and my family protection from wrongful misuse of SBA's regulatory acts as well as refusing to honor our original SBA business loan of $250,000, although, sir,

[1] The prepared statement of Mr. Pointer appears in the Appendix on page 134.

they acknowledged that they would replenish the $250,000 during the criminal investigation.

The Department of Justice, along with the SBA's investigation team, worked in the State of Tennessee starting in 1989 after 5 days, sir, of me notifying the Atlanta office that there was misuse and possibly criminal use of their investment company. It started in 1989 and the official criminal request was in 1993. So all those years, sir, I was trying to still maintain an existing business, a business that was doing business or serving products with Martin Marietta, the company who developed ammunition and was servicing Desert Storm. I was supplying fuel for that plant in West Tennessee, and unfortunately, I had to shut down due to bankruptcy causes.

The U.S. Federal Court eventually found the SBA's fraudulent investment firm and owner guilty of Federal fraud to the SBA and to some of the various portfolio firms, such as Pointer Oil Company. Even my sole testimony, sir, gave the SBA the opportunity to be granted the receivership in the State of Tennessee, but nevertheless, after they were granted receivership, they took my attorney and my family on a 7-year journey of trying to find out what kind of claims do we truly have against now the SBA's receiver company, the investment firm. Also, the former owner died eventually while waiting on his Federal prison sentence.

So, Chairman, can you imagine now you have got the SBA, the SBA receiver, you have got the estate of the former owner now teaming together and fighting me in Federal court as well as in State and local courts in the State of Tennessee, denying me the rights of getting just a simple restitution.

The SBA was granted $3 million of liquidated losses. Now, mind you, I want to back up and say, Chairman, that the investment company had been in existence 10 years prior to my notification. So, therefore, the U.S. Small Business Administration had put a Federal suit out against the estate of Walter Cohen, the former owner, and his investment company of over $22 million. So the bottom line is that they received $3 million, requested in their Federal final order that the Federal judge at that time request that all documentations be destroyed, sir, and they brought back here to Washington $3 million. Whoopee. Can you imagine, sir, the amount of legal payments for attorneys here within the SBA and attorneys they used in the State of Tennessee and all their travels? I mean, that was $3 million that was used in all of that process.

So I stand here today, sir, willing to answer any questions not only about my personal concerns, but my existence at this point in time. I want to say this. I am no longer with the State of Mississippi. Just as I am proud of your letter you sent me, and I submitted that to my officials at the State of Mississippi, they began signing papers to terminate my effectiveness down in the State of Mississippi. The retaliations have been unreal and I hope the SBA officials will give that information back to Chief Administrator Barreto and I thank you for the time.

Senator COBURN. Mr. Pointer, thank you. I just want to assure you that I asked the Administrator to have people here. He does have several people here, and I wanted to make sure he was aware of your situation.

Every agency has a horror story.

Mr. POINTER. Yes, sir.

Senator COBURN. That has happened because of the size of the government. Is it your experience to suggest that this is a symptom of a larger problem within the SBA?

Mr. POINTER. I think it is, sir. I think there is a concern, just as Chief Administrator Barreto was very proud to talk about small businesses, you and I both know, as well as Congressmen and Senators here in Washington, they are talking about larger small businesses. What about the one- to ten-employee operations that are desperately needing these business opportunities?

What about the legitimate, and I want to talk about this since I am no longer with the State of Mississippi. Mr. Barreto talked about how proud of the loans that had been submitted down in the Gulf Coast, sir. We did a survey while I was employed, effective in January 2006. Prior to my coming on board, they did a market survey just in the Gulf Coast area of Mississippi and they found out over 500 firms that were in that distressed county areas, the majority of them were SBA minority-certified and a lot of the white females testified it was their husbands' companies.

And also we found out in market surveys that they had applied for bridge loans. The State of Mississippi had submitted their bridge loans. They were happy. The SBA, even as far as just a few weeks ago, had not—they had not received their SBA loans.

So I think it is a hypocrisy as far as the Chief Administrator to proudly talk about what is going on down in Katrina. Larger businesses are doing very well. They are getting their loans, sir. They are getting SBA contracts also.

I was sitting in—I was part of a meeting with veterans, disabled veterans down on the Gulf Coast and they talked to the SBA Regional Administrator on the fact that there is not any preference opportunities. We also know that there are also sham companies that are using disabled veterans as fronts. I did not see that Administrator, sir, say, well, listen, we have a district office here. Here is the contact. Here is a phone number. Or, sir, let me take down that information. I will pass it on. Or, here is our toll-free number.

For us to keep looking away, everything that is on your tripod over there, there is no accountability, nothing but just a proud order to come and tell Senators and Congressmen here that they are doing a great job.

Senator COBURN. Thank you.

Ms. de Rugy, was it your testimony that 29 percent of the private capital loans were to minorities and small business?

Ms. DE RUGY. No, the Small Business Administration——

Senator COBURN. Through the Small Business Administration?

Ms. DE RUGY. For the 7(a) loan.

Senator COBURN. For the 7(a), 29 percent.

Ms. DE RUGY. Yes.

Senator COBURN. And then you said the private market was——

Ms. DE RUGY. No, I said but it is still going, so their claim that without them, minorities couldn't do it, because there is this huge gap. And I say, well, it is surprising because it is true that a large share of all the 7(a) loans go to minorities, 29 percent, which is a great increase in the last 10 years. However, they are still serving only percent of minority-owned businesses, which is quite irrelevant.

Senator COBURN. So 97 percent of minority-owned businesses can get capital?

Ms. DE RUGY. Can get capital either through traditional bank loans or through credit cards or non-traditional loans.

Senator COBURN. It has been said you are anti-small business by critics who take shots at you or criticism. Does one have to be for SBA programs to be anti-small business, or small business pro?

Ms. DE RUGY. Well, actually, it seems that someone has to be pro-government subsidy of all sorts to be in favor of small businesses. This is what people are blaming me for, is that I called for the abolishment of small business subsidies because they were inefficient and, in fact, they were probably hurting small businesses, and that enraged everyone because it seemed that people misunderstand attacking the government for attacking small businesses.

Senator COBURN. It is a great advocacy when you can do that. I want to get these——

Ms. DE RUGY. I have also been called anti-American.

Senator COBURN. I don't think you are that.

Ms. DE RUGY. No. Actually, in fact, I guess I am the only one who chose to live here.

Senator COBURN. Ninety-nine-point-five percent of all small businesses finance outside of the SBA, is that right?

Ms. DE RUGY. Yes. The number I have for 2004 is the private sector issued 15.3 million small business loans, and if you add the roughly a little over 100,000 loans issued by SBA, that is less than 1 percent.

Senator COBURN. And I want to ask your opinion. If loans don't cost the Federal Government any money, and I am not certain that they don't because we are exposed to $70 billion right now, but if they don't, why shouldn't we just have the SBA loan everybody all the money?

Ms. DE RUGY. I think the relevant question is why should the Federal Government be doing that business when the private sector seems to be doing it perfectly well.

Are they really costing nothing to the taxpayer? And I think you are wise to be skeptical. For one thing, I think the experience of the last 10 years, or the last 5 years, where small businesses who have overpaid fees is the proof that the SBA and OMB are unable to estimate what fees are needed, based on what the economy is going to be, to actually make it a zero subsidy.

Senator COBURN. Are you saying with low interest rates and readily available capital today, the private capital market in many ways for some of these firms could be cheaper than through the SBA when you take a total cost——

Ms. DE RUGY. Yes.

Senator COBURN [continuing]. Associated with that?

Ms. DE RUGY. Yes. It is also important for the record to say that not everyone who wants to start a small business actually should if they are not willing to pay the price. I mean, the market provides a great indicator and also a great service, which is to eliminate people who are not willing to—who are not able to provide a service at a cost that people are willing to pay for. And asking taxpayers to back up people who still want to do that is quite irresponsible.

But to go back to your zero subsidy question, when the economy was growing, obviously the SBA and the OMB were not able to estimate the kind of fees that were needed for it to run a successful program. Actually, they were over-successful. They measure their zero subsidy and the fee that goes with it right now based on an estimate of what the economy is going to be. The economy is booming. The economy is doing really well. And these fees are probably in check right now and we don't really have enough years to actually really measure. In fact, their own Inspector General is actually challenging that idea that it is really that great of a new model.

But what is going to happen when the economy goes south? That is when even more people are going to default. That is when our budget, because of unemployment, is going to actually go up. And that is when the SBA is going to have to turn over a lot of taxpayers' money to lenders.

Senator COBURN. That is right. OK. Thank you.

Mr. Bartram, we went to your website and I want to ask you a couple of questions about it. Your website indicates that the SBA's 7(a) program in particular is a great tool for lenders to expand their client base and make a good return on investment. How much money do banks and lending institutions make off 7(a) loans?

Mr. BARTRAM. Well, I can only speak somewhat to what U.S. Bank does, because that is the bank that I do work for. I represent the trade association as the Chairman as a volunteer type of a position. But if I could, too, I would also like to answer the subsidy question, if you would give me an opportunity after I answer this.

Senator COBURN. Sure. I will be happy to, and if I don't, remind me to.

Mr. BARTRAM. OK. As to the program itself, these are loans made to companies that need longer terms. So there is an incentive to the lender to use the 7(a) program to match up a proper term with the company's need. That way, the company has a better chance for success. If you look at a 3-year loan versus a 10-year loan, there is a savings of about 40 percent in the cash flow that the small business would experience. So, therefore, the company has a greater chance to succeed with that type of term.

As far as the profitability——

Senator COBURN. You are increasing their short-term working capital.

Mr. BARTRAM. Correct.

Senator COBURN. OK.

Mr. BARTRAM. As far as the profitability, we can be as profitable in a 7(a) loan program as we are in our conventional lending if done correctly, and done correctly meaning that we are prudent as to how we approve credits. We are going to have higher delinquencies with a 7(a) loan than we would have with a conventional loan, but we share in the risks, so our losses should be similar to that of a conventional loan. That is the role——

Senator COBURN. You are markedly decreasing the risk, correct?

Mr. BARTRAM. We have a 25 percent exposure, let us say, rather than a 100 percent exposure.

Senator COBURN. Right.

Mr. BARTRAM. But these are also loans that we would not do on a conventional basis. So that is the enhancement that we have to utilize the 7(a) program.

Senator COBURN. Well, what about the other 95 percent of the people that are small business who finance a 10-year, $4 million loan for their equipment? Where are they getting their loans?

Mr. BARTRAM. Well, I think that you are assuming, and I think you are referring to the $25 million——

Senator COBURN. No, I am talking about the testimony that you gave that you said. You talked about the fact that these people would not be able to get—but it is less than 5 percent of the people out there that require a capital loan that is a small business. Ninety-five percent of them do it without an SBA loan. I am wanting to know, where do they finance?

Mr. BARTRAM. I think that you are assuming, though, that every small business is actually looking for financing, which is not true. Additionally, according to Dunn and Bradstreet, 80 percent of the small businesses have revenues of $100,000 or less. So those companies probably have very small needs. So I think you have to cut that sample size down to see what the effectiveness is.

Senator COBURN. OK. That is a good point.

Mr. BARTRAM. If you look at financial call reports that banks have to provide and you look at small businesses that are contained within these call reports as they are compiled, loans of 3 years or more, the SBA makes up 40 percent of all those loans made. So that is really the target group that the SBA hits upon. Not every small business out there, but companies that need long-term financing——

Senator COBURN. Let me re-ask my question in a different way, then. You said they supply 40 percent. Well, where do the other 60 percent get their capital?

Mr. BARTRAM. Well, basically, banks still make conventional loans to small businesses. Some business loans——

Senator COBURN. But if I was a bank and I thought I could get the government to be on the hook for 75 percent and me only 25 percent, why wouldn't I go the other way? Which comes back to the point that there is no cost to the taxpayers of this country except for the possibility of default in a recession, which is real. If there is no cost, why shouldn't all the capital to small business be run through the SBA and be guaranteed by the government?

Mr. BARTRAM. Because small business wouldn't stand for it. It is more expensive for them to get an SBA loan than it is to get a conventional loan. We charge a lesser rate of interest on our conventional loans than we do on SBA loans. There is also a large upfront fee that the SBA requires that pays for the program that we wouldn't charge the customer if they were to get a conventional loan.

Senator COBURN. But we are——

Mr. BARTRAM. We are not allowed to put a company——

Senator COBURN. But if they had the ability to repay but yet were higher risk, their interest rate would go up, right? So when you make those loans, you discount them and resell them in the market, correct, most of them?

Mr. BARTRAM. No, we——

Senator COBURN. Well, that is what you all say on your website.

Mr. BARTRAM. There are some—that is the trade association's website——

Senator COBURN. Right.

Mr. BARTRAM [continuing]. And there are some lenders, about 40 percent of the loans, SBA loans that are made, the SBA portion is sold. Banks still service it, though.

Senator COBURN. Let me get this into the record. Here is what your trade association says, and I think it is important because I think—I am not critical of where we are, but I think it is important that SBA's policies are about helping small business, not helping the people who help small business.

Mr. BARTRAM. I would agree.

Senator COBURN. So here is what it says. The SBA's flagship 7(a) program provides loans to small businesses unable to secure financing on reasonable terms through conventional credit channels. That is Ms. de Rugy's complaint with it, is that maybe there is not a market there. But let us take her away for a minute and say that there is.

For lenders, the 7(a) loan program has the potential to increase profitability. Return on assets of SBA loans can easily exceed 5 percent, and return on equity can exceed 70 percent. That is a pretty good term for a bank. That is as good as credit cards. Increase the size of your portfolio. Provide Federal guarantees as high as 90 percent. Increase liquidity. Seven(a) loans can be readily sold on the program's healthy secondary market. Increased competitiveness. Ability to offer terms as long as 25 years gives you more desirable products to offer prospective and existing customers.

My point is how much of—if this is a policy of the Federal Government to incentivize the aiding of small business if, in fact, there is a capital shortage—we will discount Ms. de Rugy's comments for a minute—how much of that profit should—I mean, 70 percent return on equity annualized is a pretty healthy return. There are not a lot of businesses other than what some would say about the oil industry today that can do that. So why shouldn't that rate even be lower to small business if, in fact, there is 70 percent return on equity on turning SBA loans?

Mr. BARTRAM. Well, basically, if you were to sell the SBA guarantee portion, now you have only 25 percent of direct exposure on your bank's books——

Senator COBURN. Right.

Mr. BARTRAM [continuing]. So that is the reason why there is a leveraging power there. That is the reason why the loan can be profitable. However, there still is a larger risk of loss to an SBA customer than there would be to a conventional client. So it is basically risk versus returns. So the lender is taking——

Senator COBURN. OK, but when I go and look at Citibank's return on investment, return on invested assets, there are not anywhere close to 70 percent. They are not anywhere close to 40 percent. They are not anywhere close to 20 percent. So you are having one-fourth exposure.

My point is this, and I am not critical of the market that you all have developed. I am not saying it is not fair. But what I am saying is, as a policy question, if there is that kind of return on equity in being involved in 7(a) loans in the SBA, then the rates ought to go down some to better reflect, even with the increased risk, your return would seem to me to be highly excessive compared to what you can do in the commercial market outside of SBA. And if I am wrong, are you making 90 percent equity on businesses that aren't SBA guaranteed? No. This is a higher-end business because it has got a Federal guarantee to it, right?

Mr. BARTRAM. Correct.

Senator COBURN. OK. Now, you had wanted to answer a question earlier and I have forgotten what it was.

Mr. BARTRAM. About the subsidy rate.

Senator COBURN. Yes.

Mr. BARTRAM. We talked a lot about that today, and my understanding is that there are rules and basically laws under credit reform that actually dictate how that is done and how that is calculated. But effectively, the fees of the program that are charged go to the Treasury and there is a loan loss reserve set up just like a bank would have a loan loss reserve, and as the economy turns down, those costs have already been covered, and with a new budget coming out, fees would go up to cover those costs. So there is no taxpayer risk of future SBA loans or loans made today. Those costs are either already covered through the loan loss or they would be charged higher fees in subsequent years.

Senator COBURN. The fact is if we were to have a severe recession tomorrow and we have a $70 billion exposure, there is not the money in a reserve form at the Treasury, even taking all nets coming from the SBA, to cover anywhere close to 20 percent of that. The last numbers I saw, I can't remember what they were, but there is not anywhere—and I guess it would be good to ask GAO that question. The fact is if tomorrow, $35 billion went up delinquent, 75 percent of it or 80 percent of it being Federal Government's share, is the money sitting in the Treasury to pay for that?

Mr. SHEAR. No, it isn't.

Senator COBURN. Yes.

Mr. SHEAR. I think that what you have here is a budget accounting system, which does its best whenever loans are originated in a year of estimating what is the present value of those future payments. So you could almost think of it, on average, what do we expect to happen?

And so you are posing a very good question in terms of why would anybody participate in this program if there is no subsidy involved, and then you get into certain questions as far as there is a certain exposure that lenders take when there is no subsidy involved and what happens if there is a very severe recession, either nationally or in a region of the country where there is a concentration of 7(a) loans.

So it is a distinction between what is used for budget accounting purposes and whether there is still a real economic subsidy involved. It is a little hard to believe that you could have participation in a program, large participation in the program in the absence of a real economic subsidy, and then you are raising also a very good question, what do we get for that economic subsidy that is involved?

Obviously, when the budgetary cost was larger, when you had a "positive subsidy program," it was costing more both in terms of budget terms and in terms of economic subsidy. But nonetheless, there is some economic subsidy involved.

Senator COBURN. Right. And is it true that actually the people who borrow this money are the ones that are actually paying that subsidy?

Mr. SHEAR. That is a difficult question but, again, you are posing very good questions. What does it mean that there is a market failure? Certain times, we have all been exposed to the claim that if some borrowers pay interest rates that somehow just are considered too high in the view of somebody's value judgment, is it a market failure or is it a response to the riskiness of providing a loan to that individual? So it is—to say that the borrowers are paying too high a rate is difficult to say because the borrowers and the lenders participating in a program see it in their advantage.

Senator COBURN. But ultimately, the fees associated with these loans and the interest rate that is charged and the net profit that whoever the lender is, whether they roll and sell it in the secondary market or they keep it themselves, those fees are consumed as a part of the cost of doing business one way or the other, and it is either a lessened profit or a higher profit that is figured in. Most businessmen know what their costs are and figure those costs as they roll the thing.

The fact is, if there is a subsidy—I guess the other policy question is, if there has to be a subsidy, should it be the borrowers paying it or should it be the American taxpayer? I guess that is the policy question. If there has to be a subsidy for it, should it be the American taxpayer or should it be the group of borrowers? I am not advocating one way or the other. I am raising the policy question.

Mr. SHEAR. I think the policy question there becomes one for those who participate in the program, they probably see some advantage of participating in the program. They are probably borrowers, as was intended, that are higher-risk borrowers, and the question from the standpoint of the exposure of the American taxpayer is that what are we getting for that, either in terms of serving those borrowers, the businesses, the jobs they are creating, the general welfare of the local economies they are operating in. These are the types of questions we have to ask. Somewhere there is an exposure of the American taxpayer.

Senator COBURN. OK.

Mr. POINTER. Senator, may I add something on that?

Senator COBURN. Sure.

Mr. POINTER. I want to comment on the fact that, privately, as you mentioned, and as a private businessman on the front end of this, having a college degree, having post-graduate degrees, working with the small business that had been working with Fortune 500 companies prior to my starting my own business, you are so correct on the fact that when I looked at the SBA, after being turned down initially by several banks in the State of Tennessee, to know that, hey, here is a program. Yes, I am a minority, but the fact is that when you are sucked into that program, seeing, well, it is a few points below prime for me to enter, and yes, I could be classified as a small disadvantaged business, knowing that I wasn't economically or socially disadvantaged, those are the sort of taste buds that are out there that attracts people into this program.

If it is legitimate, if it means something to the people, especially the small disadvantaged businesses, then it has to stand for it. It cannot just be a token program. And I ask that you guys mandate that the SBA really looks into this, and I ask that you guys, when you go to New Orleans, you will find that there are not a lot of certified—and I ask for you to look at the State of Louisiana's certification process as well as the SBA's process down there to see who is legitimately certified, either federally or in the State requirements, that are women-owned and minority-owned and veteran-owned to see how many of them are actually doing business in Katrina. Just don't get a fluff number, Senator, and bring it back. I think you will be disillusioned.

And the last thing I want to add, sir, I ask and I pray—I brought my daughter here, Danielle, who is 16 years of age—you were talking about accountability and regulatory misuse. When my wife was in her birthing room 16 years ago to bring forth this wonderful child, the SBA were even in there trying to get us to sign affidavits and for me to wear live wire tapes and everything as far as with their concerns, but yet they could care less about how I was going to get restituted. Senator, I think these are issues that really need to be looked at.

Senator COBURN. I would just—anybody that is hearing this testimony would do well to read the record of Mr. Pointer's full testimony. It doesn't speak well for our government and what has happened in the past and the lack of responsiveness, and I will leave it at that.

I am going to come to you in just a second, Mr. Bean.

Mr. Bartram, you all have access to profitability information about your members that is available only to your members, correct?

Mr. BARTRAM. No. Basically, the only thing we could provide is what they would publicly disclose. But no, we don't have anything that would be of any kind of private information publicly. Whatever they have through——

Senator COBURN. You all haven't combined data associated with your association?

Mr. BARTRAM. Nothing to do with——

Senator COBURN. No combined data at all associated with your association on profitability?

Mr. BARTRAM. No.

Senator COBURN. Mr. Shear, I want to ask you one question. In the GAO look at the SBA, do they measure economic outcomes according to real data or do they measure measurements that aren't associated with true economic outcomes? What does the GAO—I am saying, we see the number of loans, we see this and this. What is the economic impact of that and are they measuring the right thing?

Mr. SHEAR. We haven't evaluated the effectiveness or economic impact of the programs in general.

Senator COBURN. Has anybody?

Mr. SHEAR. This is an area where there are certain data out there, none of which I would say are very convincing, on economic impact. It is clear that one can state who is—the characteristics of certain borrowers who receive these loans. In terms of saying what activity does it crowd out or who gets the loan, one business gets the loan rather than another.

And let me go even further back, before there was any sense of monitoring the lenders and what they were giving out Federal guarantees for. We really didn't know, was it just somebody that was trying to leverage an investment further rather than a person that might have been able to put up the collateral? So the "what if" questions, what would happen if these borrowers did not get these loans, what would be the impact on those specific borrowers, but even what would be the impact in those local economies where those borrowers are operating?

It gets to your question that why are there so many businesses, so many small businesses that don't rely on SBA? Well, one reason could be the zero subsidy or low subsidy, but part of it could be the absence of any information. What happens when somebody walks into the bank between what they have to do to get a conventional loan or an SBA loan? What happens there and how does that affect the economy? There is nothing that we have seen that is convincing.

Senator COBURN. So your testimony, there is nothing out there in the literature that measures outcomes, that measures economic outcomes—in other words, the whole part of the PART system and the whole part of us in terms of our government ought to be if we have a purpose in mind and we fund a program in mind, there ought to be an end point at which we see and then we ought to measure it to see if we are getting there.

And what I guess my question is, has anybody ever measured to see if we are getting there? We have some disputed testimony here today. There is no question about it. All I am asking is, where is the science? Where are the studies that would show, and has GAO ever been asked, what are the program's goals and is it meeting its goals? Is there an economic impact?

Mr. SHEAR. We haven't been asked and——

Senator COBURN. Get ready. You are getting ready to be asked.

Mr. SHEAR. OK. We like to serve the Congress, and you are asking good questions.

Senator COBURN. I have to ask Comptroller General Walker first, but I will ask.

Mr. SHEAR. OK. But I am sure we would welcome it and I am sure the Comptroller General would welcome questions like that of trying to establish, if not, trying to resolve the controversies, but at least of trying to identify what would be good indicators or good comparisons——

Senator COBURN. Measures.

Mr. SHEAR. What are good benchmarks to use to try to evaluate what the economic impact of the 7(a) and other programs are?

Senator COBURN. And nobody should want to object that you would want to measure that to see if it is accomplishing what it says it is supposed to, right?

Mr. SHEAR. I would hope not. Just as we said in the late 1990s, Congress and SBA and others should know how this Federal guarantee is being administered by private lending institutions, I am sure there were some that objected to that, but I think this is part of what we do to serve the Congress.

Senator COBURN. That is fine. Thank you.

Mr. Bartram, I asked the question wrong, so I apologize. On your website, you claim to have ready access to the following data: A list of the top 30 SBA lenders by dollar and volume, 1998 to present; SBA's total loan portfolio for both 7(a) and 504 programs, 2004 to present; 7(a) and 504 loan volume by State, 1998 to present; 7(a) and 504 loan volume by industry, 2004 to present; how often 7(a) and 504 loans failed by industry; and 7(a) program loss reports, 1975 to present. You all do have that data?

Mr. BARTRAM. Correct.

Senator COBURN. Can you share that with the Subcommittee?

Mr. BARTRAM. Certainly. I don't see any objection.

Senator COBURN. Thank you. That is what I was looking for. I misstated the question.

Mr. BARTRAM. OK.

Senator COBURN. And now, finally to Mr. Bean. You gave in your——

Mr. BEAN. Before, just to add one thing, Mr. Chairman, in 1967 in a hearing much like this, I asked for the same data on measuring impact. The SBA coughed up some tables. I asked what the data was and then said they couldn't locate it. So the question was asked in 1967 and you are probably the first one——

Senator COBURN. Mr. Bean, I have a reputation of not taking no for an answer, and I assure you, if we ask, we will get the information.

You had some suggestions to eliminate waste, fraud, and abuse associated with the SBA. Would you share those with us, and we will finish up after this.

Mr. BEAN. Sure. I am glad to be here with Veronique and with my friend, John Pointer. The SBA has dodged some very fundamental issues which I think make waste, fraud, and abuse systemic in many of its programs, particularly contracting, Section 8(a), but not exclusively those.

We start with definitions. There were attempts in the past to reform size standards. You asked SBA Administrator Barreto, how large is a small business, and he gave you an answer. He whipped up a number. He has no idea where those numbers came from. They were concocted not by an economist, but by a bureaucrat in the 1950s and 1960s and are encrusted in SBA code. They are arbitrary.

There is a mismatch between the man-in-the-street definition of small business, which is family-owned, locally-owned, independently owned and operated, and the SBA's statistics as a result are absolute junk, which I think Veronique implied, but I will state more forcefully. It relies on self-certification, as Mr. Barreto noted, and self-certification. So the agency needs to take a real hard look at the definition of small business because it has policy consequences which turned up in one of your previous charts with affiliates and subsidiaries of large corporations receiving benefits that they shouldn't.

The same with the definition of disadvantaged. Most people think of a disadvantaged person as being poor. The net worth of the typical disadvantaged business enterprise receiving a Section 8(a) contract is greater than the average American, and we hear disadvantaged and minority used interchangeably. The U.S. Civil Rights Commission has asked the SBA and other agencies to come up with race-neutral alternatives to get in conformance with civil rights law.

So the SBA has gotten on this wave of getting credit for creating minority jobs. These programs were originally intended, rightly or wrongly, to help people like Mr. Pointer, African Americans who had a history of discrimination. The statistics that Veronique discussed, 29 percent of the loans went to minorities, I saw almost two-thirds of those went to Asians. Throw in Hispanics, you have 11 percent go to African Americans.

So there is a great deal of support for these programs based on a rather dubious definition of disadvantaged. So I think that SBA needs to look at the Civil Rights Commission's report on redefining disadvantaged.

Second, in terms of reporting, they can't rely on self-policing. It needs to measure impact. I work at a university. We have to measure impact. We have to produce data on graduation rates for our students. We follow cohorts. If you are not going to do it for all small businesses, do it for cohorts. Find some way to do it. The rest of the world has to do it.

Third, the SBA is a conglomerate agency with many different missions. It is stretched far too thin. It has 3,300 employees, I believe, which was the number it had in 1965. I am not arguing for a massive increase in the SBA bureaucracy. On the contrary, I think it should be stripped of certain functions.

They wouldn't say this publicly, but in interviews with me, since they were now retired, prior SBA administrators said that they wanted to have disaster lending removed from their purview because it was a people-eater during times of crisis, so that would be one concrete suggestion, to consider removing and relocating disaster lending.

Privatize SCORE, Service Corps of Retired Executives, which has the loosest connection with the SBA.

Spin off the SBDCs, which are affiliated with universities, to the Department of Education.

This is a small agency which does a great deal of harm in some cases to certain small businesses and profits others, particularly bankers. There are good people at the SBA doing good work, but they cannot police a vast small business community and that is why we have this rampant fraud continually in small business certification, in 8(a) certification. I just got on the Internet, the SBA Inspector General has another report on fraud, 8(a) contracting, an Asian Indian woman, $500 million in contracts because she is disadvantaged. That doesn't resonate with the American people and the SBA shouldn't get away with it.

Senator COBURN. All right.

Mr. BEAN. Oh, and one last suggestion—two last suggestions. To deal with situations like John Pointer's, give the SBA more teeth, the ability to fine or to bar fraudulent contractors or large corporations from further contracting. They have done that at the municipal level to deal with minority fraud. They can do it at the Federal level.

And offer some protection and compensation for whistleblowers like John Pointer, who may not be in the government but have information.

And last but not least, I believe you are a doctor, is that correct?

Senator COBURN. I am.

Mr. BEAN. I think it was the classical version of the Hippocratic Oath that said, first, do no harm. The Congress should be the watchdog of small business when it formulates its legislation, not the SBA, which is a bureaucratic mosquito. I hope that Congressmen and women, when they frame laws, will think of the intended consequences and not rely on the SBA.

Senator COBURN. Well, I want to thank each of you for being here. The purpose of this hearing is to make the government efficient, to look and see if we are achieving the goals that we need to be achieving, do we have measurement techniques and processes in place, and to hear all viewpoints. I think we got to do that today.

You each will receive some written questions from us, which we would very much appreciate you answering in a timely manner.

I want to thank you for taking the time to prepare testimony and also the time to be here to give it, and I am sorry this hearing lasted so long. Thank you so much.

The hearing is adjourned.

[Whereupon, at 4:45 p.m., the Subcommittee was adjourned.]

APPENDIX

Statement of Senator Carl Levin
April 6, 2006

Subcommittee on Federal Financial Management, Government Information, and International Security Hearing on The Effectiveness of the Small Business Administration

It's widely accepted that small business is the backbone of our economy for job creation and job retention. The statistics show that small businesses create the majority of the new jobs in our economy when many of the Nation's large corporations are downsizing or even filing for bankruptcy protection. Small businesses helped fuel the longest period of economic expansion. According to the Small Business Administration (SBA), small businesses:

- provide approximately 75 percent of the net new jobs added to the economy;
- employ 50.1 percent of the private work force;
- account for 39.1 percent of jobs in high technology sectors;
- account for over 50 percent of private sector output .

Small businesses make huge contributions in every single state across the country. In my home state of Michigan:

- 98.4 percent of businesses were small;
- small businesses employed almost 2 million individuals, or 50.8 percent of the state's non-farm private sector, which is just slightly more than the national average.

As a member of the Senate Committee on Small Business and Entrepreneurship, I understand the important role SBA plays in helping small business owners generate jobs and expand their businesses. One of the biggest hurdles facing small business entrepreneurs is finding the capital to get started, expand, or just stay in business. One of the most important things SBA does is to make sure small businesses have access to credit. The reality is that commercial banks are often less interested in making the smaller loans used by small businesses because these loans are less profitable precisely because they are smaller. Yet the smaller loans take just as much time to process and manage as bigger loans so the banks naturally gravitate to the larger more profitable loans and, as a result, small businesses are often left out.

To encourage commercial banks to lend to small businesses, SBA's 7(a) loan program guarantees a portion of the loan, making the loans more attractive for banks to make and allowing small companies to get loans they otherwise could not get. Other SBA programs provide counseling and technical assistance services to small businesses ranging from assistance in writing a business plan, marketing and securing credit.

Many Michigan small businesses have benefitted from SBA programs. I am including in the Committee hearing record numerous testimonials and letters from small businesses across

Michigan that provide specific examples of how SBA programs helped them start or grow their businesses.

For example, Primera Plastics president Noel Cuellar from Zeeland, Michigan, wrote that no bank would consider lending to him to start his business. Mr. Cuellar wrote, "***Yet, the SBA was there to grant me an opportunity through loans and various programs that allowed my business to grow and expand from two, to our now standing one hundred forty employees.***" He also testifies that another SBA lending program, the 504 program, allowed his company to acquire the funding to build its $3.6 million facility.

Michael T. Fox, President of Quality Air of Midland, Inc, based in Midland Michigan, wrote, "***...I have come to appreciate the many services and support functions offered by the U.S. Small Business Administration (SBA). 500,000 small businesses in Michigan couldn't get these SBA services anywhere else. Over the years we have used the services of SBAM [Small Business Association of Michigan] and its related business support groups, like the SBA funded Michigan Small Business and Technology Development Center, to help our company identify growth opportunities and secure a brighter future for our employees.***" The company now employees 30 people.

Other Michigan entrepreneurs wrote that they were able to purchase their buildings with SBA loans and that it would have been difficult to qualify for such loans without SBA assistance. Still others wrote that SBA programs helped them develop a business plan to expand and assist in selecting a building site, secure financing for the building and even helped with the planning and marketing for the grand opening of the building.

Finally, I want to reference a research paper published by SBA's Office of Advocacy in 1998 entitled, "*Mergers and Acquisitions in the United States, 1990-1994*" by Dr. Alicia Robb. This report found that from 1990-1994, small businesses created 1.45 million new jobs and large business lost 1.15 million jobs. That's 300,000 net new jobs that were created, all thanks to small business. The report can be found on SBA's Office of Advocacy website, http://www.sba.gov/advo/research/chron.html#1998.

The federal government should continue to try to help small entrepreneurs generate jobs and stay in business.

I ask that the attached statements be included in the Committee record.

SBA Mission Statement:

The mission of SBA is to maintain and strengthen the Nation's economy by enabling the establishment and viability of small businesses and by assisting in the economic recovery of communities after disasters.

Who Benefits From the 7(a) Program?

SBA 7(a) Program

The SBA's flagship 7(a) program provides loans to small businesses unable to secure financing on reasonable terms through conventional credit channels. The program operates through private-sector lenders that make loans backed, or "guaranteed" by the SBA in the case of default.

For lenders, the 7(a) loan program has the potential to:

- **Increase Profitability—Return on assets of SBA loans can easily exceed 5% and return on equity can exceed 70%.**
- Increase the Size of Your Portfolio—The mitigated risk **provided by federal guarantees as high as 90% allows you to comfortably expand your customer base.**
- **Increase Liquidity—**7(a) **loans can be** readily **sold on the program's healthy secondary market.**
- Increase Regulatory Loan Limits—Only the unguaranteed portion of an SBA loan counts against your regulatory loan limit per customer.
- **Increase competitiveness—The ability to offer terms as long as 25 years gives you a more desirable product line to offer prospective and existing customers.**

Estimated Outlays vs. Actual Outlays 2002-2006

Fiscal Year	Estimated Outlays (in millions of dollars)	Actual Outlays (in millions of dollars)
2002	687	493
2003	587	1,558
2004	770	4,075
2005	683	2,502
2006	790	1,188
Totals	**$3,517**	**$9,816**

Big Companies Get Small Business Contracts

Company	*Small Business Awards in FY2002 (in millions)*	*Net Income (in millions)*	*Revenues (in millions)*	*# of Employees in 2003-2004*
Titan Corp.	$539.9	$(11.45)	$1,370	10,500
Raytheon Co.	$126.7	$(640)	$16,760	76,000
Northrop Grumman Corp.	$100	$455	$17,400	120,000
Computer Sciences Corp.	$32.7	$346	$11,256	90,000
General Dynamics Corp.	$29.4	$917	$13,660	71,600
Hewlett-Packard Co.	$12	$(903)	$56,000	151,000
Oracle Corp.	$11.6	$2,224	$9,673	40,650
TOTAL SPENDING ON LARGE COMPANIES	**$2,000**			

Testimony of U.S. Congresswoman Sue Kelly (R-NY-19)
Homeland Security and Governmental Affairs Committee
Subcommittee on Federal Financial Management, Government Information, and International Security
April 6, 2006

Thank you, Mr. Chairman, for this opportunity to testify here today.

The success of our local economy in New York's Hudson Valley, where I represent, is especially dependent on the success of small businesses.

Let me begin by telling the story of a small business owner in my Congressional District named Mandy Villodas.

Mandy operates the English Rose Day School in Washingtonville, which is located in Orange County, N.Y. She began her child care business in her home. Later, she rented space from a church and operated her child care business from there for a few years.

Then, she began working with the Small Business Administration to expand her small business and build a permanent child care center. With the help of an SBA guaranteed loan, Mandy was not only able to expand her child care services – she preserved 15 existing jobs and created 5 new jobs for local residents. The English Rose Day School has been operating very successfully ever since.

Without the help of the SBA, Mandy wouldn't be where she is today. Her small business would not be having such a profound impact on many lives throughout our local area:

- Mandy's success in getting construction money through SBA resources helped provide additional work for local construction crews – remember many of them are also small businesses.
- Her school is a happy, safe environment for parents to leave their children in good care while they work hard during the day at businesses both large and small.
- Those parents are earning money that they turn around and spend at other small businesses in our area.

Successful small businesses have a very positive ripple effect through so many aspects of our local communities. This is the ideal example of the importance of the government's investment in small businesses to boost job creation. The resources that Congress and the SBA devote to help small businesses grow and succeed are imperative to the growth and success of our economy.

When times are tough, small businesses revitalize our workforce and our communities. For instance, IBM operates a large facility in southern Dutchess County where I represent. While IBM has had to downsize – particularly during the 1990s – New York's industries, government, unions, and non-profits have worked together to rebuild the employment infrastructure in Dutchess County through small business growth.

Dutchess County economic development records show that 33 new firms opened their doors in Dutchess County between February 1994 and February 1996. This alone created more than 3,000 new local jobs at a critical time when IBM was cutting them.

That trend continues today, not only in Dutchess County but in every other county in New York's Hudson Valley. Increasing numbers of new small businesses are creating increasing numbers of new local jobs.

The numbers show that without the help of SBA funding and resources relied upon by the Small Business Development Center at Mid-Hudson, small businesses in our area may not make it. Lack of support for our small businesses translates into lack of jobs for residents in our local communities.

SBDC Mid-Hudson has worked directly with **12,338 businesses,** helping them to **invest $363 million dollars** in the area economy. These efforts **created or saved 10,429 jobs.**

Small businesses in Orange County tell me that the 504 loan product available through the SBA has been especially critical to meeting their needs. These small businesses say banks are simply unwilling to do business with them.

So when banks shut their doors on small businesses and leave them with no other source of financial assistance, SBA programs have provided them millions of dollars in financing to preserve their business and preserve local jobs. SBA programs like the 504 loan program have enabled lenders and borrowers to have a dialogue that would never exist otherwise.

In ways like these, the SBA can play such a critical role in the livelihood of our local communities. In Washington, we need to give more than lip service to the key role that small businesses play in creating 7 out of every 10 new jobs. We cannot pat small businesses on the back for supplying new jobs, and then stifle their access to capital at the same time.

Effective SBA programs that are working need our continued support in Congress, just as small businesses need the continued support provided through those programs.

In fact, there are some additional steps that the SBA and Congress need to be taking to encourage small business growth. One group that particularly needs our increasing attention in the next few years is America's veteran population.

New York is one of the states with the largest deployment of reservists to Iraq and Afghanistan. Every month, reservists are coming back to New York and other states, and their previous jobs are not always waiting for them when they return. Some are returning to find that the small business they owned or the small firm where they worked has suffered dramatically in their absence. This leaves them hard-pressed to make ends meet and in dire need of capital or other forms of assistance.

We need the SBA to be increasingly pushing veterans' business opportunity programs. At one time, the SBA used to offer veterans lending assistance at a discount. But currently, other than some procurement programs, there are few assistance areas at the SBA where our veterans receive any preference at all.

At a time when new veterans are returning to our country after proudly defending us in the War on Terror, we need to provide SBA with the support it needs to work with veterans and do them proud when they return.

We need to equip SBA and its affiliates with the resources they need to work with reserve offices, visit veterans who are hospitalized upon their return, and provide veterans every opportunity to start a small business of their own.

In other words, the SBA should be even more of a resource for local residents and communities in the future instead of less of one. Our economy needs small businesses, and small businesses need the SBA.

Thank you, Mr. Chairman, for giving me this opportunity to testify today.

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

TESTIMONY OF
HONORABLE HECTOR V. BARRETO
ADMINISTRATOR
U.S. SMALL BUSINESS ADMINISTRATION

SUBCOMMITTEE ON FEDERAL FINANCIAL MANAGEMENT, GOVERNMENT INFORMATION, AND INTERNATIONAL SECURITY
COMMITTEE
HOMELAND SECURITY AND GOVERNMENT AFFAIRS

APRIL 6, 2006

Chairman Coburn, Ranking Member Carper, Members of the Subcommittee, thank you for inviting me to testify about the U.S. Small Business Administration (SBA) and its programs.

At the risk of repeating information you already have, let me mention some facts about small business:

- The U.S. Census Bureau reports that 98% of businesses in the U.S. have less than 100 employees.
- Economists from the SBA's Office of Advocacy report that America's more than 24 million small businesses employ over half of all Americans and that they create more than 50% of the American non-farm private gross domestic product (GDP).
- The most recent report from the Bureau of Labor Statistics states that "from September 1992 through March 2005, firms with fewer than 500 employees [small businesses] accounted, on average, for 65 percent of quarterly net employment growth, representing 13.5 million out of 20.6 million net jobs created by the total private sector."

Nobody is more supportive of small business than President George W. Bush. When the President asked me to do this job because, having been involved with small business since an early age, I knew from personal experience the challenges they face, as well as the opportunities they create and contributions they make. My task was, and is, to make SBA more relevant to more of those businesses. Making the SBA the most productive, efficient and effective organization has been our mission. One we are proud to tell you about today.

The role of the SBA is to counsel and assist nascent entrepreneurs and existing small businesses by providing tools to help them survive and thrive. The objective is to provide the resources for small businesses to grow, prosper and create jobs.

When I came to SBA in 2001 the Agency guaranteed roughly $14 billion in loans to 42,000 small businesses at a cost of over $110 million in government credit subsidy. At that time small businesses were awarded only $50 billion in Federal contracts.

Four years later, in FY 2005, SBA guaranteed over $19 billion dollars at no subsidy cost to the taxpayers, and over 98,000 small businesses received financing at terms they could not have otherwise found. In addition, for two consecutive years government agencies met their 23% goal for small business contracting, with nearly $70 billion in Federal contract awards, an increase of 40%. Finally, our technical assistance partners have trained or counseled over 1.1 million small businesses in FY 2005.

Improved methods to assist small businesses in gaining access to government contracting opportunities have been implemented. By restructuring key Agency operations and reengineering the Agency's largest loan programs, the SBA has achieved record program growth while operating more efficiently. SBA's FY 2007 budget request is more than 30% less than its FY 2001 appropriation, adjusted for FY 2001 supplemental Disaster funding. The SBA has improved the effectiveness of the taxpayers' dollars supporting small business development.

The FY 2007 budget request allows us to offer up to $28 billion dollars in financial assistance while retaining a zero subsidy, and our goal is to continue to increase assistance to small business in reaching and exceeding the statutory goal of 23% of government contract awards.

Financial Assistance Programs

As I stated before, SBA has significantly increased our loan volume since 2001, more than doubling the number of 7(a) and 504 loans funded. Each year we are reaching more small businesses at an extraordinary rate and doing so at no subsidy cost to the taxpayer. In FY 2001, the loan programs served about 42,000 small business borrowers. In FY 2005, this number jumped to 98,000 small business borrowers in the 7(a) and 504 loan programs. The President's FY 2007 proposal provides $28 billion in SBA financing for small businesses. The proposal requests authorizations of $17.5 billion for the 7(a) program, $7.5 billion for the 504 program, and $3.0 billion for the SBIC debenture program.

The 7(a), 504 and SBIC program levels build on the success SBA has achieved in its loan programs over the past four years. In FY 2005, we served more small businesses than ever before. In our two major loan programs, we increased the numbers of loans funded by 22% in one year, from 80,000 in FY 2004 to nearly 98,000 loans in FY 2005. Lending to minorities increased by 23% and to women-owned businesses by 39%, in terms of the number of loans funded during the same period. These record level lending numbers are possible because of the zero subsidy policy that was adopted at the beginning of FY 2005 for the 7(a) program.

As previously mentioned, our main financial programs operate at zero subsidy. Moving to zero subsidy allowed the Agency to continue to meet the financing demands of small businesses without the need for taxpayer subsidy. For the first time in several years, the SBA was able to stabilize the 7(a) loan program and provide financing without the need for loan caps or temporary suspensions of program availability. With zero subsidy, adequate loan levels are established to meet the demands of the lending and small business communities. In addition, it focuses Agency resources on enhanced oversight of the portfolio in order to maintain a zero subsidy rate.

Government Contracting

Government contracting dollars going to small businesses has grown steadily since FY 2000. There were $20 billion more in small business contracts in FY 2004 than in FY 2000. That amount supported an estimated 156,000 jobs. With improved efficiencies in FY 2007, SBA will be able to serve record numbers of small businesses with a total budget request of $74 million for Government Contracting and Business Development assistance.

Small Business Contracting Awards

Year	Small Business	Total SDB	8(a)	Women	HubZone	Service Disabled Vets
2004	23.08% ($69.2B)	6.18% ($18.5B)	2.81% ($8.4 B)	3.03% ($9.1B)	1.59% ($4.8B)	0.38% ($1.2B)
2003	23.61% ($65.6B)	7.01% ($19.5B)	3.64% ($10.1B)	2.98% ($8.3B)	1.23% ($3.4B)	0.20% ($549M)
2002	22.62% ($53.3B)	6.75% ($15.9B)	2.39% ($5.7B)	2.50% ($6.8B)	0.71% ($1.7B)	0.13% ($298M)
2001	22.81% ($50.1B)	7.12% ($15.6B)	2.86% ($6.3B)	2.49% ($5.5B)	0.72% ($1.6B)	0.25% ($554M)
2000	22.26% ($44.7B)	3.61% ($7.3B)	2.88% ($5.7B)	2.28% ($4.6B)	0.33% ($663M)	N/A

SBA's Office of Government Contracting and Business Development (GCBD) has increased the number of Procurement Center Representatives (PCRs) assisting small business with Federal procurement issues from 35 to 58 since FY 2000. For non-salary direct operating budget items specifically addressing Government Contracting and Business Development assistance, the request is for $4.9 million in FY 2007. This includes $2 million in direct costs for 7(j), $1.1 million for HUBZone administrative costs such as travel, office supplies and contract support (in addition to over $1.4 million in compensation and benefits). GCBD has 177 employees, of which 103 are located around the country providing small business contracting assistance. Their salaries and benefits are included in SBA's overall request for compensation and benefits.

In FY 2004, small businesses received contract awards totaling a little over $69 billion of the approximately $300 billion in total Federal prime contract awards. Additionally, there were an estimated $45 billion in government related subcontracts awarded to small businesses.

SBA's Office of Government Contracting and Business Development also instituted enhanced practices and technological improvements. The Office is working with other agencies to help them meet their missions, as well as helping small businesses to identify contracting opportunities through these technological improvements. Systems such as the e-PCR system create increased efficiencies concerning government contracting opportunities and monitoring.

Strides have been made to maximize staff resources and monitor contracting activities, as well as to improve communication and interaction with the small business community through the automation of many basic systems. These systems include the Electronic Subcontracting Reporting System, the electronic 8(a) application, the HUBZone Procurement Query and Reporting System, as well as the Central Contractor Registration, and Tech-Net among others. As technology is ever changing and improving, so are the efficiencies enhanced by using these E-gov systems.

The added benefit of these technological advances is apparent in the business matchmaking efforts following the Gulf Coast Hurricane disasters. More than 500 small businesses were registered and assisted by PCRs. Approximately $30 million in contract support has already been awarded to many of these firms. In other Katrina-related contracting, approximately $1.24 billion in contracts listed in Federal Procurement Data System-Next Generation (FPDS-NG) were awarded to small business. An additional $1.5 billion in FEMA small business awards are pending.

Entrepreneurial Development Programs

SBA's Office of Entrepreneurial Development manages a strong distribution channel of service centers for small businesses across the country. The services offered include assistance in preparing business plans, loan applications, GSA procurement requests, strategic plans, marketing plans, export advice, pricing plans and competitive assessments.

We serve these small businesses through our three resource partners: Small Business Development Centers (SBDCs), Women's Business Centers (WBCs), and SCORE (formerly called Service Corps of Retired Executives). In FY 2005, our resource partners trained and counseled over 1.1 million clients. In addition, 311,000 clients registered for our 23 courses online through our Small Business Training Network and 1.04 million accessed the SBA website.

This past year definitions for reporting various types of counseling services performed were synchronized for all types counseling partners. Now, all types of counseling partners are reporting services rendered in a more consistent manner.

Paul D. Coverdell Drug Free Workplace Program

In 2005, SBA provided almost $1 million in grants under the Drug Free Workplace program. As a result of previous legislation, there are a wider variety of grantees now eligible. We have also established a data collection and evaluation reporting system that will help us assess program effectiveness. The Agency will continue to promote these grants through our partners.

CONCLUSION

Chairman Coburn, Ranking Member Carper, Senators, SBA today is assisting more small businesses than ever before and at less cost to the taxpayer than ever before. Through technology, solid management and by pursuing a course designed to improve Agency and program performance, we are being more efficient and effective in the delivery of our programs and services. While there is still work to do, we re committed to a path of delivering greater results for the American taxpayer . I am proud of our achievements and proud of the efforts by SBA's employees to make this possible.

However, I do not believe that SBA's programs alone can drive small business growth. As consistently championed by President Bush through his small business agenda, keeping enacted tax cuts permanent, eliminating unnecessary regulation, passing an association health plan bill and opening additional international markets to American goods and services are also needed.

Mr. Chairman, I thank you again for the opportunity to testify and look forward to your questions.

United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Federal Financial Management, Government Information, and International Security, Committee on Homeland Security and Governmental Affairs, U.S. Senate

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SMALL BUSINESS ADMINISTRATION

Improvements Made, but Loan Programs Face Ongoing Management Challenges

Statement of William B. Shear, Director
Financial Markets and Community Investment

GAO
Accountability * Integrity * Reliability

GAO-06-605T

April 6, 2006

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Highlights

Highlights of GAO-06-605T, a testimony to the Subcommittee on Federal Financial Management, Government Information, and International Security, Committee on Homeland Security and Governmental Affairs, U.S. Senate

SMALL BUSINESS ADMINISTRATION

Improvements Made, but Loan Programs Face Ongoing Management Challenges

Why GAO Did This Study

The Small Business Administration's (SBA) purpose is to promote small business development and entrepreneurship through business financing, government contracting, and technical assistance programs. SBA's largest business financing program is its 7(a) program, which provides guarantees on loans made by private-sector lenders to small businesses that cannot obtain financing under reasonable terms and conditions from the private sector. In addition, SBA's Office of Disaster Assistance makes direct loans to households to repair or replace damaged homes and personal property and to businesses to help with physical damage and economic losses.

This testimony, which is based on a number of reports that GAO issued since 1998, discusses (1) changes in SBA's oversight of the 7(a) business loan program; (2) steps SBA has taken to improve its management of information technology, human capital, and financial reporting for business loans; and (3) SBA's administration of its disaster loan program.

www.gao.gov/cgi-bin/getrpt?GAO-06-605T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact William B. Shear at (202) 512-8678 or shearw@gao.gov.

What GAO Found

Since the mid-1990s, when GAO found that SBA had virtually no oversight program for its 7(a) guaranteed loan program, SBA has, in response to GAO recommendations, established a program and developed some enhanced monitoring tools. The oversight program is led by its Office of Lender Oversight, which was established in 1999. Strong oversight of SBA's lending partners is needed to protect SBA from financial risk and to ensure that qualified borrowers get 7(a) loans. In addition to its bank lending partners, loans are made by Small Business Lending Companies (SBLC)—privately owned and managed, non-depository lending institutions that are licensed and regulated by SBA. Since SBLCs are not subject to safety and soundness oversight by depository institution regulators, SBA has developed such a program under a contract with the Farm Credit Administration. Over the years, SBA has implemented many GAO recommendations for lender oversight and continues to make improvements toward addressing others.

Since the late 1990s, SBA has experienced mixed success in addressing other management challenges that affect its ability to manage the 7(a) loan program. With respect to using information technology to monitor loans made by 7(a) lenders, between 1997 and 2002, SBA was unsuccessful in developing its own system to establish a risk management database as required by law. However, SBA awarded a contract in April 2003 to obtain loan monitoring services. Regarding SBA's most recent workforce transformation efforts begun in 2002, GAO found that SBA applied some key practices important to successful organizational change but overlooked aspects that emphasize transparency and communication. SBA has implemented some related GAO recommendations for improvements in those areas. SBA has also made good progress in response to GAO recommendations addressing financial management issues.

With respect to SBA's administration of its disaster loan program after the September 11, 2001, terrorist attacks, GAO found that SBA followed appropriate policies and procedures for disaster loan applications in providing approximately $1 billion in loans to businesses and individuals in the disaster areas, and to businesses nationwide that suffered economic injury. GAO's preliminary findings from ongoing evaluations of SBA's response to the 2005 Gulf Coast hurricanes indicate that SBA's workforce and new loan processing system have been overwhelmed by the volume of loan applications. GAO identified three factors that have affected SBA's ability to provide a timely response to the Gulf Coast disaster victims: (1) the volume of loan applications far exceeded any previous disaster; (2) although SBA's new disaster loan processing system provides opportunities to streamline the loan origination process, it initially experienced numerous outages and slow response times in accessing information; and (3) SBA's planning efforts to address a disaster of this magnitude appear to have been inadequate.

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to be here today as you consider the effectiveness of the Small Business Administration (SBA). Established by Congress in 1953 to fulfill the role of several previous agencies, SBA's purpose is to promote small business development and entrepreneurship through business financing, government contracting, and technical assistance programs. In addition, SBA's Office of Disaster Assistance (ODA) makes loans to households to repair or replace damaged homes and personal property, and to businesses to help with physical damage and economic losses. For over a decade, SBA has been centralizing some functions to improve efficiency and has moved more toward partnering with outside entities, such as private-sector lenders, to provide direct services to small businesses. Significant changes in SBA's management of its loan programs, information technology, human capital, and financial resources have occurred, and we have studied various aspects of these changes.

My statement today is based on a number of reports that we have issued over the past decade addressing SBA's administration of its major loan guarantee and disaster loan programs. I will discuss (1) changes in SBA's oversight of the 7(a) business loan program; (2) steps SBA has taken to improve its management of information technology, human capital, and financial reporting for business loans; and (3) SBA's administration of its disaster loan program after the September 11, 2001, terrorist attacks and the recent Gulf Coast hurricanes.

In summary:

- Since the mid-1990s, when we found that SBA had virtually no oversight program for its 7(a) guaranteed loan program, SBA has, in response to our recommendations, established a program and developed some enhanced monitoring tools. The oversight program is led by its Office of Lender Oversight (OLO), which was established in 1999. Strong oversight of SBA's lending partners is needed to protect SBA from financial risk and to ensure that qualified borrowers get 7(a) loans. In addition to its bank lending partners, loans are made by Small Business Lending Companies (SBLC)—privately owned and managed, non-depository lending institutions that are licensed and regulated by SBA. Since SBLCs are not subject to safety and soundness oversight by depository institution regulators, SBA has developed such a program under a contract with the Farm Credit Administration. Although we have not comprehensively reviewed the 7(a) program in some time, over the years, SBA has implemented many of our recommendations for lender oversight and continues to make improvements toward addressing others.

- Since the late 1990s, SBA has experienced mixed success in addressing other management challenges that affect its ability to manage the 7(a) program. With respect to using information technology to monitor loans made by 7(a) lenders, between 1997 and 2002, SBA was unsuccessful in developing its own system to establish a risk management database as required by law. However, SBA awarded a contract in April 2003 to obtain loan monitoring services. Regarding SBA's most recent workforce transformation efforts begun in 2002, we found that although SBA applied some key practices important to successful organizational change, it overlooked aspects that emphasize transparency and communication. SBA has implemented some related recommendations for improvements in those areas. SBA has made good progress in response to our recommendations addressing financial management issues.

- With respect to SBA's administration of its disaster loan program after the September 11, 2001, terrorist attacks, we found that SBA followed appropriate policies and procedures for disaster loan applications in providing approximately $1 billion in loans to businesses and individuals in the disaster areas, and to businesses nationwide that suffered economic injury. Our preliminary findings from ongoing evaluations of SBA's response to the 2005 Gulf Coast hurricanes indicate that SBA's workforce and new loan processing system have been overwhelmed by the volume of loan applications. We identified three factors that have affected SBA's ability to provide a timely response to the Gulf Coast disaster victims: (1) the volume of loan applications far exceeded any previous disaster; (2) although SBA's new disaster loan processing system provides opportunities to streamline the loan origination process, it initially experienced numerous outages and slow response times in accessing information; and (3) SBA's planning efforts to address a disaster of this magnitude appear to have been inadequate.

Background

SBA was established in 1953, but its basic mission dates to the 1930s and 1940s when a number of predecessor agencies assisted small businesses affected by the Great Depression and, later, by wartime competition. The first of these, the Reconstruction Finance Corporation, was abolished in the early 1950s; SBA was established by the Small Business Act of 1953,[1] to continue the functions of the previous agencies. By 1954, SBA was making business loans directly to small businesses and guaranteeing loans banks made, making loans directly to victims of disasters, and providing a wide range of technical assistance to small businesses.

Today, SBA's stated purpose is to promote small business development and entrepreneurship through business financing, government contracting, and technical assistance programs. SBA also serves as a small business advocate, working with other federal agencies to, among other things, reduce regulatory burdens on small businesses. Most SBA financial assistance is now provided in the form of guarantees for loans made by private and other institutions, but the agency's disaster program remains a direct loan program and is available to homeowners and renters that are affected by disasters of any kind; and to all businesses, regardless of their size, to cover physical damages.

At the end of fiscal year 2005, SBA had authority for over 4,000 full-time employees and budgetary resources of approximately 1.1 billion.[2]

SBA Has Developed and Continues to Improve an Oversight Program for Its Business Loan Program

Providing small businesses with access to credit is a major avenue through which SBA strives to fulfill its mission. The 7(a) loan program, which is SBA's largest business loan program, is intended to serve small business borrowers who cannot obtain credit elsewhere.[3] Because SBA guarantees up to 85 percent of each 7(a) loan made by its lending partners, there is risk to SBA if the loans are not repaid.

SBA is to ensure that lenders provide loans to borrowers who are eligible and creditworthy. Therefore, strong oversight of lenders by SBA is needed to ensure that qualified borrowers get 7(a) loans and to protect SBA from financial risk. As of September 30, 2005, SBA's portfolio of 7(a) loans totaled $43 billion. In administering the 7(a) program, SBA has evolved from making loans directly to depending on lending partners, primarily

[1]Pub. L. No. 83-163, tit. II, 67 Stat. 232 (July 30, 1953), as amended, which was withdrawn as part of that Act and made a separate Act known as the "Small Business Act" by Pub. L. No. 85-536, 72 Stat. 384 (July 18, 1958) (*codified at* 15 U.S.C. §§ 631 – 657e).

[2]Budgetary resources include new budget authority and unobligated balances of previous budget authority.

[3]15 U.S.C. § 636(a).

banks that make SBA guaranteed loans.[4] SBA's other lending partners are Small Business Lending Companies (SBLC)—privately owned and managed, non-depository lending institutions that are licensed and regulated by SBA and make only 7(a) loans. Unlike SBA's bank lending partners, SBLCs are not generally regulated by financial institution regulators.[5]

Since the mid-1990s, when SBA had virtually no oversight program for its 7(a) guaranteed loan program, the agency has established a program and developed some enhanced monitoring tools. We have conducted four studies of SBA's oversight efforts since 1998 and made numerous recommendations related to establishing a lender oversight function and improving it. Although we sometimes repeated recommendations in more than one report because SBA had not acted to address them, SBA has now addressed many of the outstanding recommendations and is in the process of addressing others.

Prior to December 1997, SBA's procedures required annual on-site reviews of lenders with more than three outstanding guaranteed loans. But in a June 1998 study, we could not determine from the district offices' files which lenders met this criterion and should have been reviewed.[6] In the five SBA district offices we visited, we found that about 96 percent of the lenders had not been reviewed in the past 5 years and that some lenders participating in the program for more than 25 years had never been reviewed. When we did our study, SBA was implementing a central review program for its "preferred" lenders (those SBA certifies to make loans without preapproval).[7] The Small Business Programs Improvement Act of

[4]Within the 7(a) program, there are three classifications of lenders—regular, certified, and preferred lenders. The Small Business Administration continues to provide final approval of loans made by its regular lenders. Certified lenders have the authority to process, close, service, and may liquidate SBA guaranteed loans. Preferred lenders are given full authority to make loans without prior SBA approval.

[5]Small Business Lending Companies that are subsidiaries of bank holding companies are subject to Federal Reserve Board oversight.

[6]See GAO, *Small Business Administration: Few Reviews of Guaranteed Lenders Have Been Conducted*, GAO-98-85 (Washington, D.C.: June 11, 1998).

[7]The percentage of loans accounted for by preferred lenders represented about 30 percent of 7(a) loan approvals and 50 percent of loan volume in 1997.

1996 required SBA to review preferred lenders either annually or more frequently.[8]

In our 1998 report, we recommended that SBA establish a lender review process for all of its 7(a) lenders, including the SBLCs. In 1999, SBA established OLO and charged it with, among other duties, managing lender reviews, including safety and soundness examinations of SBLCs. In the same year, SBA contracted with the Farm Credit Administration—the safety and soundness regulator of the Farm Credit System—to perform examinations of SBLCs. Numerous deficiencies were identified in those first examinations, but the SBLCs and SBA responded positively to address the recommendations. SBA continues its contracting arrangement with FCA.

It was during our 2000 study on oversight of SBLCs that we first recommended that SBA clarify its authority to take enforcement actions, if necessary, against SBLCs, and to seek any statutory authority it might need to do so.[9] We made this recommendation again in 2002 and in 2004 and included a call to clarify procedures for taking actions against preferred lenders as well. We recommended that SBA provide, through regulation, clear policies and procedures for taking enforcement actions against preferred lenders or SBLCs in the event of continued noncompliance with its regulations. During this time, SBA sought appropriate authority from Congress to take enforcement actions against SBLCs similar to those of other regulators of financial institutions, such as cease-and-desist and civil money penalty powers. Congress provided SBA enforcement authority over non-bank lenders in late 2004, and SBA announced related delegations of authority in the Federal Register in April 2005 to clarify responsibilities within the agency.[10] SBA officials have told us that they will issue related regulations in 2006.

[8]The assessments are to include, among other things, defaults, loans, and recoveries of loans made by the lender. Pub. L. No. 104-208, div. D, title 1, § 103(h), 110 Stat. 3009, 3009-728 (Sept. 30, 1996) (*codified at* 15 U.S.C. § 634 note).

[9]GAO, *Small Business Administration: Actions Needed to Strengthen Small Business Lending Company Oversight*, GAO-01-192 (Washington, D.C.: Nov. 17, 2000).

[10]See Small Business Reauthorization and Manufacturing Assistance Act of 2004 (Pub. L. No. 108-447, div.K, § 161, 118 Stat. 2809, 3458 (Dec. 8, 2004) (*codified at* 15 U.S.C. § 650); and 70 Fed. Reg. 21262, 21263 (Apr. 25, 2005).

Our 2002 study focused more broadly on the relatively new OLO and found that the agency had made more progress in developing its lender oversight program.[11] OLO had developed guidance, centralized the lender review processes, and was performing more reviews of its lenders. We did, however, find some shortcomings in the program and made recommendations for improving it. For example:

- While elements of the oversight program touched on the financial risk posed by preferred lenders, weaknesses limited SBA's ability to focus on, and respond to, current and future financial risk to its portfolio. Neither the lender review process nor SBA's off-site monitoring adequately focused on the financial risk lenders posed. The reviews used an automated checklist to focus on lenders' compliance with SBA's 7(a) processing, servicing, and liquidation standards. The reviews did not provide adequate assurance that lenders were sufficiently assessing borrowers' eligibility and creditworthiness. We recommended that SBA incorporate strategies into its review process to adequately measure the financial risk lenders pose to SBA, develop specific criteria to apply to the "credit elsewhere" standard, and perform qualitative assessments of lenders' performance and lending decisions.[12] By 2004, as I will discuss in a moment, we found that SBA had made progress in its ability to monitor and measure the financial risk lenders pose but had not developed criteria for its credit elsewhere standard.
- Although SBA had taken a number of steps to develop its lender oversight function, the placement of its OLO within the Office of Capital Access (OCA) did not give OLO the necessary organizational independence it needed to accomplish its goals. OCA has other objectives, including promoting the lending program to appropriate lenders. We recommended that SBA make lender oversight a separate function and establish clear authority and guidance for OLO. SBA has taken several steps to address this recommendation but has not made OLO an independent office. In the 2005 delegations of authority published in the Federal Register, SBA specified that a Lender Oversight Committee (comprised of a majority of senior SBA officials outside of OCA) would have responsibilities for reviewing reports on lender-oversight activities; OLO recommendations

[11]See GAO, *Small Business Administration: Progress Made but Improvements Needed in Lender Oversight*, GAO-03-90 (Washington, D.C.: Dec. 9, 2002).

[12]15 U.S.C. § 636(a)(1)(A) prohibits SBA from providing financial assistance to an applicant that can obtain credit elsewhere. 13 C.F.R. § 120.101 states, in part, "SBA provides business loan assistance only to applicants for whom the desired credit is not otherwise available on reasonable terms from non-Federal sources."

for enforcement action; and OLO's budget, staffing, and operating plans. SBA officials believe that these and other measures will ensure sufficient autonomy and authority for OLO to independently perform its duties. These measures appear to provide the opportunity for more independence for OLO, but we have not evaluated how the measures are actually working.

Our most recent review of SBA's oversight efforts, completed in June 2004, focused on the agency's risk management needs and its acquisition and use of a new loan monitoring service.[13] Using an assessment of best practices, we determined that SBA would need to base its capabilities for monitoring its loan portfolio and lender partners on a credit risk management program.[14] Largely because SBA relies on lenders to make its guaranteed loans, it needs a loan and lender monitoring capability that will enable it to efficiently and effectively analyze various aspects of its overall portfolio of loans, its individual lenders, and their portfolios. While SBA must determine the level of credit risk it will tolerate, it must do so within the context of its mission and its programs' structures. Since SBA is a public agency, its mission obligations will drive its credit risk management policies. For example, different loan products in the 7(a) program have different levels of guarantees. These and other differences influence the mix of loans in SBA's portfolio and, consequently, would impact how SBA manages its credit risk.

Such a credit risk management program would likely include a comprehensive infrastructure—including, skilled personnel, strong management information systems, and functioning internal controls related to data quality—along with appropriate methodologies and policies that would ensure compliance with SBA criteria.

In 2003, SBA contracted with Dun and Bradstreet for loan monitoring services. These services could enable the agency to conduct the type of monitoring and analyses typical of "best practices" among major lenders, and are recommended by financial institution regulators. The services SBA obtained reflect many best practices, particularly those related to infrastructure and methodology, and can facilitate a new level of

[13]See GAO, *Small Business Administration: New Service for Lender Oversight Reflects Some Best Practices, but Strategy for Use Lags Behind*, GAO-04-610 (Washington, D.C.: June 8, 2004).

[14]"Credit risk" is the risk of financial loss due to borrower default.

sophistication in SBA's oversight efforts.[15] The services also give SBA a way to measure the financial risk posed by its lending partners, and analyze loan and lending patterns efficiently and effectively. However, SBA did not develop the comprehensive policies it needed to implement the best practices as we recommended.

SBA officials have told us that they have taken steps to address this recommendation. For example, the management plan governing the agency's relationship with Dun and Bradstreet addresses a process for continuous improvement. SBA has also established the Lender Oversight Committee and a Portfolio Analysis Committee to review portfolio performance. SBA officials told us that these committees meet frequently. They also described the type of analyses of the loan portfolio and individual lenders made available for review and discussion by the committees, and provided examples of these analyses. Although these developments could provide the tools for risk management that we envisioned, we have not evaluated them.

SBA Has Experienced Mixed Success in Addressing Other Management Challenges to Its 7(a) Loan Program

Since the late 1990s, SBA has taken steps to address other management challenges that affect its ability to manage its business loan program and the technical assistance it provides small businesses. Information technology, human capital, and financial management have posed challenges for SBA, as we have noted in special reports to Congress.[16]

[15]The best practices include continuous improvements in the service and its tools, frequent and routine portfolio reviews, and active involvement of senior managers in reviewing how the information from the service is used.

[16]GAO, *Major Management Challenges and Program Risks: Small Business Administration*, GAO-03-116 (Washington, D.C.: Jan. 2003); see www.gao.gov/pas/2005 for a 2005 update. We first addressed these management challenges in 2001. See GAO, *Major Management Challenges and Program Risks: Small Business Administration*, GAO-01-260 (Washington, D.C.: Jan. 2001).

SBA Has Made Advancements in Information Technology Critical to Business Loans

SBA has now acquired the ability to monitor its portfolio of business loans through its arrangement with Dun and Bradstreet, as mentioned earlier. SBA took this positive step after an unsuccessful attempt to establish a risk management database as required by the Small Business Programs Improvement Act of 1996.[17] We monitored the agency's progress as it attempted to meet this challenge on its own. When we reviewed SBA's plans in 1997, we found that it had not undertaken the essential planning needed to develop the proposed system.[18] We periodically reported on SBA's progress in planning and developing the loan monitoring system since 1997.[19] From 1998 to 2001, SBA's estimate for implementing the system grew from $17.3 million to $44.6 million. By 2001, SBA had spent $9.6 million for developmental activities, but had never completed the mandated planning activities or developed a functioning loan monitoring system.

In 2001, Congress did not appropriate funds for the loan monitoring system and instead permitted SBA to use reprogrammed funds, provided that SBA notify Congress in advance of SBA's use of the reprogrammed funds.[20] Congress also directed SBA to develop a project plan to serve as a basis for future funding and oversight of the loan monitoring system. As a result, SBA suspended the loan monitoring system development effort. Of the $32 million appropriated for the loan monitoring system effort, about $14.7 million remained. In 2002, SBA contracted for assistance to identify alternatives and provide recommendations for further developing a loan monitoring system. This effort led to SBA awarding a contract to Dun and Bradstreet in April 2003 to obtain loan monitoring services, including loan and lender monitoring and evaluation; and risk management tools. The

[17]Pub. L No. 104-208, div. D, title I, § 102,110 Stat. 3009-724, 3009-725, (Sept. 30, 1996) (*codified at* 15 U.S.C. § 633(b)(3).

[18]GAO, *Small Business Administration: Better Planning and Controls Needed for Information Systems*, GAO/AIMD-97-94 (Washington, D.C.: June 27, 1997).

[19]GAO, *Small Business Administration: Mandated Planning for Loan Monitoring System Is Not Complete*, GAO/AIMD-98-214R (Washington, D.C.: June 30,1998); *Small Business Administration: Planning for Loan Monitoring System Has Many Positive Features but Still Carries Implementation Challenges*, GAO/T-AIMD-98-233 (Washington, D.C.: July 16, 1998); *SBA Loan Monitoring System: Substantial Progress Yet Key Risks and Challenges Remain*, GAO/AIMD-00-124 (Washington, D.C.: Apr. 25, 2000); *Loan Monitoring System: SBA Needs to Evaluate the Use of Software*, GAO-02-188 (Washington, D.C.: Nov. 30, 2001).

[20] See Pub. L. No. 107-77, 115 Stat. 748, 796-799 (Nov. 28, 2001); and H.R. Conf. Rep. No. 107-278 at 164 (2001).

contract includes four 1-year options at an average cost of approximately $2 million a year.

SBA Has Applied Key Practices but Overlooked Transparency and Communication During Its Workforce Transformation

In 2001 we reported on SBA's organizational structure and the challenges it presented for SBA to deliver services to small businesses.[21] We reviewed how well SBA's organization was aligned to achieve its mission. We found a field structure that did not consistently match with SBA's mission requirement. This was caused by past realignment efforts during the mid-1990s that changed how SBA performed its functions, but left some aspects of the previous structure in place. Among the other weaknesses we identified were:

- ineffective lines of communication;
- confusion over the mission of district offices; and
- complicated, overlapping organizational relationships.

SBA began realigning its organization, operations, and workforce to better serve its small-business customers in the 1990's. With less responsibility for direct lending and a declining operating budget, SBA streamlined its field structure by downsizing its 10 regional offices, moving the workload to district or headquarters offices, and eliminating most of the regional offices' role as the intermediate management layer between headquarters and the field. SBA created the Office of Field Operations, largely to represent the field offices in headquarters and to provide guidance and oversight to field office management. In 2002, the agency planned to approach its 5-year transformation efforts in phases, testing a number of initiatives in order to make refinements before implementing the initiatives agencywide. These efforts are ongoing. SBA's current transformation objectives are to:

- streamline ODA by realigning offices, employees, and space to better serve disaster victims and leverage use of the new disaster loan processing system;

[21]GAO, *Small Business Administration: Current Structure Presents Challenges for Service Delivery*, GAO-02-17 (Washington, D.C.: Oct. 26, 2001).

- centralize all 7(a) loan processing in two centers to standardize procedures and reduce the workforce required for this program;
- centralize all 504 loan liquidations in two centers to standardize processing and increase efficiency;
- centralize disaster loan liquidations in one center to standardize processing and increase efficiency; and
- transform the regional and district offices by standardizing their size and function.

In October 2003, when we reported on SBA's transformation, SBA was near completion of the first phase of its transformation process.[22] This initial phase aimed to

- transform the role of the district office to focus on outreach to small businesses about SBA's products and services, and link these businesses to the appropriate resources, including lenders; and
- centralize some of its loan functions to improve efficiency and the consistency of its loan approval and liquidation processes.

We found that the agency had applied some key practices important to successful organizational change, but had overlooked aspects that emphasize transparency and communication. For example, SBA had top leadership support and a designated transformation-implementation team, but the makeup of the team was not communicated to employees and stakeholders, and the team's leadership was not always consistent. Also, SBA had developed a transformation plan that contained goals, anticipated results, and an implementation strategy--but the plan was not made public, and employees and stakeholders were not apprised of the details of the plan. Also, certain aspects of the plan were revised, causing further confusion among non-management employees. Further, SBA had developed strategic goals to guide its transformation, but these goals were not linked with measurable performance goals that would demonstrate the success of the agency's plan to expand the focus of the district offices on marketing and outreach.

[22]GAO, *Small Business Administration: Progress Made, but Transformation Could Benefit from Practices Emphasizing Transparency and Communication*, GAO-04-76 (Washington, D.C.: Oct. 31, 2003).

Based on our findings and the possibility that further progress could be impeded by budget and staff realignment challenges, we recommended that SBA:

- ensure that implementation leadership is clearly identified to employees and stakeholders;
- finalize its transformation plan and share it with employees and stakeholders;
- develop performance goals that reflect the strategic goals for transformation, and budget requests that clearly link resource needs to achieving strategic goals;
- use the new performance management system to define responsibilities;
- develop a communication strategy that promotes two-way communication; and
- solicit ideas and feedback from employees and the union, and ensure that their concerns were considered.

SBA officials have told us of the Administrator's increased efforts to communicate with staff by holding agencywide meetings with employees, for example. In addition, the agency plans to finalize a transformation plan and share it with employees in June. These actions could address some of the recommendations we made to SBA, but we have not documented or evaluated the efforts.

SBA Addressed Major Financial Management Issues, but Additional Steps are Necessary to Sustain Progress

SBA has made good progress towards addressing financial management issues that for several years prevented it from obtaining an unqualified audit opinion on its financial statements. We reported on some of these issues in our January 2003 report on SBA's loan sales.[23] Specifically, we found that SBA lacked reliable data to determine the overall financial results of its loan sales. Further, because SBA did not analyze the effect of loan sales on its remaining portfolio, we reported that its credit program

[23]GAO, *Small Business Administration: Accounting Anomalies and Limited Operational Data Make Results of Loan Sales Uncertain*, GAO-03-87 (Washington, D.C.: Jan. 3, 2003). Between fiscal years 1999 and 2003, SBA conducted seven loan sales, divesting itself of about 166,000 loans with an outstanding balance of about $5.7 billion. Approximately 86 percent of the amount sold was from disaster assistance loans.

cost estimates for the budget and financial statements may have contained significant errors. In addition, SBA could not explain unusual account balances related to the disaster loan program, which indicated that the subsidized program was expected to generate a profit. These issues raised concerns about SBA's ability to properly account for loan sales and to make reasonable estimates of program costs.

In response to our findings and several recommendations, SBA conducted an extensive analysis to resolve the issues we identified and implemented a number of corrective actions. For example, SBA developed a new cash-flow model to estimate the costs of its disaster loan program, and implemented standard operating procedures for annually revising the cost estimates for its credit programs. SBA also revised its approach to determine the results of loan sales and found that loans were sold at losses, which was contrary to the original determination that the sales generated gains. These findings prompted SBA to eventually discontinue its loan sales program. We reviewed the improvements made by SBA and reported in April 2005 that the loan accounting issues we previously identified were resolved, and that the new cash-flow model improved its ability to prepare more reliable cost estimates and to determine the results of prior loan sales.[24] However, we recommended additional steps that would improve the long-term reliability of the cost estimates, such as routine testing of the model. According to SBA officials, steps have been taken to address each of our recommendations, including the development of policies and procedures on how to operate and test the model.

These improvements helped SBA achieve an unqualified audit opinion on its fiscal year 2005 financial statements, which represents significant progress from prior years. However, for fiscal year 2005 SBA's auditor continued to note weaknesses in SBA's overall internal controls. The auditor noted three areas involving internal controls that are considered to

[24]GAO, *SBA Disaster Loan Program: Accounting Anomalies Resolved but Additional Steps Would Improve Long-Term Reliability of Cost Estimates*, GAO-05-409 (Washington, D.C.: Apr. 14, 2005).

be weaknesses.[25] The first area, which the auditor considered to be a significant weakness, related to financial management and reporting controls. Specifically, the auditor found that SBA needed to improve its funds management (i.e., canceling loan amounts not disbursed and closing out grants), its review process for accounting transactions, and its financial statement preparation process. The other two less significant control weaknesses related to SBA's ODA administrative expenditure controls and agencywide information system controls. While these internal control weaknesses were not severe enough to impact SBA's audit opinion for fiscal year 2005, it is important for SBA to address them to help ensure that SBA continues to be able to generate reliable financial data.

SBA Provided Disaster Loans in Response to September 11th and Now Is Responding to the Gulf Coast Hurricanes

Disaster assistance has been part of SBA since its inception, and SBA's physical disaster loan program is the only form of assistance not limited to small businesses.[26] Through the ODA, SBA provides low-interest, long-term loans to individuals and businesses to assist them with disaster recovery. Unlike the 7(a) program, the disaster loan program provides loans directly to disaster victims. Businesses can apply for "physical loans" to repair or replace business property to pre-disaster conditions, as well as economic injury disaster loans (EIDLs) to obtain working capital funds to meet their normal operating expenses. The maximum loan amount for both physical business loans and EIDLs is $1.5 million, but SBA was given federal authority and supplemental appropriations to increase the amount for 9/11 disaster loans. Homeowners and renters can also apply for loans to cover their uninsured losses. The maximum amount available for home loans is $200,000, and personal property loans to replace items such as automobiles, clothing, and furniture are available up to $40,000.[27] SBA offers terms of up to 30 years for repayment. According to SBA, although

[25]There are two types of internal control weaknesses. A "reportable condition" is a significant deficiency in the design or operation of internal controls that could adversely affect the organization's ability to provide reasonable assurance on the reliability of its financial reporting, performance reporting, and compliance with laws and regulations. The more significant weakness, referred to as a "material internal control weakness," is a reportable condition that does not reduce to a relatively low level the risk that errors, fraud, or noncompliance involving significant amounts may occur and may not be detected in a timely manner, by employees in the normal course of performing their assigned functions.

[26]The economic injury disaster loan (EIDL) program under 15 U.S.C. § 636(b)(2) covers small business concerns and small agricultural cooperatives located in a disaster area.

[27]13 C.F.R. § 123.105.

ODA aims to provide loan funds to disaster victims as quickly as possible, its focus is on long-term recovery, and not on emergency relief.

Since SBA provides low-interest loans, the agency is required to determine whether each applicant is able to obtain financial assistance at reasonable rates and terms from non-government sources prior to assigning an interest rate. A higher rate applies for physical loan applicants if they are determined to have other credit available, and economic injury loan applicants are ineligible if they have other credit available. Physical business loans–where the applicant has credit available from other sources–are also subject to a maximum 3-year term for repayment.[28] SBA also has standard procedures and requirements for disaster loans, including verification of losses claimed, verification of repayment ability, and collateral to secure loans for economic injury loans over $5,000 or for home loans or physical disaster business loans over $10,000.[29] SBA verifies losses for physical loans and also deducts certain forms of compensation, including insurance recoveries, from the eligible loan amount. Federal Emergency Management Agency (FEMA) is the coordinating agency for presidential disaster declarations, and most disaster victims register with FEMA initially before receiving a referral to SBA.[30] SBA can review FEMA's information to determine if an applicant has already received federal assistance or insurance proceeds to avoid duplication of benefits.[31] If insurance reimbursement is undetermined at the time of application, SBA can approve a loan for the total replacement cost, but any insurance proceeds must be assigned to SBA to reduce the loan balance. In considering any loan, SBA must have reasonable assurance that the loan can be repaid. To make this determination, SBA examines federal tax returns and income information and reviews credit reports to verify the manner in which an applicant's obligations, including federal debts, have been met. One of the reasons that SBA may decline a loan application is

[28]13 C.F.R. § 123.203(a).

[29]13 C.F.R. § 123.11.

[30]Non-business disaster victims initially register with the Federal Emergency Management Agency (FEMA) and are directed to apply for an SBA disaster assistance loan if they meet certain basic criteria. Business owners are also encouraged to register with FEMA. Applicants not approved for an SBA loan are referred back to FEMA for possible grant assistance.

[31]ODA's new Disaster Credit Management System (DCMS) has a direct link to FEMA's database, which allows SBA to conduct the duplication of benefits (DOB) review electronically.

unsatisfactory history on a federal obligation. The law does not require collateral for disaster loans, but SBA policy establishes collateral requirements in order to balance the agency's disaster recovery mission with its responsibility as a lender of federal tax dollars. For example, for physical disaster loans over $10,000, applicants are required to provide collateral that will best secure the loan, and multiple loans totaling over $10,000 also require collateral to secure each loan. Real estate is the preferred form of collateral, but SBA will not automatically decline an application if the best available collateral is insufficient in value to secure the loan.

Following the terrorist attacks of September 11th, SBA provided approximately $1 billion in loans to businesses and individuals in the federally declared disaster areas and to businesses nationwide that suffered related economic injury.[32] Home and business owners in the federally declared disaster areas received just under half of the disbursed loans; the remainder went to eligible businesses around the country. Congress and SBA made several modifications to the programs in response to complaints from small businesses. For example, the EIDL program was expanded to the entire country and to industries that had not previously been covered, size standards for some eligible business were changed, and loan approval and disbursement were expedited.[33]

In 2004, in response to concerns that about half of the loan applications submitted by small businesses were declined or withdrawn, we reviewed a representative sample of these applications and found that SBA had followed the appropriate policies and procedures in making loan

[32]GAO, *Small Business Administration: Response to September 11 Victims and Performance Measures for Disaster Lending,* GAO-03-385 (Washington, D.C.: Jan. 29, 2003).

[33]SBA was given supplemental appropriations to make loans after September 11th and the 2005 Gulf Coast hurricane disasters.

decisions.[34] We compared SBA's loan requirements to those of selected nonprofit agencies in the New York area that provided financial assistance to local small businesses following the disaster. Generally, we found that SBA had loan requirements that were similar to these nonprofits, but the nonprofits' programs allowed some additional flexibility to address the particular needs of their small business constituents.

We also currently have work under way to identify and assess the factors that have affected the SBA's ability to respond to victims of Hurricane Katrina and the other 2005 Gulf Coast hurricanes in a timely manner.[35] As part of our work, we are evaluating how SBA's new Disaster Credit Management System, which has been in use since January 2005, affected SBA's response. As the primary federal lender to disaster victims, including individual homeowners, renters, and businesses, SBA's ability to process and disburse loans in a timely manner is critical to the recovery of the Gulf Coast region. As of February 25, 2006, SBA faced a backlog of about 103,300 applications in loan processing pending a final decision, and the average time these applications had been in process was about 94 days. During the month of March, SBA continued to process applications. By March 25, 2006, SBA had mailed out more than 1.6 million loan applications, received over 350,000 completed applications, processed more than 290,000 applications, and disbursed about $600 million in disaster loan funds. Although SBA's current goal is to process loan applications within 7 to 21 days, as of March 25, 2006, SBA faced a backlog of about 55,000 applications in loan processing pending a final decision and the average age of these loan applications was about 88 days. SBA also has more than 43,000 loan applications that have been approved but

[34]GAO, *Small Business Administration: SBA Followed Appropriate Policies and Procedures for September 11 Disaster Loan Applications*, GAO-04-885 (Washington, D.C.: Aug. 31, 2004). In addition to SBA disaster loans, Congress allowed SBA to collect reduced annual fees on 7(a) loans made by lenders to small businesses "adversely affected" by the terrorist attacks and their aftermath (see Pub. L. 107-117, § 203, 115 Stat. 2230, 2297-2298 (Jan. 10, 2002)). These loans were designated by SBA as "Supplemental Terrorist Activity Relief" or STAR, loans. When the STAR program expired on January 10, 2003, approximately $3.7 billion in STAR loans had been approved. In a review of the STAR loan program, SBA's Office of Inspector General found that most lender files did not contain sufficient information to demonstrate that borrowers were adversely affected by the attacks and their aftermath, and that SBA did not establish specific requirements to review or verify lenders' STAR justifications. See SBA, Office of Inspector General, *Audit of SBA's Administration of the Supplemental Terrorist Activity Relief (STAR) Loan Program*, Rept. No. 6-09 (Washington, D.C.: Dec. 23, 2005). We did not review the STAR program.

[35] Hurricane Katrina struck the Gulf Coast on August 29; Hurricanes Rita and Wilma struck the U.S. Mainland on September 24 and October 24, respectively.

have not been closed or fully disbursed. As a result, disaster victims in the Gulf Region have not received timely assistance in recovering from this disaster and rebuilding their lives.

Based on our preliminary analysis of SBA's disaster loan origination process, we have identified several factors that have affected SBA's ability to provide a timely response to Gulf Coast disaster victims. First, the volume of loan applications SBA mailed out and received has far exceeded any previous disaster. Compared with the Florida hurricanes of 2004 or the 1994 Northridge earthquake, the hurricanes that hit the Gulf Coast in 2005 resulted in the issuance of roughly two to three times as many loan applications. Second, although SBA's new disaster-loan processing system provides opportunities to streamline the loan origination process, initially it experienced numerous outages and slow response times in accessing information. However, we have not yet determined the duration and impact of these outages on processing. SBA officials have attributed many of these problems to a combination of hardware-and telecommunications-capacity limitations as well as the level of service SBA has received from its contractors. Third, SBA's planning efforts to address a disaster of this magnitude appear to have been inadequate. Although SBA's disaster planning efforts focused primarily on responding to a disaster the size of the Northridge earthquake, SBA officials said that it initially lacked the critical resources such as office space, staff, phones, computers, and other resources to process loans for this disaster. SBA has participated in disaster simulations on a limited basis only and it is unclear whether previous disaster simulations of category 4 hurricanes hitting the New Orleans area were considered.

We are also assessing other factors that have affected SBA's ability to provide timely loans to disaster victims in the Gulf region including: workforce transformation, the exercise of its regulatory authority to streamline program requirements and delivery to meet the needs of disaster victims, coordination with state and local government agencies, SBA's efforts to publicize the benefits offered by the disaster loan program, and the limits that exist on the use of disaster loan funds.

Mr. Chairman, this concludes my prepared statement. I would be happy to answer any questions at this time.

Contacts and Acknowledgments

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Testimony Submitted

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The Effectiveness of the Small Business Administration

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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.[1] 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.

My testimony is devoted to a basic question: are these SBA loan guarantees desirable? Should the SBA remain in the banking, credit allocation, and subsidy business or should these activities be terminated? I ask whether there is in fact a market failure that justifies government intervention via the SBA. If there is a market failure, are the SBA programs well designed to address the problem? Or if there is no market failure, does the SBA help achieve policy goals important enough to justify its meddling in a well-functioning market?

This work concludes that there seems to be 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.

This testimony also demonstrates that even if credit were a serious problem for small firms, SBA loans wouldn't make a statistically significant difference. Judging based on the SBA's ability to meet announced public policy goals—namely filling the gap between the demand and supply of small business loans, particularly for minority and woman owned small firms—this work finds no evidence that the SBA loan guarantees serve any focused or rigorous defined public policy purpose at all.

Section 2: Are the SBA's Loan Guarantee Programs Justified Economically?

The SBA's 7(a) loan guarantee program rests on the dubious premise that small businesses are denied adequate credit in the free market because of a market failure.

The most frequently cited obstacle to new business formation is the inability of would-be entrepreneurs to acquire the capital necessary to start a business. 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?

2.1: The Market Failure Theory

In their seminal paper "Credit Rationing in Markets with Imperfect Information," Stiglitz and Weiss (1981) explain that the asymmetry of information between lenders and borrowers—potential borrowers know their own financial situation and likelihood of repayment far better than lenders—makes credit rationing the natural equilibrium result in financial markets.[2] That is, worthy projects will be denied loans.

Advocates of SBA loan guarantees argue that to the extent that small firms are credit rationed, government intervention may be justified.

2.2. The Not-So-Rationed Credit Market

However, in recent years, a growing body of research has challenged the widely-held belief that credit rationing makes it difficult for small businesses to obtain capital. A series of papers by de Meza and Webb questions the theoretical underpinnings of the Stiglitz-Weiss model.[3] The firm conclusion of their work is that government intervention is not necessary and may actually be detrimental to entrepreneurship.

In addition to these theoretical arguments, it is also interesting to observe that the National Federation of Independent Business (NFIB), the largest small business advocacy group, does not lobby Congress to promote the SBA loan guarantee programs. In fact, facilitating access to capital markets is nowhere in their 22-page agenda.[4] This is consistent with the fact that historically, support for the SBA came from members of Congress rather than small business owners.[5] More importantly, an increasing number of empirical studies show that small businesses do not face significant credit constraints and that the private market seems to be operating efficiently.[6]

For instance, the Federal Reserve Board's Report to Congress on the Availability of Credit to Small Businesses (2002) explains that the demand for small business financing closely tracked the pattern of debt growth from 1997 to 2002, which suggests a 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).

A more refined version of the capital access argument is that only women- and minority-owned businesses have difficulties accessing credit and thus only they are the ones who require preferential treatment. Controlling for many other factors, the economics literature finds that minority-owned small businesses are indeed more likely to be denied credit than white-owned small businesses but women, on the other hand, do not face significantly higher loan denial probabilities.[8] Given this evidence, there might be a case to be made for correcting financial market inefficiencies for minority-owned, but not women-owned, small firms through government-sponsored business loans or other preferential treatments.

Yet, more recent findings suggest that this conclusion might not be as simple as it seems. An SBA-sponsored study by Mitchell and Pearce (2005) underlines that discrimination may be confined to only some segments of the loan market. [9] Furthermore, difficulty accessing bank loans does not imply no access to loans at all. Mitchell and Pearce find that while minority firm owners are less likely to have bank loans of any kind, they have easy access to transaction loans from non-banks.

Indeed, it is important to realize that traditional bank loans represent only one of many ways to acquire credit. The Federal Reserve's 1998 Survey of Small Business Finance, which had a nationally representative sample of approximately 3,500 firms with fewer than 500 employees, illustrates this point, as shown in Table 2.

The table shows the percentage of all small firms, and small minority- and women-owned firms specifically, that used credit, and what type of credit they used.

More than 80 percent of small businesses surveyed used some kind of credit. Over half used traditional sources of credit. Approximately 71 percent used non-traditional sources of financing, of which personal credit cards were the most prevalent. About 38 percent of small businesses had debt outstanding with commercial banks, which account for 57 percent of the total outstanding debt for all small firms.[10]

The survey also showed that small minority- and women-owned businesses differed from small businesses in general. The results may suggest that women and minorities have difficulty accessing credit, but more information on owner characteristics is necessary before drawing that conclusion.

More information about small business financing comes from a 2005 U.S. Chamber of Commerce survey of 1,080 small business owners.[11] The findings suggest that some of the differences in the credit used by women and minorities may reflect differences in the types of businesses they start.

According to the Chamber of Commerce survey, by far the greatest source of initial and ongoing funding was personal savings—81 percent of respondents used savings for initial costs, 60 percent for ongoing costs. Only about 3 percent of respondents reported using SBA loans for start-up funds. Older, larger firms were more likely to use SBA loans, and women and minorities were not more likely to use the loans. The results for ongoing expenses were very similar.

In line with the evidence cited earlier, when the small business owners were asked about problems they faced, availability of credit was the next-to-last most important problem. Only 25 percent of those surveyed chose that answer.

When considering all the different types of credit available, it is hard to argue that small businesses, whether women-owned or minority-owned, have real difficulty accessing to credit.

More generally, there is no compelling reason in the literature or in the data to suggest that new businesses would not get created without the SBA.

2.3. Market Responses to Information Problems

According to some proponents of the credit rationing theory, government intervention is necessary to overcome the problem of not funding all worthy projects in the economy. However, it seems that a better solution to the alleged lack of information or high cost of information in financial markets would be a mechanism to reduce this cost, rather than one involving government becoming a supplier of capital. For one thing, why would the SBA be more capable of acquiring information than private lenders?

Interestingly, financial markets have been very effective at developing private solutions to information problems, especially in recent years. Banks have long relied on close relationships with clients to gain information, and more recently, innovations in information and communications technology, as well as improvements in credit evaluation methods, have also made it easier for lenders to gather information about potential borrowers.[12]

Lending relationships are one of the mechanisms that have emerged to address the information problem in capital markets, particularly for smaller banks. When evaluating long-time clients, banks will consider not only their immediate creditworthiness, but also the potential lost profits from damaging a good relationship.[13]

Lending relationships are also about gaining information. Repeated interactions with a client over time and for different purposes give the lender information about the client's creditworthiness, either specific financial information or "soft information" about his personal character. Greater information lowers the cost of lending and thus increases the availability of credit. For instance, after having a positive experience with a small business, the bank might expect future loans to be less risky and will therefore be more likely to lend again to the business. Or, a bank may be able to learn more about a client's financial situation if he already has a checking account at the bank. The information from this prior relationship will also lower the bank's cost of lending. In this way, lending relationships are a market method for resolving the information problems that lead to credit rationing.

A number of empirical studies have shown the importance of relationship lending.[14] Relationships increase the availability of credit to small firms, and may cause a small decrease in the price of credit.

Another way to help overcome the information asymmetry in lending is credit scoring, which is more often used by larger banks.[15] Credit scoring involves taking information from a credit applicant and using statistical methods to generate a numeric score that predicts his/her propensity to default or become delinquent. Credit scoring makes credit evaluation quicker, cheaper, more objective, and more consistent. It greatly reduces the cost of information-gathering, and by improving a bank's ability to predict default, it can significantly improve the efficiency of lending. It was first used in small business lending in the early to mid-1990s.

In theory, credit scoring could increase small business lending as it lowers the cost of evaluation, lowers borrowing costs, and enables long-distance borrowing, which creates greater competition. It also provides a way to evaluate new firms, which are difficult to assess by traditional methods because they don't have a history, and small businesses in particular, which often do not have certified audited financial statements or publicly-traded equity or debt.

Credit scoring could also increase the availability of loans for small businesses by drawing large banks into the market. Small-business lending has traditionally been the domain of smaller banks, which are better able to build the personal relationships with small business owners that overcome informational difficulties, but the informational advantages of credit scoring may encourage large banks to become more involved in small business lending.

The evidence bears out the theory and suggests that credit scoring has in fact increased the availability of credit to small firms.[16] According to one study, the total effect of credit scoring technology in 1997 was an increase of $2.2 billion in small business lending.[17] In particular, credit scoring increases credit availability for relatively risky borrowers.[18]

Both lending relationships and credit scoring have developed without government intervention. They are just two examples of how financial markets have found their own ways to overcome the information problems faced by lenders when dealing with small businesses.

Section 3. Is the SBA Doing What It Says It Does?

But even if we assume, for the sake of argument, that there is a significant market failure that prevents small businesses from receiving adequate credit, the SBA's loan programs are not an effective way to combat the problem.

To measure the SBA's results, I will concentrate our attention on the SBA's flagship loan guarantee program, the 7(a) program. I will analyze the flow of SBA credits to evaluate who receives them and whether the SBA is meeting its stated policy objectives to promote new startups, encourage female and minority business owners, and 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. Furthermore, the program may do more harm than good as it creates an unlevel playing field and it may impose costs on taxpayers with little return.

3.1. Background

There are about 25 million small businesses in the United States. 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. Graph 1 shows that the number of 7(a) loans guaranteed by the SBA went from less than 20,000 in 1990 to over 95,000 in 2005.

The SBA does not make direct loans to small businesses; rather, the 7(a) program provides security for commercial lenders by providing them with a guarantee for a percentage of a small business loan, typically ranging from 75 to 85 percent. The program specifies loan guarantee amounts, total loan size, allowable interest rates to be charged for the loan, and relevant fees, but the funds for the loan come directly from the participating lenders.

3.2. SBA Lending Profile

Analyzing the flow of SBA credit will help 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 can be drawn from the data. One, no more than 1 percent of small businesses receive 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.

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. 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.

3.2.1. The SBA vs. the Market as a Whole

How many firms is the SBA helping relative to the entire market? If there were a true need for government intervention, we would expect to see the SBA guaranteeing a large share of the total number of loans to small businesses. Yet, SBA loans are only a tiny fraction of all small business lending. The SBA estimates that in FY2004 there were approximately 24.7 million small businesses. According to the SBA's FY2004 Performance and Accountability Report, 1.6 million start-up and existing small businesses received financial, technical, and/or procurement assistance from the SBA in 2004. Of that total, 102,000 received financial assistance, which includes the 7(a) Loan Program, the 504 Loan Program, the Microloan Program, and other programs. That same year, banks made 15.26 million small business loans (defined as loans of less than $1 million; there were 14.45 million loans under $250,000 and 13.58 million loans under $100,000). It means that SBA loans represent less than 1 percent of all small business loans issued that year.[19]

Most SBA loans are 7(a) loans. In FY2004, SBA guaranteed 81,133 7(a) loans. According to a survey by the U.S. Chamber of Commerce, even in some of the industry sectors most likely to receive 7(a) loans, no more than 3 percent of start-up small businesses received

SBA loans.[20] This means that 97 percent of the survey respondents managed to start their businesses without any financial help from the SBA.

SBA-guaranteed 7(a) loans are also a small fraction of the total amount of small business lending. The value of SBA-guaranteed 7(a) loans in FY 2004 was $12.7 billion. That number is dwarfed by the $522.3 billion in total small business loans (defined as loans of less than $1 million; loans under $250,000 totaled $228.4 billion, and loans under $100,000 totaled $125.3 billion).[21]

These numbers show that the private banking system finances most loans and that the SBA is therefore largely irrelevant in the capital market. Moreover, the data suggests that rather than serving the public good, SBA programs inflict unfair competition on the 99 percent of small businesses who have to finance their business activities through commercial loans.

This economic harm could arguably be justified if the relatively few firms aided by SBA-guaranteed credit each year made a much greater contribution to economic growth, or if the guaranteed loans otherwise produced benefits to outweigh their costs. As the subsequent analysis will show, however, this is not the case. It therefore seems that the SBA ends up harming the vast majority of small businesses.

3.2.2. Where Do SBA Loans Flow?[22]

Table 3 shows the number and amount of 7(a) loans by industry in FY2002.[23] The overwhelming bulk of SBA of 7(a) loans—75 percent—flows to a small fraction of firms in the service, retail, and wholesale sectors. Overall, only 1 in 500 small businesses received a 7(a) loan guarantee in FY2002.

Taking a closer look at the data is useful. Table 4 uses more refined industry classifications to show the 25 business sectors that received the most SBA loans. Several characteristics stand out:

First, every sector was mainly comprised of small business firms, ranging from about 40,000 in the case of beer, wine, and liquor stores (96 percent of all establishments in that sector) to over 860,000 in the category "services to buildings and dwellings" (over 99 percent of all establishments in that sector).

Furthermore, in most of these sectors, the relatively few larger firms did not pose a serious threat to competition. In 17 of the 25 business sectors receiving the most 7(a) loan guarantees, the 8-firm market concentration ratio was 20 percent or less. Conversely, the business sectors that were most concentrated received less than a third of the loans that the least concentrated sectors received (Table 5). Clearly, the bulk of subsidized SBA loan guarantees are not being used to help small business compete against big business.

Instead, the SBA is helping a minuscule fraction of small businesses in each sector compete against other small businesses in the same market. In the top 25 sectors, less than 0.5 percent of the small businesses received 7(a) loan guarantees (Table 4). 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.

These top 25 sectors do not seem to warrant special attention from the SBA. They do not exhibit any of the classic symptoms of market imperfections; instead, they are characterized by numerous firms, strong innovation, and robust competition. Nor do they play a particularly important role in the economy. A relatively small number of new or bigger gas stations, liquor stores, or dentist offices will have little effect on national prosperity.

Table 6 breaks down 7(a) loan guarantees by specific business categories. The category that received the largest share of 7(a)-guaranteed loans in 2002 was bars, restaurants, and liquor stores. This sector received 4,185 loans, some $1 billion or 8.4 percent of all 7(a) guaranteed loans. But the recipients of these loans were only 1.3 percent of all small businesses in this category. Over 300,000 other small firms were competing to serve the same market.

This trend is not unique. While there were over 73,000 bars, only 351 received SBA 7(a) loan guarantees in 2002. It means that a disproportionate share—99.5 percent—of all bars did not need and did not receive SBA loans. Because they had to compete with 351 bars that have received help from the government, they were at a competitive disadvantage.

For another example, 5.7 percent of SBA 7(a) loans went to a variety of professional offices, including doctors, dentists, and accountants, but of all offices, only a tiny fraction—0.2 percent—received loans, meaning that 99.8 percent of offices functioned without government help. Similarly, out of more than 25,000 laundromats, only 317 received SBA 7(a) loan guarantees in 2002.

In a sampling of other service industries, the SBA served just 0.1 percent of all small businesses. Less than 1 percent each of florists, clothing stores, shoe stores, sporting goods stores, book stores and newsstands, and music stores received SBA 7(a) loan guarantees in 2002. Of the more than 100,000 used car dealers classified as small businesses, only 205 received SBA loans.

It is difficult to make the case that valuable policy objectives are being served by extending subsidized credit to such a tiny fraction of small businesses when millions of small businesses make it without subsidized credit. They compete in an open, dynamic marketplace that satisfies the needs and wants of consumers across all business sectors, from dentists to dry cleaning. As David Stockman, former director of the Office of Management and Budget explained in 1985, "In this context, SBA's few thousand loans make only one consistent difference: millions of taxpaying small businesses face unneeded and uneconomic competition from bureaucratic clients who can't compete profitably, or at all, on a level playing field."[24]

The limited number of loan recipients would be more defensible if the SBA's assistance brought greater dynamism to the market. Table 7 shows, however, that 7(a) loan guarantees have little effect on business turnover. For instance, between 1998 and 2002, over 900,000 new small businesses appeared in the 25 business sectors that received the most SBA 7(a) loans. This number is over half as large as the number of small businesses in 1998. The gross turnover rate, which combines business starts with closures, is an incredible 98 percent. The high turnover indicates vigorous competition and a robust rate of small business entry in those 25 industries.

The role of the SBA in this process was minimal. Compared to the more than 1.8 million small businesses in these sectors in 1998, the 27,000 that received 7(a) loan guarantees in 2002 are insignificant. The dynamic entry and exit of nearly 1.7 million small businesses was driven primarily by free market forces.

Despite the SBA's emphasis on start-ups, its efforts are largely irrelevant in promoting competition. For example, nearly 60,000 new car repair and maintenance shops opened between 1998 and 2002, which equals 41 percent of the number in 1998. The SBA guarantees approximately 2,500 loans per year in this business sector. Even if all of those loans went to start-ups, it clearly affects only a small fraction of new businesses. Even in the restaurant market, the SBA's largest lending category, the number of loan guarantees is far smaller than the number of start-ups.

Another possible defense of the small number of 7(a) loan recipients is that the loans focus on new firms on the cutting edge of technology, firms venturing into fields so new that banks have trouble evaluating their potential. But Table 8 counters this proposition. Each of the 12 high-tech industry sectors is characterized by strong small business job growth from 1998 to 2002, rising by nearly 29 percent—compared to about 9 percent small business job growth in the overall U.S. economy. And for the most part, they achieved this spectacular growth without the help of the SBA: each year, only about 3,300, or 1.1 percent, of these high-tech businesses received 7(a) loan guarantees.

For example, the telecommunications industry created over 65,000 new small business jobs from 1998 to 2002, a growth rate of nearly 60 percent, yet fewer than 2 percent of telecommunications establishments received 7(a) loan guarantees each year. Almost 160,000 new small business jobs were created in the computer systems design and related services sector, a 32 percent increase from 1998. Only about 1.2 percent of small businesses in this sector received 7(a) loan guarantees each year. As was the case for the wholesale, retail, and service industries described earlier, the high-tech sector has no trouble meeting the vast majority of its funding needs with private financing.

Of course one should not be surprised that bureaucratic lending is not needed to foster new business formation. The attractions of profit making and independent entrepreneurship are far more powerful and determinative. In fact, the marketplace miracles of small business and high-tech growth have almost nothing to do with the bureaucratic myths about the value of SBA lending.

3.2.3. Is the SBA Catering to Women and Minorities?

According to the SBA, women and minorities face special competitive challenges, so its programs devote particular attention to them. Women and minorities receive a significant share of 7(a) loan guarantees. Table 9 shows that the percentage of 7(a) loan guarantees going to minority business owners has increased steadily from less than 13 percent in 1990 to almost 29 percent in 2004. This figure is especially striking given that, in the most recent statistics, minority-owned businesses accounted for just 18 percent of all firms.[25] But when the Chamber of Commerce reports that among all minority small business owners, 3.2 percent used SBA loans for start-up and slightly less than 3 percent used SBA loans for ongoing expenses, it is hard to argue that the SBA makes a big difference for minorities.

The share of 7(a) loan guarantees going to women increased from 13 percent in 1990 to a plateau of about 21 percent in recent years. Unlike minorities, however, this share is less than the 28 percent of all businesses owned by women. But here too, of all women-owned small business owners, only about 3 percent used SBA loans—the same rate as for men. Hence, it can be argued that SBA makes almost no difference for women either.

It should be noted that according to the Chamber of Commerce survey mentioned earlier, only a tiny fraction of women and minority business owners use SBA loans and, except for Hispanics, they use SBA loans at about the same rate as men and white business owners.

3.2.4. How Do We Know?

All of the evidence presented above points in one direction: the SBA's 7(a) loan guarantee program is not having 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.

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, thus costing taxpayers money, 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.

3.3. 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.

3.3.1. 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.[26] 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.[27] 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.[28] 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.[29] 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.[30] 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.[31] 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, will the SBA 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.[32] 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.[33] 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.[34]

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.[35] 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.[36]

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."[37] 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.[38] 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.[39] 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."[40] 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.

3.3.2 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.

3.3.3. Lenders Are the Ones Really Benefiting from the SBA Loan Programs

Since the SBA's assistance serves only a tiny fraction of the nation's small businesses and likely has a high cost for taxpayers, one must ask who is really benefiting from the loan programs. One major beneficiary is SBA lenders. The SBA does not provide loans directly; rather, borrowers have to apply to an SBA-certified bank.

On average, the government guarantees 80 percent of each loan made in the 7(a) program. Because of this high guarantee rate, banks bear only a small fraction of the responsibility for any losses from defaults. They therefore have a strong incentive to issue more SBA loans.

The first way banks benefit from SBA programs is that by participating in the SBA's guarantee programs, a bank is able to increase its lending at the same profitability as the rest of its business.

The second is that when there is a default the bank doesn't have to pay most of it. It means that even though SBA borrowers are more risky than others, the downside risk to the bank is only 25 percent of what it would be otherwise. In other words, even though business owners applying for SBA loans are intrinsically more risky than others, the loan guarantee makes the risk for SBA lenders lower for SBA loans than for traditional loans.

In addition, through the SBA's Secondary Market Program, lenders have other ways to reduce their risk even further and also to increase their lending capability. This program allows lenders to sell the guaranteed portion of SBA-guaranteed loans to investors. By doing so, lenders can improve their liquidity and free up more capital for new loans. Lenders who sell loans must pay a small program fee to the SBA. If the loan is sold for more than 110 percent of the outstanding principal balance, half of the excess is paid to SBA.

This process of selling loans on the secondary market is known as securitization. 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.[41]

To encourage a secondary market, Congress passed a law in 1994 that reduced regulatory barriers for the securitization of small business loans. Small business loans are typically not good candidates for securitization because their terms vary so much, their underwriting tends not to be standardized, and their riskiness requires such a high degree of credit enhancement that securitization becomes unprofitable. SBA-guaranteed loans do not have these problems, however, 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.[42]

In the end, this program creates adverse consequences and increases the risk to taxpayers.

3.3.4. The Federal Government Should Stop its Involvement in the Loan Guarantee Business

Even if the SBA were capable a running a program at no cost for taxpayers, government loans are not the way to help small firms. Targeted policies have often proven to be bad policy. For instance, economists have shown that targeted policies that favor small firms over large ones will make it more profitable to stay small rather than grow.[43] This perverse incentive will lead to a misallocation of resources away from the most productive uses and will interfere with the natural growth and evolution of firms.

The federal government should end its involvement in the loan and loan guarantee business. As described in Section 2, the evidence supports the idea that the private banking industry is vibrant and has been meeting the demand for credit in a very effective way. Also, even if there were a gap to fill because of imperfections in the lending market, we know that the SBA probably wouldn't make much of a difference. We know for instance that most years the 7(a) program represents less than 1 percent of all loans to small businesses, and about 1 percent of all small business receive 7(a) loan guarantees. And the SBIC Participating Securities program represents only about 3 percent of activity in the venture capital industry over the period 1994 to 2004.[44]

Of course, none of these reasons is intended to minimize the benefits that flow from fostering an economic environment that supports the creation and growth of small businesses. In fact, it is precisely because a vibrant business sector is important that government subsidies and other preferential policies should be abolished. Market economies generate faster growth because resources are allocated on the basis of profit-maximization rather than political considerations. In the absence of government intervention, resources are quickly shifted from inefficient uses to more productive uses.

Special programs designed to help small businesses are likely to hinder this process and will distract entrepreneurs and investors from focusing on serving the needs of consumers. Instead of preferential policies, the government can best help small business – and other segments of the economy – by creating an environment conducive to productive behavior. Policymakers should establish a tax and policy environment that encourages small, mid-size firms with strong growth potential to evolve into successful large enterprises. In general, they should establish an environment where firms of all size can thrive. This means low tax rates, low levels of regulation, and a stable legal structure that protects property rights.

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.

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 programs should be terminated.

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[42] Ibid., p. 60.
[43] Douglas Holtz-Eakin (1995), "Should Small Businesses be Tax Favored?," *National Tax Journal* 48(3): 390.
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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[1]

	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

[1]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 Credit 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.

Table 3: SBA 7(a) Loan Program: FY2002 Lending by Industry (2-Digit NAICS Codes)

Industry		SBA Lending				Industry Characteristics	
NAICS Code	Description	# of Loans	Share of SBA Total[1]	Loan Amount ($1,000)	Share of SBA Total[2]	# of Small Business Establishments[3]	SBA Loan Ratio[4]
11	Agriculture, Forestry, Fishing, and Hunting	581	1.1%	$222,291	1.8%	246,102	0.2%
21	Mining	99	0.2%	30,870	0.3%	102,644	0.1%
22	Utilities	41	0.1%	8,139	0.1%	21,519	0.2%
23	Construction	3,512	6.8%	672,656	5.5%	2,774,684	0.1%
31-33	Manufacturing	4,957	9.6%	1,501,743	12.3%	598,445	0.8%
42	Wholesale Trade	3,036	5.9%	837,903	6.9%	746,209	0.4%
44-45	Retail Trade	10,217	19.8%	2,341,171	19.2%	2,669,307	0.4%
48-49	Transportation and Warehousing	1,472	2.8%	240,452	2.0%	977,373	0.2%
51	Information	731	1.4%	150,971	1.2%	316,444	0.2%
52	Finance and Insurance	579	1.1%	97,491	0.8%	949,270	0.1%
53	Real Estate and Rental and Leasing	757	1.5%	199,170	1.6%	2,159,941	0.0%
54	Professional, Scientific, and Technical Services	4,202	8.1%	662,140	5.4%	3,284,654	0.1%
55	Management of Companies and Enterprises	14	0.0%	6,810	0.1%	22,974	0.1%
56	Administrative and Support and Waste Management and Remediation Services	2,457	4.8%	345,622	2.8%	1,560,899	0.2%
61	Educational Services	487	0.9%	90,729	0.7%	413,853	0.1%
62	Health Care and Social Assistance	4,156	8.0%	1,010,585	8.3%	2,091,068	0.2%
71	Arts, Entertainment, and Recreation	1,072	2.1%	312,715	2.6%	971,336	0.1%
72	Accomodation and Food Services	7,487	14.5%	2,205,679	18.1%	709,723	1.1%
81	Other Services (except Public Administration)	5,809	11.2%	1,270,891	10.4%	3,163,065	0.2%
	Total for Services, Retail, and Wholesale Sectors	38,923	75.3%	9,077,434	74.4%	15,610,114	0.2%
	Total	**51,666**	**100.0%**	**12,208,027**	**100.0%**	**23,818,871**	**0.2%**

[1]Share of total 2002 SBA 7(a) loan approvals.

[2]Share of total 2002 SBA 7(a) loan guarantees.

[3]A small business is defined as an establishment with fewer than 500 employees, including establishments with no paid employees. This is the definition used by the SBA for research purposes; for determining loan eligibility, the SBA uses different definitions for different industries. See http://app1.sba.gov/faqs/faqindex.cfm?areaID=24 and http://www.sba.gov/size/index.html.

[4]SBA loans divided by total number of small business establishments in the industry.

Sources: SBA lending data from Small Business Administration; industry characteristics from 2002 Statistics of U.S. Businesses and 2002 Economic Census.

Table 4: SBA 7(a) Loan Program: FY2002 Lending by Top 25 Industries (4-Digit NAICS Codes)

Industry		SBA Lending				Industry Characteristics		
NAICS Code	Description	# of Loans	Share of SBA Total[1]	Loan Amount ($1,000)	Share of SBA Total[2]	# of Small Business Establishments[3]	SBA Loan Ratio[4]	Market Concentra-tion (Top 8 Share, by Sales)
7221	Full-Service Restaurants	3,240	6.3%	$770,370	6.3%	210,837	1.5%	11.0%
7222	Limited-Service Eating Places	2,563	5.0%	491,930	4.0%	215,964	1.2%	12.8%
8111	Automotive Repair and Maintenance	2,482	4.8%	686,515	5.6%	429,573	0.6%	2.8%
6213	Offices of Other Health Practitioners	1,355	2.6%	184,748	1.5%	385,541	0.4%	4.5%
8121	Personal Care Services	1,267	2.5%	134,103	1.1%	757,064	0.2%	12.8%
4471	Gasoline Stations	1,208	2.3%	676,454	5.5%	93,233	1.3%	15.3%
5617	Services to Buildings and Dwellings	1,060	2.1%	133,046	1.1%	869,558	0.1%	10.8%
4451	Grocery Stores	1,018	2.0%	282,416	2.3%	114,539	0.9%	43.4%
7211	Traveler Accommodation	987	1.9%	765,969	6.3%	77,741	1.3%	27.8%
2359	Other special trade contractors	929	1.8%	188,049	1.5%	n/a	n/a	n/a
8123	Drycleaning and Laundry Services	900	1.7%	238,570	2.0%	76,578	1.2%	25.9%
7139	Other Amusement and Recreation Industries	834	1.6%	253,038	2.1%	173,074	0.5%	12.9%
6212	Offices of Dentists	821	1.6%	247,771	2.0%	149,874	0.5%	2.1%
6211	Offices of Physicians	769	1.5%	193,160	1.6%	365,264	0.2%	4.3%
5419	Other Professional, Scientific, and Technical Services	748	1.4%	195,601	1.6%	835,976	0.1%	10.7%
5415	Computer Systems Design and Related Services	703	1.4%	93,685	0.8%	373,771	0.2%	21.7%
4539	Other Miscellaneous Store Retailers	700	1.4%	95,321	0.8%	195,517	0.4%	17.1%
5413	Architectural, Engineering, and Related Services	667	1.3%	111,706	0.9%	310,853	0.2%	11.8%
4452	Specialty Food Stores	645	1.2%	104,084	0.9%	61,444	1.0%	9.2%
6244	Child Day Care Services	642	1.2%	209,567	1.7%	682,303	0.1%	21.4%
4481	Clothing Stores	621	1.2%	69,041	0.6%	109,069	0.6%	38.7%
4841	General Freight Trucking	614	1.2%	87,502	0.7%	410,351	0.1%	18.5%
5416	Management, Scientific, and Technical Consulting Services	610	1.2%	56,617	0.5%	577,383	0.1%	15.1%
4511	Sporting Goods, Hobby, and Musical Instrument Stores	608	1.2%	82,492	0.7%	98,912	0.6%	32.9%
4453	Beer, Wine, and Liquor Stores	594	1.1%	167,607	1.4%	37,869	1.6%	10.0%
	Total for Top 25 Industries	26,585	51.5%	6,519,361	53.4%	7,612,288	0.3%	
	Total for All Industries	51,666		12,208,027		23,818,871	0.2%	

[1]Share of total 2002 SBA 7(a) loan approvals.

[2]Share of total 2002 SBA 7(a) loan guarantees.

[3]A small business is defined as an establishment with fewer than 500 employees, including establishments with no paid employees. This is the definition used by the SBA for research purposes; for determining loan eligibility, the SBA uses different definitions for different industries. See http://app1.sba.gov/faqs/faqindex.cfm?areaID=24 and http://www.sba.gov/size/index.html.

[4]SBA loans divided by total number of small business establishments in the industry.

Sources: SBA lending data from the Small Business Administration; industry characteristics from 2002 Statistics of U.S. Businesses and 2002 Economic Census.

Table 5: SBA 7(a) Loan Program: FY2002 Lending to Most and Least Concentrated Service, Wholesale, and Retail Industry Sectors

NAICS Code	Description	Loan Amount ($1,000)	Share of SBA Total*	Market Concentration (Top 8 Share, by Sales)
15 Most Concentrated Industry Sectors				
4521	Department Stores	$1,300	0.0%	88.8%
4529	Other General Merchandise Stores	32,709	0.4%	87.9%
7131	Amusement Parks and Arcades	12,476	0.1%	74.3%
4231	Motor Vehicle, Motor Vehicle Parts, and Supplies Wholesale	55,326	0.6%	67.4%
4512	Book, Periodical, and Music Stores	11,127	0.1%	61.2%
5621	Waste Collection	16,195	0.2%	60.8%
7223	Special Food Services	54,634	0.6%	60.5%
4242	Drugs and Druggists' Sundries Wholesale	10,315	0.1%	57.6%
5622	Waste Treatment and Disposal	11,136	0.1%	53.5%
4461	Health and Personal Care Stores	76,620	0.8%	53.0%
4482	Shoe Stores	14,164	0.2%	52.4%
4431	Electronics and Appliance Stores	57,297	0.6%	51.4%
4532	Office Supplies, Stationery, and Gift Stores	46,280	0.5%	49.6%
4441	Building Material and Supplies Dealers	101,561	1.1%	45.3%
5612	Facilities Support Services	6,701	0.1%	43.9%
	Subtotal	$507,840	5.6%	
15 Least Concentrated Industry Sectors				
6212	Offices of Dentists	$247,771	2.7%	2.1%
4531	Florists	27,432	0.3%	2.4%
8111	Automotive Repair and Maintenance	686,515	7.6%	2.8%
7224	Drinking Places (Alcoholic Beverages)	85,166	0.9%	2.9%
5411	Legal Services	66,794	0.7%	3.2%
5611	Office Administrative Services	3,729	0.0%	3.6%
6213	Offices of Other Health Practitioners	184,748	2.0%	3.9%
6241	Individual and Family Services	16,269	0.2%	4.1%
6211	Offices of Physicians	193,160	2.1%	4.3%
5414	Specialized Design Services	32,694	0.4%	4.4%
8134	Civic and Social Organizations	100	0.0%	4.5%
8139	Business, Professional, Labor, Political, and Similar Organization:	1,483	0.0%	4.8%
4412	Other Motor Vehicle Dealers	44,955	0.5%	6.1%
7115	Independent Artists, Writers, and Performers	4,331	0.0%	6.2%
4411	Automobile Dealers	84,292	0.9%	7.2%
	Subtotal	$1,679,437	18.5%	
	Total for Services, Retail, and Wholesale Sectors	$9,077,434		

*Share of total 2002 SBA 7(a) loan approvals to service, wholesale, and retail industry sectors.

Sources: Lending data from Small Business Administration; concentration data from 2002 Economic Census.

Table 6: SBA 7(a) Loan Program: FY2002 Lending for Selected Industries (6-Digit NAICS Codes)

Business Sector	SBA Lending			Industry Characteristics	
	# of Loans	Loan Amount ($1,000)	Share of SBA Total[1]	# of Small Business Establish-ments[2]	SBA Loan Ratio[3]
Bars, Restaurants, Liquor Stores					
Full-Service Restaurants	3,240	$770,370	6.3%	210,837	1.5%
Bars	351	85,166	0.7%	73,217	0.5%
Beer, Wine, and Liquor Stores	594	167,607	1.4%	37,869	1.6%
Subtotal	*4,185*	*1,023,143*	*8.4%*	*321,923*	*1.3%*
Professional Services					
Physicians	769	193,160	1.6%	365,264	0.2%
Dentists	821	247,771	2.0%	149,874	0.5%
Other Health Services	1,355	184,748	1.5%	385,541	0.4%
Accountants	216	37,705	0.3%	92,233	0.2%
Real Estate Agents and Brokers	129	29,950	0.2%	642,853	0.0%
Subtotal	*3,290*	*693,334*	*5.7%*	*1,635,765*	*0.2%*
Personal Care Services					
Barber shops/beauty shops	1,003	99,410	0.8%	651,060	0.2%
Laundromats	317	76,713	0.6%	26,776	1.2%
Dry cleaners	554	154,049	1.3%	45,556	1.2%
Subtotal	*1,874*	*330,172*	*2.7%*	*723,392*	*0.3%*
Other Services					
Pet Care Services	147	29,438	0.2%	46,962	0.3%
Child Day Care Services	642	209,567	1.7%	682,303	0.1%
Exterminating and Pest Control Services	43	10,352	0.1%	18,028	0.2%
Landscaping Services	552	64,565	0.5%	282,306	0.2%
Subtotal	*1,384*	*313,922*	*2.6%*	*1,029,599*	*0.1%*
Discretionary Goods					
Florists	270	27,432	0.2%	48,417	0.6%
Clothing Stores	621	69,041	0.6%	109,069	0.6%
Shoe Stores	118	14,164	0.1%	12,878	0.9%
Sporting Goods Stores	336	48,787	0.4%	43,482	0.8%
Book Stores and Newsstands	94	9,120	0.1%	34,345	0.3%
Music Stores	34	2,007	0.0%	9,611	0.4%
Subtotal	*1,473*	*170,550*	*1.4%*	*257,802*	*0.6%*
Other Retail					
Movie Rental	79	9,525	0.1%	14,513	0.5%
Pharmacies and Drug Stores	167	33,972	0.3%	24,603	0.7%
Used Car Dealers	205	58,336	0.5%	109,310	0.2%
Furniture Stores	280	63,739	0.5%	40,159	0.7%
Hardware Stores	190	53,041	0.4%	18,228	1.0%
Subtotal	*921*	*218,613*	*1.8%*	*206,813*	*0.4%*
Total for All Industries	**51,666**	**12,208,027**		**23,818,871**	**0.2%**

[1]Share of total 2002 SBA 7(a) loan guarantees.
[2]A small business is defined as an establishment with fewer than 500 employees, including establishments with no paid employees. This is the definition used by the SBA for research purposes; for determining loan eligibility, the SBA uses different definitions for different industries. See http://app1.sba.gov/faqs/faqindex.cfm?areaID=24 and http://www.sba.gov/size/index.html.
[3]SBA loans divided by total number of small business establishments in the industry.

Sources: SBA lending data from the Small Business Administration; industry characteristics from 2002 Statistics of U.S. Businesses an

Table 7: SBA 7(a) Loan Program: Business Turnover in Top 25 Industries

Industry			1998-2002 New Starts		1998-2002 Gross Turnover[1]		2002 7(a) Loans	
NAICS Code	Description	Base # of Small Business Establish-ments (1998)[2]	Number	% of Base	Number	% of Base	Number	% of Base
7221	Full-Service Restaurants	148,916	80,590	54.1%	157,756	105.9%	3,240	2.2%
7222	Limited-Service Eating Places	147,329	76,766	52.1%	151,262	102.7%	2,563	1.7%
8111	Automotive Repair and Maintenance	144,302	58,660	40.7%	118,293	82.0%	2,482	1.7%
6213	Offices of Other Health Practitioners	79,258	36,731	46.3%	65,251	82.3%	1,355	1.7%
8121	Personal Care Services	79,385	39,700	50.0%	79,085	99.6%	1,267	1.6%
4471	Gasoline Stations	85,496	27,977	32.7%	63,116	73.8%	1,208	1.4%
5617	Services to Buildings and Dwellings	113,361	70,780	62.4%	139,074	122.7%	1,060	0.9%
4451	Grocery Stores	64,358	34,112	53.0%	66,836	103.9%	1,018	1.6%
7211	Traveler Accommodation	35,219	16,435	46.7%	31,555	89.6%	987	2.8%
2359	Other special trade contractors	55,649	36,588	65.7%	66,784	120.0%	929	1.7%
8123	Drycleaning and Laundry Services	38,997	13,979	35.8%	30,778	78.9%	900	2.3%
7139	Other Amusement and Recreation Industries	45,260	20,285	44.8%	39,382	87.0%	834	1.8%
6212	Offices of Dentists	108,796	22,015	20.2%	41,771	38.4%	821	0.8%
6211	Offices of Physicians	169,732	61,055	36.0%	114,811	67.6%	769	0.5%
5419	Other Professional, Scientific, and Technical Services	42,665	27,653	64.8%	45,248	106.1%	748	1.8%
5415	Computer Systems Design and Related Services	60,901	65,410	107.4%	119,360	196.0%	703	1.2%
4539	Other Miscellaneous Store Retailers	34,520	20,272	58.7%	39,204	113.6%	700	2.0%
5413	Architectural, Engineering, and Related Services	84,484	37,827	44.8%	72,007	85.2%	667	0.8%
4452	Specialty Food Stores	16,970	14,352	84.6%	25,078	147.8%	645	3.8%
6244	Child Day Care Services	52,958	26,783	50.6%	49,887	94.2%	642	1.2%
4481	Clothing Stores	44,838	19,352	43.2%	42,873	95.6%	621	1.4%
4841	General Freight Trucking	34,926	32,724	93.7%	59,855	171.4%	614	1.8%
5416	Management, Scientific, and Technical Consulting Services	65,754	62,646	95.3%	110,971	168.8%	610	0.9%
4511	Sporting Goods, Hobby, and Musical Instrument Stores	33,259	12,992	39.1%	28,705	86.3%	608	1.8%
4453	Beer, Wine, and Liquor Stores	24,201	9,341	38.6%	18,498	76.4%	594	2.5%
	Total for Top 25 Industries	**1,811,534**	**925,025**	**51.1%**	**1,777,440**	**98.1%**	**26,585**	**1.5%**

[1] Combined number of establishments that started or disappeared during 1998-2002 in each industry.

[2] Establishments with fewer than 500 employees, *not* including establishments with no paid employees.

Source: Small Business Administration.

Table 8: SBA 7(a) Loan Program: Growing, High-Tech Industries

Industry			1998-2002 Net New Jobs		2002 7(a) Loans	
NAICS Code	Description	Base # of Small Business Jobs (1998)[2]	Number	Percent Increase	Number	Ratio[3]
3254	Pharmaceutical and Medicine Manufacturing	44,883	11,992	26.7%	24	1.9%
3342	Communications Equipment Manufacturing	65,075	4,485	6.9%	30	1.7%
3391	Medical Equipment and Supplies Manufacturing	135,007	8,746	6.5%	107	1.0%
5112	Software Publishers	142,176	17,357	12.2%	20	0.2%
5133	Telecommunications	115,671	66,792	57.7%	158	1.9%
5141	Information services	66,580	66,312	99.6%	98	1.6%
5413	Architectural, Engineering, and Related Services	781,483	116,539	14.9%	667	0.8%
5415	Computer Systems Design and Related Services	502,814	159,837	31.8%	703	1.2%
5416	Management, Scientific, and Technical Consulting Services	412,716	168,511	40.8%	610	0.9%
5417	Scientific Research and Development Services	145,378	66,850	46.0%	47	0.5%
5419	Other Professional, Scientific, and Technical Services	336,300	98,929	29.4%	748	1.8%
6215	Medical and Diagnostic Laboratories	76,343	18,875	24.7%	77	1.3%
	Total	**2,824,426**	**805,225**	**28.5%**	**3,289**	**1.1%**

[1]Establishments with fewer than 500 employees, *not* including establishments with no paid employees.
[2]Jobs at establishments with fewer than 500 employees, *not* including establishments with no paid employees.
[3]2002 SBA 7(a) loans divided by total number of small business establishments in the industry in 1998.

Source: Small Business Administration.

Table 9: Women and Minorities in Business

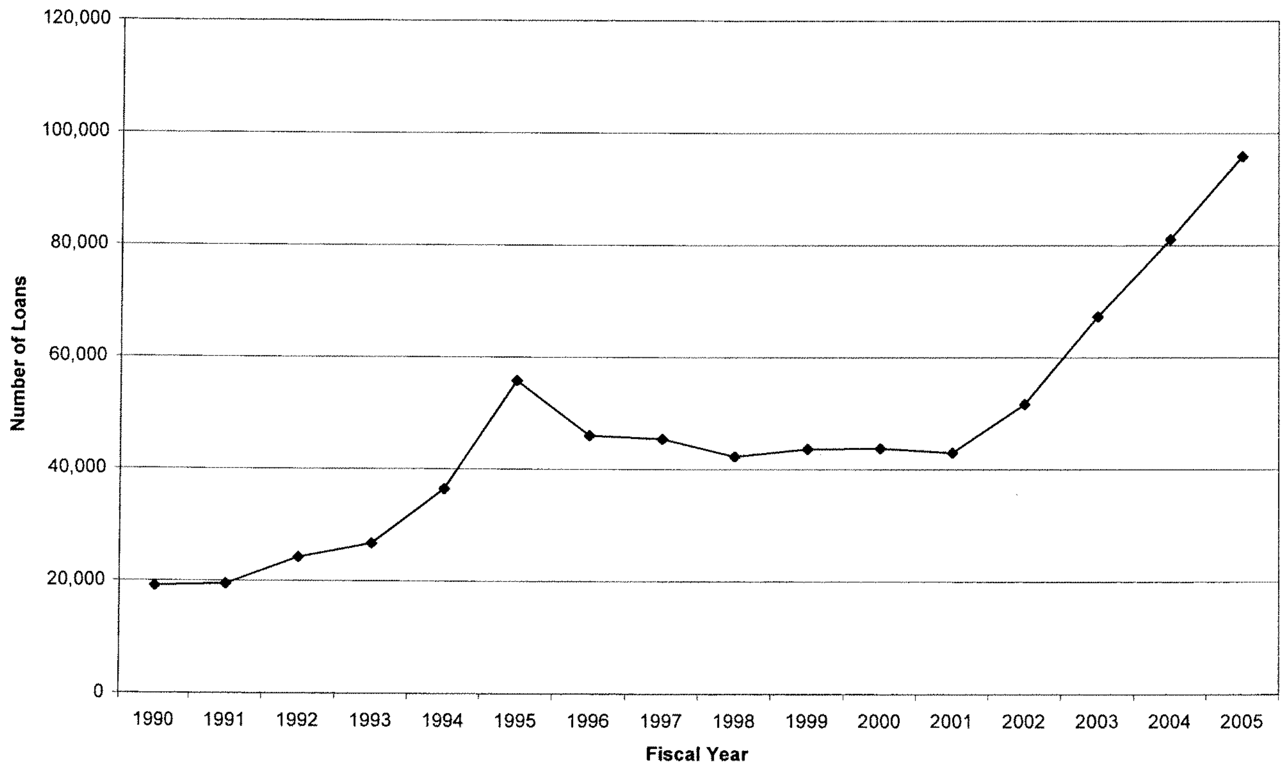
	U.S. Businesses: Number of Firms*					SBA 7(a) Loans Approvals				
FY	Women	Minorities	Total	% Women	% Minorities	Women	Minorities	Total	% Women	% Minorities
1990						2,530	2,450	19,129	13.2%	12.8%
1991						2,422	2,821	19,468	12.4%	14.5%
1992	6,407,000	2,149,484**	19,286,000	33.2%	11.1%	3,279	3,461	24,176	13.6%	14.3%
1993						3,799	4,067	26,690	14.2%	15.2%
1994						7,125	6,646	36,419	19.6%	18.2%
1995						13,396	10,308	55,786	24.0%	18.5%
1996						10,470	8,979	45,980	22.8%	19.5%
1997	5,417,034	3,133,655	20,821,934	26.0%	15.0%	10,077	9,538	45,378	22.2%	21.0%
1998						10,271	10,133	42,268	24.3%	24.0%
1999						9,470	11,134	43,636	21.7%	25.5%
2000						9,216	11,110	43,748	21.1%	25.4%
2001						9,011	10,745	42,958	21.0%	25.0%
2002	6,489,483	4,115,900	22,974,685	28.2%	17.9%	10,364	13,202	51,666	20.1%	25.6%
2003						14,332	18,702	67,306	21.3%	27.8%
2004						17,682	23,481	81,133	21.8%	28.9%
2005								95,900		

* Data from different years are not directly comparable due to changes in methodology.

** Unlike other data for U.S. businesses, "C" corporations are not included.

Sources: Firm data from the 1992 and 1997 Surveys of Minority- and Women-Owned Business Enterprises and the 2002 Survey of Business Owners; 2000-2004 women and minorities loan data from SBA's Performance and Accountability Report, Fiscal Year 2004; 1990-1999 women and minorities loan data from Minorities in Business 2001 and Women in Business 2001, Office of Advocacy, SBA; 1998-2005 total loans data from SBA's Performance and Accountability Reports, Fiscal Years 2005 and 2002; 1990-1997 total loans data from Minorities in Business 2001.

Graph 1: SBA 7(a) Loan Approvals



Sources: SBA's 2002 and 2005 Performance and Accountability Reports, and Minorities in Business 2001.

"Who Needs the SBA?

An Historical Perspective on The Small Business Administration"

[Adapted from Jonathan J. Bean, *Big Government and Affirmative Action: The Scandalous History of the Small Business Administration* (University Press of Kentucky, 2001)][1]

The Small Business Administration (SBA) has a scandalous history dating back to its founding in 1953. Massive SBA scandals embroiled both Republican and Democratic administrations. Ronald Reagan had "Wedtech," while Bill Clinton had "Whitewater"–an example of SBA fraud that led indirectly to presidential impeachment. Scandals have erupted in disaster lending, with minority "fronts," and in the misuse of venture capital funds. Honest business owners, such as John Pointer; and hard-working taxpayers pay the price for SBA corruption and for its general ineffectiveness as an advocate for small business.

What is to be done? Recognizing the agency's incompetence, nearly every president desired to abolish the SBA or merge it with the Commerce Department. For example, a Carter Transition Team noted the agency's "'cry-baby' and 'loser'" reputation. The SBA was a "hostage to Congress" and a "necessary nuisance" to the Executive Branch.[2] Yet, the agency lingers on with the strong backing of bankers and members of Congress. Politically-active business owners, meanwhile, have shown little interest in the SBA--once dubbed "the Great Unknown" by the National Federation of Independent Business (NFIB).[3] In short, if the SBA fell dead in the economic forest, few people not on its dole would hear it crash.

Overview

To be blunt: The SBA is in the discrimination business. It takes wealth from taxpayers and awards loans and contracts to small and minority business owners–groups never adequately defined, by the agency's own admission. By awarding loans and government contracts to a select group of firms, the agency gives them a competitive advantage over other companies. As critics noted in the 1960s, the practice of "setting aside" contracts for "small" firms constituted reverse discrimination against "large" companies. The SBA responded with arguments that sound familiar to students of affirmative action: Small firms deserved preference because they suffered "institutionalized discrimination" by banks and procurement agencies. SBA officials also argued that statistical disparity in the awarding of contracts was prima facie evidence of such discrimination.

Yet what is "small" business? Is it really a group with interests separate from "big" business? The latter question is of great importance, as we usually assume that our modern federal bureaucracy embodies the influence--past and present--of organized interest groups. The Small Business Administration challenges this assumption. Support for the agency came from members of Congress rather than small business owners, who were unorganized and considered economic conservatives opposed to the welfare state. The small business community falls into the category of a large group with conflicting internal interests. What did a "Mom-and-Pop" grocery have in common with a "small" manufacturer employing hundreds of people in a high-tech industry? At what point did a "small" business become a "big" business? The one thing that many small business owners had in common was a resentment of government interference. For a minority of business owners--those who joined national associations--this resentment overcame the "free rider" problem inherent in organizing a political lobby. The welfare state was anathema to these small companies, since it legitimized laws, regulations, and taxes that hit the business owner particularly hard. Here we confront a fundamental paradox: could a federal agency represent the interests of a group that rejected the underlying premise of our welfare state?

By establishing the SBA, Congress declared that a federal agency could represent small business. But the devil is in the definitional details. The public definition of small business encompassed "Mom-and-Pop" firms with fewer than ten employees, yet SBA size standards included companies with hundreds or even thousands of employees because they were "small" within their industry.[4] Congressional pressure to raise size standards allowed larger companies to benefit from agency resources.[5] Furthermore, the inherent economies of scale in some programs, including procurement and venture-capital investment, forced the agency to lift size standards even higher. Critics charged that the SBA was biased toward these "not-so-smalls." This theme of the smalls versus the "not-so-smalls" runs throughout the agency's history.

During the past half-century, the SBA has experienced remarkable growth. Established as a tiny lending agency in 1953, the SBA mushroomed into a financial institution with a significant presence in credit markets. New programs were later established to provide venture capital to growth-oriented companies, assist minority entrepreneurs, and lend management assistance to firms struggling to survive. By the 1990s, the SBA had become a conglomerate agency pursuing multiple policy objectives.

The agency's political support derives from a contested ideology. Classical liberals held to the original Jeffersonian conception of small business as the embodiment of self-reliance; a thriving small business sector was a bulwark against an overreaching state. Thus, government assistance to "free enterprise" was a contradiction in terms. They also disputed the concept of an arbitrary line separating "small" and "big" business. Preferences for one class of business owner, they argued, placed others at a disadvantage.

How, then, did congressional supporters of the SBA reconcile government assistance with the supposed independence of small business, the very basis for its popular appeal? Earlier generations argued that small firms were victims of "institutionalized discrimination" in the marketplace and government; the SBA countered the effects of such discrimination. Over time, this welfare ideology evolved as small business advocates offered new rationales. During the civil rights era, SBA administrators pointed to racial disparities as justification for assistance to disadvantaged businesses. The economic crisis of the 1970s gave rise to an ideology depicting small firms as dynamic job creators. Members of Congress have characterized SBA loans as a sound investment in a growing sector of the economy. This belief in small business as the "engine" of economic growth continues to captivate policymakers, even though economists have seriously challenged it.[6]

In sum, the SBA was and is an affirmative action agency for small and minority enterprise. By discriminating in favor of ill-defined interest groups, the SBA has become embroiled in constant controversy. Yet, these programs continue to grow and have become entrenched. Nevertheless, periodic scandals and policy failures fuel the continued debate over this troubled agency. Moreover, controversy continues to surround the existence and nature of the small business interest. Do small business owners want more or less government, and what role, if any, should the Small Business Administration play in fostering their interests?

Critical Findings: Who Needs the SBA?

The SBA embodies a vague public sentiment favoring small enterprise–a sentiment seized upon by members of Congress for their own interests. Yet, the symbolic value of the SBA–as the embodiment of public support for the "little guy"–was undercut by the agency's inability to define "small" business. SBA size standards were arbitrary and susceptible to political pressure from members of Congress. Furthermore, the size standards deviated sharply from the public definition of small business, thus lending support to Senator William Proxmire's criticism that the SBA is "a medium-size or even a big business administration."[7] Little has changed since the 1950s, when one author wrote that "discussions of 'small business' almost always turn out to be about medium-sized business."[8] The SBA's definition of "small" encompasses nearly 99 percent of the business population, from sole proprietors to corporations with thousands of employees. The awarding of small business status to American Motors Corporation was an extreme example of this bias toward the "not-so-smalls." Periodic efforts to lower the size standards faltered because of congressional opposition. In short, the SBA and Congress benefit from misplaced public support.

This expansive definition of "small" business had important policy consequences. The agency devoted much of its resources to the "not-so-smalls," the segment of the small business community least in need. Firms with more than twenty employees maintained their market share while the very smalls, especially those with fewer than five employees, lost significant ground. "Mom and Pop" have seen better days.[9]

How well does the SBA represent its constituency? In its early days, the SBA, together with the Small Business Committees, acted as the small business lobby in Washington. But the agency was a weak advocate for small business. During the 1960s, SBA administrators failed to represent the interests of small firms affected by urban renewal and the riots.[10] The following decade witnessed a small business backlash against government regulation, but the SBA frequently placed itself on the side of "Big Government." Congress created an Office of Advocacy to take independent stands on controversial issues but SBA executives vetoed position statements that conflicted with those of the incumbent administration. The SBA remained a bump on the political landscape; other federal agencies considered it a "bureaucratic mosquito" lacking strong interest-group support.

The emergence of a powerful small business lobby, led by the National Federation of Independent Business (NFIB), filled this interest-group vacuum. Since the late 1970s, the NFIB has been an effective and powerful advocate for small business interests. Yet, unlike most organized interest groups, the NFIB was indifferent to the fate of its representative agency; the association supported Ronald Reagan's attempts to eliminate all SBA functions except advocacy.

The Reagan administration's battle to abolish the SBA showed that the agency's strongest support–its real constituencies–were the Small Business Committees and the nation's banks, not the organized small business lobby. The SBA socialized the risks of small business finance, thus turning banks into avid supporters of government lending. The political appeal of investment guarantees was obvious: Congress could magnify the apparent government contribution to small business investment and coopt a leading opposition group (bankers, who once denounced government loans to business as "creeping socialism"). Loan guarantees also concealed and deferred the costs to the taxpayers. However, even with the great expansion in loan guarantees, the SBA reaches a tiny segment of the small business community.

To a large extent, the SBA is a "creature of Congress."[11] Why was Congress so interested in the SBA? Many members were sincerely interested in small business issues. Others used their committee membership to strengthen ties with the business community. The SBA was a useful conduit for the constituent work of the Small Business Committees, a dumping ground for politicos, and a "petty cash drawer" for the pet schemes of Congress. The agency's extensive field structure served many congressional districts; the field directors were "often as loyal to their district Congressman as to the agency."[12] It is little wonder, then, that Congress was so fond of the SBA.

The SBA's programs for the "disadvantaged" were marred by corruption, conflicting ethnic interests, and general failure to aid the "truly disadvantaged." Inspired by the March on Washington, SBA administrator Eugene Foley inserted his "Economic Opportunity Loan" (EOL) program in the enabling legislation for the "War on Poverty."

The goal was to combat poverty and create role models in the ghetto. Unfortunately, rather than create success symbols, EOL highlighted the failure of poor entrepreneurs. The program left borrowers worse off than before they entered business.

The history of 8(a) contracting preferences demonstrated that race-based affirmative action made for strange bedfellows. This controversial program was originally a response to the inner-city turmoil of 1968. A crusading administrator, Howard Samuels, exploited the urban crisis by advocating "compensatory capitalism." Under Section 8(a) of the Small Business Act, Samuels began to "set aside" no-bid contracts for minority firms. President Richard M. Nixon dramatically increased the use of these set-asides. Theoretically color-blind but practically race-conscious, 8(a) bred dishonesty and deception in a program designed for the "socially and economically disadvantaged." Paradoxically, the Republican party, now a rhetorical opponent of affirmative action, made explicit racial quotas in government contracting. Congressional Democrats denounced this "reverse discrimination" but by the late 1970s, they, too, were promoting the new racialist policies. Ronald Reagan, who preached "color-blindness" in government, betrayed his conservative supporters by further expanding 8(a) set-asides.

The consequences of the 8(a) program were perverse. A few well-connected firms received the bulk of the set-asides while others received nothing. Obsessed with quotas, the SBA provided little practical assistance. Not surprisingly, most 8(a) firms never developed into viable enterprises. In a classic case of robbing Peter to pay Paul, the SBA took contracts from some of the least advantaged white companies and gave them to minority firms. The agency also applied its eligibility criteria inconsistently, admitting affluent immigrant groups with dark skin and denying the applications of disadvantaged light-skinned peoples. The program provoked conflicts among African-Americans, whites, women, Jews, and other ethnic groups. Political favoritism and corruption were rampant. The original targets of aid, African Americans, saw their share of the 8(a) pie dwindle as Asians and Hispanics gobbled up set-asides.

Minority businesses were not the only beneficiaries of procurement preferences; small firms benefitted from set-asides, too. In the 1950s and early 1960s, advocates of small business advanced arguments for preferential treatment that bore striking resemblance to later justifications for minority set-asides. They argued that small firms deserved a "fair proportion" of government contracts equal to their share of private-sector sales. The under representation of small business was prima facie evidence of discrimination by procurement officers, large corporations, and banks. The discrimination against small business was subtle, often unconscious and pervasive; therefore, it could not be corrected with educational campaigns. Quotas and set-asides, they argued, countered institutional discrimination and promoted "economic diversity."

The rationale for size-based preferences in contracting was dubious. Congress exaggerated the under representation of small firms by relying on crude statistical disparities. Aggregate statistics obscured the SBA concentration of set-asides in industries already dominated by small business; consequently, size preferences did not affect very large corporations. The chief victims of this well-intentioned program were the "not-so-small" companies large by industry standards but small in comparison to the national economy. A third party–the not-so-small company–lost business to compensate for the alleged discrimination of procurement officials.

The SBA's growth also created problems. The distinguished political scientist James Q. Wilson advises administrators to "avoid taking on tasks that differ significantly" from their core mission and "avoid tasks that will produce divided or hostile constituencies."[13] Yet the indeterminate dividing line between "small" and "big" business produced perennial conflicts over size standards and set-asides. Disaster loans diverted personnel from the SBA's regular business programs until the agency set up a separate disaster unit in 1980. The 8(a) program was a "people eater" that drained agency resources and engendered bitter conflicts based on race, gender, and ethnicity.

The multiplication of missions–lending, venture capital, contracting, disaster aid, etc.–led the SBA to neglect functions that produced no immediate payoff, such as advocacy and management assistance. While programs proliferated, the number of employees remained the same. Understaffing, lax oversight, and a highly decentralized agency structure fostered repeated scandals. The pursuit of disparate program objectives also produced a schizophrenic agency culture with the various divisions serving different interest groups: "Mom and Pop" businesses, medium-size government contractors, venture capitalists, disaster victims, and groups defined by race, ethnicity, or gender.

The problems associated with government growth have raised concerns about the desirability of big, bureaucratic government. Conservatives and libertarians view the federal leviathan as a threat to individual freedom. As government grows, people become less self-reliant, more dependent and more likely to view themselves as victims of circumstances beyond their control. Moderates and liberals have also expressed concern that government agencies become sclerotic and therefore fail to adjust to changing circumstances. The asymmetry of government growth–with births greatly outnumbering deaths–creates an imbalance between organized interest groups and a diffuse opposition. The fragmented structure of American government further frustrates efforts to repeal programs that have outlived their usefulness.

The Reagan administration's attempt at abolishing the SBA highlighted the difficulties faced by budget-cutters in a modern welfare state. Fiscal reformers have long argued that the only way to reduce spending is to do it all at once. The cuts have to be deep enough so that the benefits (lower taxes) are visible to the public. Yet visible cuts provoke strong responses from the affected interest groups, making them difficult to achieve. Thus, when David Stockman cobbled together programs that he could attack "on principle" he had no illusions about his chances of success. Despite a long history of scandals and policy failures, the SBA survived the White House challenge.

The political center emerged stronger in the aftermath of the Reagan Revolution. Policymakers on the left and right found their options limited to "fiddling on the margins." The goal was to "rationalize" government programs to make them more efficient and responsive to changing conditions.[14] Skeptics questioned whether government was capable of "reinventing" itself. The historian Jonathan Hughes, for example, wrote that "one can hardly become enthusiastic about government solving problems the government largely created."[15] Others expressed a more hopeful view.[16]

The SBA has a history of reinventing itself. Staffing limits forced the agency to do more with less. From the mid-1960s onward, the SBA increased its reliance on loan guarantees, thus shifting part of the work burden to bank loan officers. Excessive paperwork discouraged many financial institutions from participating, so the SBA granted banks wide latitude in approving loans. The development of a secondary market in SBA loans made them more attractive to banks and investors.

The modest "reinventing" of the SBA is unlikely to resolve the tension that persists between small business and "big" government. Overall, the business community remains suspicious and hostile toward government initiatives.[17] Although pragmatic accommodation is common, business attitudes have not changed much in the past fifty years. A survey of Fortune 500 chief executive officers found overwhelming support for reductions in government spending and greater deregulation of the economy.[18] The available evidence suggests that politically-active small business owners hold similar views. Moreover, the small business owner burdened by regulation is a sympathetic figure and useful symbol for opponents of "Big Government."[19] Thirty years ago, the historian Richard Hofstadter wrote that antitrust had become "one of the faded passions of American reform." The movement against Big Business was over.[20] Yet many small business owners continue to battle "Big Government." Do these small business owners really need an ineffective, ill-conceived agency to lift the burdens imposed by government itself?

Notes

1. See also Bean, "'Burn, Baby, Burn: Small Business in the Urban Riots of the 1960s," The Independent Review 5, no. 2 (Fall 2000), http://tinyurl.com/4aulm; and Bean, "Shame of the Cities: Setting Aside Justice for the 'Disadvantaged,' The Independent Review 8, no. 1 (Summer 2003)http://tinyurl.com/gznud. I examine the earlier history of governmental assistance to small business in Beyond the Broker State: Federal Policies Toward Small Business, 1936-1961 (Chapel Hill: University of North Carolina Press, 1996).

2. "Small Business Notes for President-Elect Carter's Advisors: SBA: It's Mission and Leadership," 6 December 1976, Jimmy Carter Library, Chief of Staff (Selig), box 163, folder "National Small Business Association, 12/6/76-2/25/77": 3 [quote], 1 [quotes].

3. National Federation of Independent Business, press release, "SBA The 'Great Unknown' to Small Business," [1984]. National Archives, Record Group 309, Accession 86-013 (Administrators Personal Files, 1983-84), box 1, folder "NFIB."

4. Robert A Peterson, Gerald Albaum, and George Kozmetsky, "The Public's Definition of Small Business," Journal of Small Business Management 24, no. 3 (July 1986): 63-68. For more on the difficulties in defining "small" business, see Andrew T. Nappi and Jay Vora, "Small Business Eligibility: A Definitional Issue," Journal of Small Business Management 18, no. 4 (October 1980): 22-27; Leah Hertz, In Search of a Small Business Definition: An Exploration of the Small-Business Definitions of the U.S., the U.K., Israel and the People's Republic of China (Washington, DC: University Press of America, 1982); Jeffrey W. Lippitt and Bruce L. Oliver, "The Productive Efficiency and Employment Implications of the SBA's Definition of "Small',"' American Journal of Small Business 8, no. 3 (Winter 1984): 46-48.

5. The agency's history is filled with battles over size standards. To give one example, in 1990 there was bitter dispute over the size standards for the dredging industry. The "bigs," "big-smalls," and "really smalls" sought congressional support and filed lawsuits to change the definition of small business used to set-aside contracts. See Viveca Novak and Peter Overby. "How Small Is Beautiful?" Common Cause Magazine 17 (May-June 1991): 16.

6. David Birch popularized this new myth of small business. David L. Birch, The Job Generation Process (Washington, DC: Economic Development Administration, 1979); David L. Birch, "Who Creates Jobs?" Public Interest, no. 65 (1981): 3-14; David L. Birch, Job Creation in America: How Our Smallest Companies Put the Most People to Work (New York: Free Press, 1987). Birch's studies prompted in-depth analysis by scholars who disputed his findings. See, e.g., Steven J. Davis, John Haltiwanger, and Scott Schuh, "Small Business and Job Creation: Dissecting the Myth and Reassessing the Facts," NBER Working Paper No. 4492 (October, 1993); Bennett Harrison, Lean and Mean: The Changing Landscape of Corporate Power in the Age of Flexibility (New York: Basic Books, 1994); Sylvia Nasar, "Myth: Small Business As Job Engine." New York Times, 25 March 1994, C1-2; Scott J. Wallsten, "Rethinking the Small Business Innovation Research Program." chap. 8 in Investing in Innovation: Creating a Research and Innovation Policy That Works, ed. Lewis M. Branscomb and James H. Keller (Cambridge: MIT Press, 1998), 194-220; and, more recently, Veronique de Rugy, Are Small Businesses The Engine of Growth? (AEI Working Paper 123, 8 December 2005).

7. William Proxmire, Can Small Business Survive? (Chicago: Regnery, 1964), 52.

8. Carl S. Shoup, foreword to Joseph D. Phillips, Little Business in the American Economy (Urbana: University of Illinois Press, 1958), v.

9. Between 1958 and 1996, very small businesses (0-19 employees) saw their share of total receipts decline from 31% to 16.8%. Table 2.13, "Distribution of Sales and Employment by Employment Size of Firm, 1958-77," U.S. President, The State of Small Business: A Report of the President Transmitted to the Congress (Washington, DC: GPO, 1982), 92; SBA, Office of Advocacy, "Employer Firms, Establishments, Employment, Annual Payroll and Estimated Receipts by Firm Size, 1988-1996," http://www.sba.gov/advo/stats/us88_96.pdf; Star, Concentration. See also: Table 2.14, "Share of Employment and Sales of Zero-Employee Firms, 1967, 1972 and 1977," U.S. President, The State of Small Business: A Report of the President Transmitted to the Congress (Washington, DC: GPO, 1983), 96.

10. Jonathan J. Bean, "'Burn, Baby, Burn': Small Business and the Urban Riots of the 1960s," The Independent Review 5, no. 2 (Fall 2000): 165-88.

11. Addison Parris, The Small Business Administration (New York: Frederick A. Praeger, 1968), 167; Howard Kurtz. "SBA Entrenched As Petty Cash Drawer." Washington Post, 11 February 1985, A12.

12. Anthony Chase, quoted in Karen DeWitt, "The Small Business Administration," Black Enterprise (January 1975): 27.

13. James Q. Wilson, Bureaucracy: What Government Agencies Do and Why They Do It (New York: Basic Books, 1989), 189-91.

14. Lawrence D. Brown and Brookings Institution, New Policies, New Politics : Government's Response to Government's Growth (Washington: Brookings Institution, 1983).

15. Jonathan R. T. Hughes, The Governmental Habit Redux: Economic Controls From Colonial Times to the Present (Princeton, NJ: Princeton University Press, 1991), 215.

16. Steven Kelman, Making Public Policy: A Hopeful View of American Government (New York: Basic Books, 1987); David Osborne and Ted Gaebler, Reinventing Government: How the Entrepreneurial Spirit Is Transforming the Public Sector (Reading, MA: Addison-Wesley, 1992).

17. David Vogel characterizes business as the only interest group with "an underlying suspicion and distrust of government." He notes the "remarkable consistency of business attitudes toward government over the last one hundred and twenty-five years." David Vogel, "Why Businessmen Distrust Their State: The Political Consciousness of American Corporate Executives," British Journal of Political Science 8, no. 1 (January 1978): 45-46. See also Robert Carlton Gibson, "Political Attitudes of Selected American Business Periodicals, 1930-1955" (Ph.D. diss., The Ohio State University, 1961).

18. Ninety-eight percent favored "cutting or slowing the growth of federal spending." Eighty-two percent supported greater deregulation. Richard I. Kirkland, Jr., "The New GOP to Big Business: Drop Dead!," Fortune, 6 February 1995, 53. In an earlier survey, 87 percent of the CEOs described themselves as "somewhat" or "strongly" conservative on economic issues. Susan Caminiti, "A Bright Future for Conservatism," Fortune, 2 July 1990, 92. See also Thomas Moore, "The New Libertarians Make Waves," Fortune, 5 August 1985, 74-78.

19. Richard Lesher [President, U. S. Chamber of Commerce], Meltdown on Main Street: Why Small Business Is Leading the Revolution Against Big Government (New York: Dutton, 1996).

20. Richard Hofstadter, "What Happened to the Antitrust Movement?" chap. in The Paranoid Style in American Politics and Other Essays (New York: Alfred A. Knopf, 1966), 88.

NATIONAL ASSOCIATION
OF GOVERNMENT GUARANTEED LENDERS

"The Effectiveness of the Small Business Administration"

Testimony Before the Subcommittee on Federal Financial Management, Government Information and International Security of the Senate Committee on Homeland Security and Governmental Affairs

Thursday, April 6, 2006

Submitted by

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and

Chairman of the Board
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NATIONAL ASSOCIATION
OF GOVERNMENT GUARANTEED LENDERS

Mr. Chairman, Ranking Minority Member Carper, and members of the Subcommittee, my name is David Bartram. I am the president of the SBA Division of U.S. Bank. Our division operates SBA lending centers in 24 states, and we are one of SBA's largest lending partners. Last year, US Bank provided $512 million in long-term SBA loans to almost 4,000 firms nationwide. U.S. Bank is a committed small business and SBA lender with an outstanding SBA portfolio of approximately $1.5 billion.

I also currently serve as Chairman of the Board of the National Association of Government Guaranteed Lenders (NAGGL) headquartered in Stillwater, Oklahoma. NAGGL is a trade association of approximately 670 lenders participating in the Small Business Administration's 7(a) loan guarantee program. Our members are dedicated to providing critical capital to our nation's small businesses so that they may grow, hire more employees, and contribute to our nation's economic vitality. NAGGL members generate approximately 80% of the annual SBA 7(a) loan volume as well as most of the lender portion of SBA 504 loans.

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We appreciate the opportunity to testify today on the effectiveness of the 7(a) loan program, SBA's largest and oldest guarantee loan program. The SBA 7(a) program fills a critical gap for small businesses that need access to long-term loans. In fact, SBA, through private sector lenders who use the 7(a) and 504 loan programs, accounts for about 40% of all long-term small business loans made in America. This means SBA is the single largest provider of long-term capital to U.S. small businesses. While it is true that commercial banks make many small business loans, these conventional loans typically have short maturities (3 years or less), since short-term deposits fund commercial banks. Therefore, the SBA fills a critical need for small businesses to bridge the credit gap, especially for start-up or early stage companies.

Let me briefly explain how the program works. The SBA has delegated most of the loan making authority to lenders while reserving the regulatory and oversight role of the program to the agency. A significant percentage of the lenders in the program today are preferred lenders who have the delegated authority to attach a federal guarantee to a loan. Less active lenders who generally make only a few loans per year participate in the program with SBA having the final authority to attach a federal guarantee to a loan.

The 7(a) loan program is self-funding. It receives no federal appropriation. Instead, fees paid by borrowers and lenders alike keep the 7(a) subsidy rate at zero. In fact, according to the administration's fiscal year 2007 budget submission, over the last 10 years fees paid by borrowers and lenders have been excessive—more than $800 million dollars in excess fees have flowed into the federal treasury beyond what was necessary. In short, the 7(a) program has been a moneymaker for the U.S. government, not only through this fee income, but in the tax revenues paid by the small businesses, their owners, and their employees.

A good question would be, "How does the small business borrower benefit from the program?" Certainly many small businesses can access the conventional capital market for their short-term needs. That is, they could perhaps get a short-term bank loan. However, the key is the terms and conditions of that loan. Typically, according to bank regulatory statistics, small business borrowers get conventional loans with maturities of 3 years or less, with the bulk of those maturities less than one year. Again, this is in keeping with the lending industry's view that they should make short-term small business loans based on short-term deposits.

Contrast this situation with the fact that the federal guarantee changes the terms and conditions of a conventional loan to make the federally guaranteed loan much more borrower friendly. The guarantee allows a small business to appropriately finance a long-term asset with a long-term loan. Again, according to federal statistics, the typical 7(a) loan has a 12-year term, not a 3-year term. This translates into the borrower having significantly lower monthly payment for a 12-year loan than the borrower would with a 3-year loan. Cash is like gold to small businesses and the federal guarantee allows the borrower to avoid becoming cash strapped by loan terms.

The efficacy of the program is proven by its usage. Over the past 5 years, while the government has been harvesting borrower and lender fee overpayments, the 7(a) program has grown by more than 66 percent. There are countless numbers of small businesses that simply would not be in business today if not for the SBA loan programs. Mr. Chairman, borrowers like Eskimo Joe's, a restaurant in Stillwater, Oklahoma and the Simple Simon's Pizza franchise based in Tulsa, Oklahoma are just a couple of the many examples of small businesses who have been assisted by the SBA 7(a) program.

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Just last fiscal year, more than 100,000 small businesses received financing through the SBA 7(a) and 504 programs. These loans totaled approximately $25 billion. For the current fiscal year, it is estimated that the combined 7(a) and 504 loan totals may reach $30 billion. No appropriations are provided for credit subsidies – meaning program user fees are covering the cost of the programs. Over the last several years, SBA has worked to streamline the lending process, helping to reduce the indirect costs of its lending participants. The results are clear – record lending levels in both the SBA 7(a) and 504 programs were realized in FY 2005, with new records expected in FY 2006. This public-private partnership has been and still is a shining example of what can be achieved when private sector lenders and the federal government work together. Like never before, the SBA 7(a) and 504 loan programs are vitally important to tens of thousands of small businesses annually, and these loan programs merit continued bi-partisan support in Congress.

Mr. Chairman, this concludes my prepared statement. Thank you for the opportunity to testify about these programs that are critical to many small businesses. I would be pleased to answer any questions.

# # #

PREPARED STATEMENT OF JOHN POINTER, SMALL BUSINESS OWNER

(Exhibits referred to in the prepared statement is retained in the files of the subcommittee.)

April 6, 2006

Submitted To: Honorable Members
Subcommittee on Federal Financial
Management, Government Information, and
International Security

Dear Senators:

It is truly an honor to be invited to give my testimony regarding my experiences with the Small Business Administration. My presentation today will exemplify my expertise in small and minority business development and full knowledge of Small Business Administration's various programs.

My wife, Vicki and I formed Pointer Oil Company in 1988. Pointer Oil, a petroleum distribution company, was capitalized by an SBA loan in the amount of $250,000 issued through Tennessee Equity Capital Corporation. TECC was a private investment firm certified and monitored by the SBA as a Specialized Small Business Investment Corporation. TECC's purpose was to assist minority businesses with contractual arrangements with guarantee agreements of SBA loans for minority businesses. Pointer Oil quickly established sizable contracts and by 1991 posted annual sales of $15 Million. The Nashville Business Journal and Memphis Minority Business Development Center recognized Pointer Oil as a Top Rated Minority Businessman in the State of Tennessee. Similar additional accolades were bestowed from former US Senator Harold Ford, Sr., who honored me with a US Proclamation as the Top Minority Businessman in Shelby County. (Please see Exhibit A)

My experience qualified me as a Whistle Blower. During that time I single-handily initiated an SBA and US Department of Justice major criminal investigation which focused on the SBA's Specialized Small Business Investment Corporation (SSBIC) in Nashville, Tennessee. Those efforts have been duly noted on the House Floor of Congress, US. Senate and Congressional Small Business Committees. The Wall Street Journal even wrote two articles about my strong actions to stop federal waste and abuse. And Washington Insiders have claimed my actions to be the Nation's Largest Minority Business Development and Loan Scandal in the history of federal programs for minorities. The Chicago Tribune did an article and an NBC affiliate news investigative program produced a story about the SBA's misuse of authority and government cover-up regarding my personal experiences.

The difficulties that I faced while applying for financial restitution from the SBA have been an ongoing battle for many years. (Please see Exhibit B.) A guilty verdict indicting Tennessee Equity Capital Corporation for defrauding Portfolio firms totaled $22 Million. (Please see Exhibit C.) However, I could not get support or assistance from the SBA. This led to the closing of my company along with personal and corporate Bankruptcy protection.

After my years as small businessman, I became an English High School teacher for a while. Then I was called into public service as the State Director of Tennessee Department of Transportation's Disadvantaged Business Enterprise Program. The DBE program is federally funded under the US Department of Transportation. And as a State Director, I exposed fraudulent companies that had received well over $200 million dollars of federal construction contracts by abusing their certified DBE status. These actions as a Whistle Blower led to the termination of my employment with this state agency.

Recently I've been the Liaison for Hurricane Katrina Recovery for Small and Minority Business Development on behalf of the State of Mississippi under their agency, Mississippi Development Authority.

Before I advise you today of my dealings with the SBA, I would like to give you an insight of my background and my strong moral beliefs. My brother, Reggie and I grew up in the small Tennessee town of Columbia. We were well nurtured by parents who worked serving the public. Our mother taught high school for 37 years, both during and after racial segregation in the South. And our father worked for 42 years in the grocery business with Atlantic & Pacific (A&P) Food Stores. He was one of the first African Americans to become a store manager in Tennessee.

We were taught Christian values and went to church every Sunday. Our parents wanted us to use the Golden Rule in life, which is to treat others the way you would want them to treat you. Our parents also trained us to be proud of our culture and heritage and never use the color of your skin as an excuse in life. My brother played basketball and graduated from Middle Tennessee State University and worked in state government for twenty three (23) years. I played football and graduated from Vanderbilt University. As an English major, my choices for the future included corporate business, small business ownership, law degree, or education and coaching.

I was blessed to have the extended opportunity to play professional football for six (6) years. I played the majority of my years as a linebacker in the Canadian Football League with a certain celebrity teammate and newly elected NFL Hall of Famer, Warren Moon. I also played against a highly competitive arch rival, named JC Watts. I finished my career with the Green Bay Packers in 1987.

While in Canada, I met my wife to be, Vicki. Our first child, Sean, was even born in Montreal. I continued my post graduate work in small business studies in Montreal during the off-season and I worked with a top flight marketing company that had contracts with Fortune 500 firms throughout North America. I also learned the business of petroleum marketing from top administrators who annually bought billions in the petroleum industry for their perspective companies such as BP of Canada and CSX Rails.

I was really proud to have received honors in the community while in Canada with such as B' Nai Brith's Man of the Year for service in the Jewish community. I also received a national award in Canada known as Americans in Canada for community and civic responsibilities.

Although saddened that my first career, pro football, was ending, I was extremely excited by the prospects of being prepared with skills for the future. I channeled my energy and increased my focus towards wonderful expectations of creating an outstanding business entity. In order to implement my business plan, I moved back to Nashville, TN in 1987. It was an economical boom town. For example, the Nissan plant was fully operating and GM's Saturn had just begun to build its plant only sixteen (16) miles from my parent's home address. With family in the area and a well known name in the middle Tennessee area, I was empowered with the freedom and the flexibility to network with some of the best and brightest business minds the city could offer. My family supported my wife's difficult transition from Canada to a town that celebrates Mule Day, and I eagerly implemented my research by traveling throughout the southeastern states developing business opportunities and establishing supplier lists of fuel and tanker truck transportation.

A valid issue that was also my top priority was future banking opportunities. I began meeting with bankers and showing them my business plan along with letters of commitment already developed such as the Saturn Plant, Fed Ex, Tennessee Valley Authority, Nashville Electric Service, as examples (Please see Exhibit D.). Banks turned me down as a start-up, but they offered me support by letting me know about the Small Business Administration (SBA) and even its minority small business programs. The SBA's District office directed me to a locally SBA certified and licensed investment firm named Tennessee Equity Capital Corporation. TECC was owned by Walter Cohen.

In January of 1988, and upon thorough research, my wife and I signed a contract as guarantors with an agreement to receive an SBA business loan of $250,000 for Pointer Oil Company. (Please see Exhibit E.) Vicki and I did not know much about Walter Cohen or TECC, so we sought our own legal council. Then we took our due diligence a step further. We met with and received assurance from the regional SBA examiner, Linda Mowery out of their Atlanta office.

With commitments from noted customers, Pointer Oil Company soon began landing multi-million dollar contracts. My company was servicing fuel at Saturn, Nashville Electric Service, Nashville School Board, Shelby County, The City of Memphis, Memphis Transit Authority, The City of Atlanta, Atlanta's Transit Authority (during the Olympics Games), and Martin Marietta, (the ammunition plant servicing the US military during Desert Storm). (Please see Exhibit F.)

From 1989 to 1992, Pointer Oil Company had a mercurial climb to the top in business development in the state of Tennessee. However during the climb to be the best business entity regardless of race and classification, I detected criminal wrongdoings. Mr. Cohen and his cronies had conducted an illegal wire transfer with a major portion of my SBA loan. (Please see exhibit G.) I also identified forged signatures on checks, state and federal taxes. Checks were also being written to Walter Cohen and his staff. (Please see Exhibit H.)

Nevertheless, I felt that there would be honesty, good faith and a full spirit of cooperation with the SBA and their Investigation Division while they dealt with their corrupt SSBIC and its criminal owner.

I made the initial contact concerning criminal wrongdoings to Linda Mowery, the SBA Regional Examiner out of Atlanta. I called her and, at her advice, I sent her copies of burden of proof of criminal intent in a FedEx overnight delivery. And within five (5) business days, the SBA sent Special Investigator Gerald Struchen from the Regional office of Atlanta to begin a full scale criminal investigation. Unbeknownst to me at that time, Special Investigator Gerald Struchen was engaged to marry Linda Mowery, the SBA examiner. The potential conflict existed by her federal requirement to validate all SBICs and SSBICs in her four state region to be sure they complied with SBA required business practices.

Initially, SBA Special Investigator, Struchen and his Investigations supervisor, Jim Albers informed me and my wife as well as my attorney, Adrian Altshuler that in the early stages, the SBA would definitely make me whole and return the $250,000 SBA business loan. This would have allowed me to continue to deliver to such urgent clients as Martin Merritta (ammunition plant servicing Desert Storm - $3 million dollar contract for POC) and the State of Tennessee General Services (servicing departments such as the State of TN Highway Patrol cars - $15 million dollar contract for POC).

Apparently, ethical obligations to my contracts were not among the criteria of the SBA. Cohen, the president of the SBA's fraudulent investment firm, TECC, found out that there was an SBA and US Department of Justice investigation against him in the early 90's. When Cohen discovered my Whistle Blowing actions, he retaliated. He notified the SBA in writing that under their SBA and SBIC regulations, he was proclaiming Pointer Oil Company to be in default. Then he filed a lawsuit against my company, my wife and me, as well as the State of Tennessee's Petroleum Tax Division, which ultimately withheld over $660,000 of fuel rebate funds that were owed to POC.

The SBA knew in detail of these actions through direct communications I had with them and with the federal investigation team, which was in the field in Nashville. This team was led by SBA Investigator Struchen. The SBA chose not to take any action to protect Vicki and me from frivolous regulatory consequences or wrongful legal attacks on our credit and character, which resulted from Cohen's SBA default claim. Because the SBA chose not to intervene, ultimately the legal attacks forced my wife and me and our company to file Bankruptcy. In the US Federal Bankruptcy Court of Middle Tennessee, US Bankruptcy Judge Keith Lundin ruled in favor of my family and former company being harmed by stating, "It is more likely than not that the transfers of cash from Pointer Oil to TECC (SBA's investment firm) in May of 1990 were preferential or fraudulent conveyances or constituted outright theft of the assets of Pointer Oil." (Please see Exhibit I.)

During this process, I began contacting as many Congressmen and Senators as possible, including the various Presidential appointed Chiefs of Administration of the SBA. From former Congressman JC Watts as well as former Senator Fred Thompson (TN) all inquired including my Tennessee State Senator and Senate Majority Leader, Bill Frist.
(Please see Exhibit J.) Former Congressman and Chairman of the Congressional Small Business Committee and now Senator, James Talent conducted an intensive Committee inquiry concerning the SBA's questionable actions against me. Congressman Harold Ford, Jr.

tried to launch an investigation through the Congressional Black Caucus. Even former Congressman Bob Clement spoke on The House Floor of Congress, which was written in the Congressional Record, July 31, 1992. He stated "that if the SBA does not conduct better monitoring, then other small and minority firms may suffer such as my company and to be left out in the cold by the SBA". Mr. Joe Rogers, former US Ambassador of France under the Reagan Administration, even wrote on my behalf to the SBA Chief of Administration. (Please see Exhibit K.)

Nevertheless, through prayer and intestinal fortitude, my wife and I tried to continue to live responsible lives within the community. Vicki traveled with her choir to such places as Jerusalem and to Russia. And I tried to be an example of a role model by still holding my "John Pointer's Back To Basic's Annual Football Camps" in my hometown of Columbia. The proceeds always went to the youth football programs and I even supplied books to a Boys and Girls Club along with contributing funds to a Black Church that was burned down due to racial attacks in the South one particular summer. I was humbled when I received such honored awards from my hometown as Maury County Male of the Year and a "John Pointer Day". (Please see Exhibit L.)

I did all of this while I had to also apply for US Food Stamps in order to take care of my family. Former Congressman Bob Clement pleaded with former US HUD Secretary, Jack Kemp, also a former pro football player, to help prevent me from losing my home. So, Mr. Kemp placed my young family in a HUD mortgage assistance program. Enormous amounts of collection agencies began submitting information of debt to us as well; while the SBA claimed that they were doing all they could to assist. (Please see Exhibit M.) Our hope in the system continued, but our financial reputation was burning to the ground.

Once, I had an opportunity to be invited to Washington to speak to high ranking SBA officials. In the presence of former Congressman Bob Clement's Chief of Staff, Mr. David Flanders, along with my attorney on the conference call listening, the SBA officials, including SBA lawyer Janice Mitnick again informed me that the SBA would pay restitution and make me whole with a SBA original loan of $250,000. This never happened. (Please see Exhibit N.)

Through the Freedom of Information Act, I was able to obtain critical documents showing internal memos where the SBA administrators were adamant in continuing to deny me restitution. These Internal Memos mirror the dates and times that the SBA was still paying lip service of wanting to assist us by communicating this to various Congressmen and Senators' inquiries. (Please see Exhibit 0.) In exhibits you will see where even SBA attorney, Janice Mitnick was conducting business quite the contrary of what she proclaimed to me and to my representatives regarding restitution. Her Internal Memo entitled "This Documentation is Prepared in Anticipation of Litigation", shows Mitnick preparing the SBA and its Receiver to litigate against me, while external letters to Congressmen and to Senators all read that the SBA was in support of me. (Please see Exhibit P.)

During these dark phases of our lives, Walter Cohen, often in a drugged and drunken state of mind, began calling our personal phone at 2:00 and 3:00 in the morning. He repeatedly threatened to kill me and to harm my family while using vile racial statements. My brother, Reggie, was at that time a state certified Bail Bondsman. Reggie signed documents and testified to SBA Special Investigator, Struchen that a client of his was solicited by Cohen to bring physical harm to me and to my family. Yet the SBA still did noting to offer us assistance.

On more than several occasions, Special Investigator Struchen came over to our home and consulted with me regarding criminal investigative information. I still feel that these were deceiving and illegal acts that violated federal regulations. Even when my wife, Vicki, was preparing to deliver birth to our second child, Danielle, SBA Special Investigator, Struchen showed up at my wife's birthing room. And in the presence of my mother and mother-in law, he pressured Vicki and me to sign a US Affidavit. He actually wanted me to start wearing a live wire tape, and to review more critical documents on various portfolio firms under the SBA's fraudulent investment firm. (Please see Exhibit Q.)

In spite of my speaking at an SBA Ombudsman Hearing, there was still no SBA support of my efforts. Due to the years of delays and overburdensome acts caused by the SBA Receiver, which was supported by the SBA, my lawyer pursued our legal right to file suit against the fraudulent SBA investment firm, TECC. Please note that the SBA was fortunate to be granted Receivership due to my sole testimony in federal court. Also, former Vice President Al Gore wrote an inquiry letter to the SBA's OIG and yet there was still no assistance by the SBA in helping our plight of financial recovery. (Please see Exhibit R.)

On February of 1993, on Valentine's Day, SBA's Special Investigator, Gerald Struchen called my house and informed us to watch the local news that day. He told us that the Grand Jury had given the US Attorney General the right to indict and arrest Walter Cohen, president of the SBA certified investment firm, along with a select few staff members. I informed Special Investigator Struchen that it finally was about time, since I first alerted the SBA of criminal wrongdoing in 1989, four years earlier. I also informed Struchen that I would have to go to my neighbors to watch the federal arrests take place. Our electricity had been turned off because we couldn't pay the bill.

In the US Court Chambers of US District Judge Thomas Wiseman, Jr., SBA's top legal counsel from Washington DC, Mark Gallagher asked me to testify in order for the SBA to be appointed as Receiver. Judge Wiseman concurred that my testimony was important in order for him to grant the SBA Receivership. Top SBA administrators came to Nashville from Washington to give their testimonies in the criminal court that started on April 6, 1993. They all testified that they knew that I (John Pointer) initiated the criminal investigation.

Please find as listed: (Please see Exhibit S.)

Nancy Braswell, Loan Specialist, SBA District Office, Nashville, TN

Richard Hobaugh, Examiner of SBIC, Supervisor of SBA, San Francisco, CA
Marvin Klapp, Administrator of developing SBIC regulations, Washington, DC
Virginia Campbell, Chief Area of SBIC, SBA, Washington, DC
Mark Gallagher, SBA Lead lawyer, Washington, DC
Linda Mowery-Struchen, Regional Examiner, SBA, Atlanta, GA
Gerald Struchen, Regional Special Investigator, SBA, Atlanta, GA
Jo Ann Gordon, Financial Analyst of Liquidation, SBA, Washington, DC

Not only did top SBA administrators witness factual testimonies of fraudulent acts, they also witnessed a rude and belligerent man, Walter Cohen, whom they (SBA) had certified and funded for years as the owner and administrator of a multi-million dollar SBA investment firm in Nashville Tennessee. TECC was federally approved to assist minority businesses. Walter Cohen had to be bound in shackles with the threat of US Judge Thomas Wiseman, Jr. willing to gag him due to his lewd cursing and spitting at the jurors and to various people in court and in the hallway. (Please see Exhibit T.) Cohen's attorney Mr. Peter Strianse even acknowledged his heavy drinking problems in court proceedings.

Walter Cohen was found guilty of federal fraud to the US Small Business Administration and to the portfolio firms in 1993. Even Federal Judge Wiseman proclaimed Cohen and his cronies as, "only setting up Blacks to head up corporations in order to qualify for SBA funds and then using the money to his own benefit to the extent that he chooses to do so." He further said, "I think he (Cohen) used the money as if it was his own without any restrictions and paid lip service to the regulations of the Small Business Administration, and he used showcase Blacks to head these corporations which were dummies, to do what he wanted to do with them." (Please see Exhibit U.) Testimony from Theodora Morrison, an African American employee explains that her company was set up as a front (sham company) in order for Cohen to receive a $250,000 SBA loan.

Mr. Cohen eventually died, apparently of heart failure, while waiting on his federal prison sentence. In the criminal trial of Walter Cohen and the SBA's Criminal Investment firm, Cohen's attorney even questioned the "Conflict of Interest" of SBA's Examiner, Linda Mowery-Struchen. He apparently saw a problem with her responsibility of examining the SBA's TECC's books while engaged and later married to SBA Special Investigator, Gerald Struchen. Then Gerald Struchen's investigation found Cohen guilty. Cohen's attorney called the SBA's action as duplicity. Judge Wiseman also questioned the poor monitoring of the SBA as well. (Please see Exhibit V.)

Working as a team, the SBA, SBA Receiver and the Estate of Cohen proceeded to fight the Pointers and their claims in Tennessee legal court rooms (Chancery and Appeals) from 1993 to 2003.

During a particular hearing in front of a Tennessee Chancery Judge, the SBA's locally hired southern lawyer, proclaimed to the judge the slur, "all Mr. and Mrs. Pointer would like to do is to get in front of a jury amongst their peers and then proclaim that because they are Black, then they were abused by big bad government, therefore government should pay them restitution". I received this information from my attorney as a racial insult and then I proceeded to protest this to the Tennessee Professional Board of Ethics and to the SBA concerning this horrible statement, yet the SBA did nothing. SBA allowed frivolous claims and lawsuits by the SBA Receiver to pursue for years, while tying us up in courts and frustrating my attorney. Also, in the Final Order in which the SBA Receiver won the claim to deny restitution over the Pointer family, only $3million dollars were found through liquidation sales. The SBA was granted to take the funds back to Washington, DC as well as destroy all documentation of all activities in the state of Tennessee as if this never happened. (Please see Exhibit W.)

I have an additional but related concern. Two White male business owners under the same fraudulent SBA investment firm received collectively nearly $500,000 in their SBA claims restitutions. Even one of the owners stated "that if it hadn't been for me (John Pointer) being a Whistle Blower, he would not have been able to receive his SBA money". I never received a dime from the SBA nor from the SBA Receiver, which were all acting as one and the same. (Please see Exhibit X.)

Tennessee Equity Capital Corporation was somehow allowed to act as an SBA certified investment firm since 1979. But for some reason, TECC did not undergo proper auditing from the SBA for over a decade prior to when I alerted the SBA's Investigations Office of criminal wrongdoing in 1989. It is conceivable that millions of SBA funds had already been lost prior to my Whistle Blowing. And with me becoming the Nation's Largest Whistle Blower effecting minority business development, the SBA apparently decided to try to discredit me.

Therefore, I now request the Honorable members of the Senate and this Special Subcommittee to authorize and instruct the SBA to make my family financially whole. There have been years and years of distrust and misuse of federal regulatory power, in and out of court. In 2003, the SBA even asked me to reapply for a loan and then they declined me due to my bad credit, bankruptcy and start-up business interest. (Please see Exhibit Y)

In 1995, an administrator, Judy England from the US General Accounting Office (GAO) testified regarding the SBA on the subject matter, "Better Oversight of SBIC Programs Could Reduce Federal Loses." This report at that time showed 189 SBICs and SSBICs in liquidation who collectively owed the SBA well over $501 million dollars. (Please see Exhibit Z.)

In my years as a Whistleblower, I have lost jobs, careers, and faced financial hardships. I've even enclosed a recent IRS notification to "Garnish My Wages" statement. Yet, I prevail knowing that I still believe in Congress and the Senate's federal mandate to continue to support minority business development in the United States.
There needs to be a Special Oversight Committee to monitor all federal agencies that have minority business development programs. And I would like to be involved in this Special Oversight group, which should report directly to this Senate Subcommittee as well as to the entire Senate governing body.

In a time when political sensitivities worry about *More* government or *Less* government, I am still an advocate of *Better* and *Responsible* government.

In closing, USA Today wrote articles about the traits of a Whistle Blower in claiming that "Whistle Blowers persist because that's the way they are – a breed apart, driven by a desire to expose dirty executives, protect consumers or avenge wrongs they feel have been done to them." (Please see Exhibit AA.)

I have written an earnest dialogue with representation of facts that is to be submitted to the Senate Subcommittee on Federal Financial Management, Government Information, and International Security under the Committee on Homeland Security and Government Affairs.

And I thank you for allowing me to fulfill an American Dream today.
(Enclosures)

Yours in Trust,

PRIMERA PLASTICS, INC.
A QS 9000 CERTIFIED COMPANY
Precision Injection Molding
A Certified Minority Enterprise

Statement of Noel Cuellar, President, Primera Plastics, Inc.
Hearing on the Effectiveness of the Small Business Administration
Subcommittee on Federal Financial Management, Government Information,
and International Security
March 31, 2006

I, Noel Cuellar, am a small business owner in the West Michigan area; and with the help and assistance of the Small Business Administration was able to build my company. In 1994, I found myself in a predicament as I soon discovered that no bank would even consider me for a loan in order start my small business. Yet, the SBA was there to grant me an opportunity through loans and various programs that allowed my business to grow and expand from two to, our now standing, one hundred forty employees.

With the SBA's technical guidance and mentorship our company was able to sustain success and efficiency. With the assistance of programs such as The Lakeshore 504 Program we were able to acquire funding to help build our $3.6 million facility, from which we now operate. The SBA has also allowed Primera Plastics to serve its local economy by creating jobs; and support a growing economy by conducting business with numerous local vendors and other small businesses.

The Small Business Administration has contributed much to the success of my company and I am saddened to think that the SBA would be done away with. I only hope that future small businesses owners will be able to look upon the SBA for assistance in growing and building their companies that may otherwise not be realized because of lack of capital. It is organizations such as the SBA that give opportunity to people who aspire to open their small businesses, and I am very grateful for the support and guidance that the SBA has provided to me and will hopefully provide to many others.

Thank you and I appreciate your consideration,

Noel Cuellar
President

3424 PRODUCTION COURT ZEELAND, MI 49464 tel 616-748-6248 fax 616-748-1174

Statement of Chris F. Willis, CEO, Media 1 Interactive, Inc.
Hearing on the Effectiveness of the Small Business Administration
Subcommittee on Federal Financial Management, Government Information,
and International Security
April 6, 2006

My name is Chris Willis. Since 1993, I have been the proud owner and CEO of Media 1 Interactive, Inc., a women-owned business enterprise (WBE.) Media 1 is a small West Michigan training company with proven ability to assist the largest multi-national corporations in solving their toughest performance challenges. In the past six years, Media 1 has designed and developed over 100 courses for HP alone. The company completed over 90 training projects for various clients in 2005, and, after initiating a new goal-driven profit sharing plan with its team members, is on track to meet revenue growth from $1 M to $1.25 M for 2006.

Over its 13-year history, Media 1 has repeatedly demonstrated the ability to re-engineer itself to overcome any and all competitive challenges, to master new technologies, and to meet ever-changing client needs. Today, as development of eLearning titles continues to shift to offshore production, Media 1 continues to recruit and train team members to offer full-service strategic learning and performance support consultation and program development to the largest global corporations. Through projects with Global 500 companies, such as HP and Siemens, Media 1 regularly works with multi-national project teams to deliver learning programs worldwide. This global focus and experience allows Media 1 to continue to thrive despite local or regional economic downturns, and positions the company ahead of many of its competitors in the emerging global economy.

All throughout our history, the SBTDC, our local business counseling branch of the SBA, has provided free or low-cost professional guidance to help us grow and thrive. They supported me with training in the early years, when I was just learning what it meant to be a successful entrepreneur, and helped us set up the financial projection and tracking systems which were the foundation for the systems we use today. They provided marketing consultation and guidance when times were lean, and support and advice that helped us survive the tech sector downturn and a severe slump following the 9/11 attacks. They have provided networking assistance, and have helped connect us with qualified strategic partners and new team members. I have always promoted the SBTDC to new and seasoned entrepreneurs as one of the most valuable business resources we have available – a true demonstration of our "tax dollars at work."

We are a creative and technical services business, and our business location is very important to recruiting and retaining the best talent. We recently relocated our business into a refurbished formal school building, nestled within the resort community of Grand Haven, where we are good neighbors to the nearby residents and support the local merchants. The space suits us so well that we are in process of purchasing the building under an SBA 504 loan; it would have been difficult for us to qualify for our building loan without SBA assistance.

With the sudden real estate investment and revitalization taking place in that area, we were highly concerned that we might find ourselves priced out of our building within a few years. By locking into fixed mortgage payments, we can enjoy and improve our space, invest in the growth of the community, and focus on building our business. And I can purchase with confidence, knowing that I won't face a mortgage "balloon" that could make it difficult to meet future mortgage payments.

SBA programs have provided my support and safety net throughout the growth of Media 1. This support, in turn, has had a positive ripple effect in many ways. For our current team members, we provide an enjoyable and financially secure career path and health care for themselves and their families. For many of those who have left us for whatever reason, I am proud to know that we provided training that launched them toward a successful career elsewhere – sometimes in support of larger businesses, and sometimes in launching new businesses of their own. We have recruited former residents back to the state of Michigan, and through our work with global companies have brought dollars from Europe back to the US. Meantime, the couple from which we are purchasing the building are reinvesting in a larger development within the community.

Why would our government do anything at this time that could in any way have a negative effect on business growth, revitalization of communities, or job creation? Dismantling the SBA would be a huge mistake with a negative impact on business, citizens, and communities in untold ways for years to come.

Sincerely,
Chris Frederick Willis, CEO
Media 1 Interactive, Inc
605 Elliott Street, Suite 3
Grand Haven, Michigan 49417

Quality Air

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Statement of Michael T. Fox, President, Quality Air of Midland, Inc.
Hearing on the Effectiveness of the Small Business Administration
Subcommittee on Federal Financial Management, Government Information, and International Security
April 6, 2006

Quality Air of Midland, Inc. (QAM) is a small business located in Midland, Michigan. I am currently an active board member of the Small Business Association of Michigan (SBAM). As such, I have come to appreciate the many services and support functions offered by the U.S. Small Business Administration (SBA). 500,000 small businesses in Michigan couldn't get these SBA services anywhere else.

Over the years we have used the services of SBAM and its' related business support groups, like the SBA funded Michigan Small Business & Technology Development Center, to help our company identify growth opportunities and secure a brighter future for our employees.

QAM's revenues are currently at $7,000,000 per year and we employ 30 people. We are on a growth track of 30 % per year for the next 5-years leading us to revenues of $25,000,000 by 2010 and a workforce of 75+ people to help us get there. We intend to use, and we will need, all the resources we can find to help us meet these challenging goals. We believe the best source for the support we will need will come from our SBA and its' related business support services.

If America is to compete in this new global economy, it must foster the growth of its young entrepreneurial companies so they might become the gazelles our economy so desperately needs. Who better to do this than our own Small Business Administration?

Thank you for this opportunity to express my views.

Sincerely,

Michael T. Fox

Michael T. Fox, President
Quality Air of Midland, Inc.

Statement of Lee & Betty Williams, owners Magic Kitchen & Catering
Hearing on the Effectiveness of the Small Business Administration
Subcommittee on Federal Financial Management, Government Information, and International Security
April 6, 2006

Mr. Chairman, Senator Levin, thank you for the opportunity to submit testimony for the hearing record on the Effectiveness of the Small Business Administration.

We are Lee & Betty Williams of Saginaw County Michigan. We started our Dry Cleaners and Self Service Laundromat business in 1987 in downtown Saginaw. We had a total commitment of $450,000.00 from the local bank, City of Saginaw Economic Development Corporation and a guarantee from the SBA through a local commercial lender.

Over the years the business has grown and changed. We now operate a Car Wash, Salon & Barber Shop, Laundromat, Take Out Foods Restaurant and Catering business in the same location. Our highest number of part time employees was 19. In 2005 we started a new business that is an extension of the catering operation at a different location. We totally renovated an existing building in Downtown Saginaw and now have a 175 seat Banquet Center with a full catering kitchen. The local bank used the SBA loan program for financing the project.

Without the Small Business Administration programs and services there would be many business failures due to; 1) a lack of counseling for small businesses just starting out, especially during the slow economic times we are facing in the Saginaw region with impending losses in wages and jobs for the automotive related workforce; 2) those considering alternative new ventures in Michigan due to loss of manufacturing jobs will not be able to receive the help of the Small Business and Technology Development Centers; and 3) the loss of access to comprehensive data and web based information that is now available on websites provided by the SBA and local SBTDC program, limiting technical assistance and business plan development.

Without these resources, our rise to the current level of business stature would have been significantly impeded over the years. We appreciate the advice and counsel of qualified individuals who were there to provide assistance during our development and expansion phases.

Respectfully submitted,

Lee & Betty Williams, owners
Magic Kitchen & Catering
1209 Wadsworth
Saginaw, MI 48607
(989) 753-1209

Elissa Rose Banquet Center
215 N. Park - Saginaw
Saginaw, MI 48607

618 Kenmoor Dr., Suite 200 • Grand Rapids, MI 49546 • 616-954-9556 www.nusoftsolutions.com

April 4, 2006

Senator Levin:

I am writing to underscore the importance of the SBA services to the state of Michigan as well as the nation at large. My company, NuSoft Solutions, of which I am co-owner, owes a key element of our heritage to the SBA's Small Business Technology Development Center. NuSoft is one of the nation's premier technology services businesses, as well as one of Michigan's leading technology services firms. When I first started my business (Sagestone, which eventually rolled into NuSoft), my first stop was to visit the SBTDC. The help, encouragement, counseling and support provided by the SBTDC, both at my business launch and then over the years, was invaluable, and certainly a factor to our strong standing today, nearly ten years and many tens of millions of dollars of revenue later.

In addition to the help with my business launch, over the years I also saw a steady stream of other small startup businesses grow and prosper under the tutelage of the SBTDC. In many cases, such businesses went on to become our teammates or potential clients. Often I directed individuals to the SBTDC as well. With the high visibility of a growing business as well as an eventual "Entrepreneur of the Year" recognition, I was often approached in the community by aspiring entrepreneurs seeking advice, guidance, and perspective on the fundamentals of starting a business. The SBTDC is always the direction I have sent them, and always with great feedback and results afterwards.

I realize that there has been discussion in various quarters lately about the role of the SBA and the need that small business entrepreneurs may have for assistance. I believe my example serves as a poster child for the payoff of such programs. In my case, I was college educated, with a great degree, and ten years plus, working at a large corporation (IBM). But that was *not* enough. I wanted to start a business, but nobody in my family had ever been an entrepreneurial business person. In spite of my strong academic and corporate world pedigree I was, quite frankly, clueless about where to turn next. Then I happened to see an article that described the services of the SBDTC and sparked my visit, and the incredible business journey that followed. Without the SBDTC, the path may have been much different. I am very thankful that it was there, as are the generations of employees and delighted clients that followed. This type of support makes such a difference to the many aspiring entrepreneurs out there, many of whom start from far more daunting circumstances than mine. The SBA and SBTDC serve as a crucial catalyst in our nation's economy and business vitality.

Very best regards,

Keith D. Brophy

Keith Brophy
President, Business Development
NuSoft Solutions Inc.
kbrophy@nusoftsolutions.com

Statement of Bambi Straebel, owner, Bambi's by Java Dave's
Hearing on the Effectiveness of the Small Business Administration
Subcommittee on Federal Financial Management, Government Information,
and International Security
April 6, 2006

My name is Bambi Straebel, and I opened my coffee shop (Bambi's by Java Dave's) on June 9th, 2005. I would have not been able to fulfill my dream of opening my own business without the assistance of a Business Consultant from the Michigan Small Business & Technology Development Center. I found value in the use of seminars that are available through the MI-SBTDC to people like me who need information. I also appreciated the support and the ability to work with consultants who are very knowledgeable and patient.

I did not know the first thing about preparing a business plan to present to the bank for a loan and was referred to the MI-SBTDC office by my lender. The consultant was by my side through a majority of the process. She was a great assistance and I would not have been able to manage without her. I was able to receive my commercial loan with the help of the SBA guaranteeing 50% of the loan amount and more favorable terms.

I am now in the 10th month of my business venture and things are going terrific. I have created three part-time positions in Saginaw Michigan, and am looking forward to the future.

The consultant has kept in contact with me to make sure things are going well and regularly asks if she or the MI-SBTDC can be of any help. It would be terrible loss if in the future small business owners did not have such a program to rely on.

Thank you for your consideration in this regard.

Respectfully submitted,

Bambi L. Straebel
Bambi's by Java Dave's
4632 State Street
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Statement of Jim Pilgrim, CTO, Pilgrim Technology, LLC

Mr. Chairman, Senator Levin, thank you for the opportunity to submit testimony for the hearing record on the Effectiveness of the Small Business Administration.

Pilgrim Technology LLC is a company that is dedicated to technology innovation and customer satisfaction. This dedication opens the doors to create a dynamic experience for employees and customers alike. As part of this experience, the company has provided challenging and interesting opportunities for personal and professional growth. Formed in 2002, Pilgrim Technology is a women-owned small business. The company began in Midland, Michigan as consultants for wireless technology. Now, it is not only a wireless consulting company, but also a Dell reseller and technology supplier. Currently, the company has nine employees: seven full-time and two part-time, one of which is a Saginaw Valley State University intern.

The company continues to support projects for US Army-TACOM, US Navy NAVSEA, and The National Automotive Center and has recently been contracted through The Department of Homeland Security – US Coast Guard and on March 21, 2006, was awarded a GSA contract.

One of its research and development outcomes is the wireless radio, incorporating emerging technologies that enhance connectivity to in-vehicle electronic and discrete sensor points. The secure wireless sensor interface allows for seamless secure transmission of sensor data and full two-way diagnostics. Pilgrim Technology LLC has seen significant progress in this area including the development of the radio platform and completion of the bread-board design. Engineering development for Phase II of this program includes decreasing the design to a 4 x 2 inch radio board for ESI hub integration. This smaller package will be low power and low profile. In June 2005 the first integrated design was demonstrated with placement in an FMTV with future integration to include Abrams tank and Stryker vehicles. A fully integrated design will be completed by March, 2006.

Pilgrim Technology recognizes that Michigan SBTDC has invested approximately 40 hours of time from 09/2004 to 12/2005 in counseling and assistance. Making connections in the local market proved difficult and the firm was unable to tap into it. Midland Tomorrow, a satellite center in Region 5 of the Michigan Small Business & Technology Development Center, helped by providing introductions.

Pilgrim Technology has experienced phenomenal growth over the past two years. During that period, general business counseling was provided to advise the firm about programs such as Michigan Works services for employee hiring and training. Currently, the company is receiving assistance from the SBTDC consultants with its multi-million dollar expansion in the coming year.

In closing, Pilgrim Technologies LLC has seen tremendous growth in sales, number of employees, business activities, and many other facets. The company is an exciting and relatively new Midland business with even higher expectations for 2006 and beyond. We are grateful for the assistance provided by the SBA through its Small Business and Technology Development Center in this region.

Respectfully submitted

Jim Pilgrim, CTO
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www.gymco.com

Mission: "To teach athletic skills for lifelong participation."

March 29, 2006

I am a degreed educator who began my own small business, Gymco Sports, 26 years ago. Gymco is a Sport Center offering lessons and services for all ages in the area of physical education and sports.

The historical growth of Gymco was slow but steady until about 6 years ago when I became aware of the services offered through the Small Business and Technology Center. I was seeking assistance to assess the viability of an ambitious building project for Gymco. I received personal help to develop a business plan for our future expansion project, review demographics to select a building site, and prepare projections and financial information to secure financing for the project. Gymco's new building and land were financed through an SBA loan because credit was not available through the private sector. When the new building was completed, the Small Business and Technology Center provided help in planning and marketing our Grand Opening.

Gymco's ambitious new facility and resulting business growth would not have been possible without the help of the SBA programs. This building project provided jobs locally for architects, construction company employees, tradesmen, technology experts and other industries associated with building and furnishing. Gymco's new location and facility has resulted in a 20% growth in corporate sales, services and new jobs, and I project continued grow as a result of new opportunities created by this project. Our small business success story is a direct result of the services and financing provided through the SBA programs.

I implore you to endorse the Small Business Administration and its services. The support of the SBA is critical to the success of small businesses such as Gymco, and the health of our economy is dependent on the success of small businesses. Small businesses operate with narrower profit margins and less capitol than large businesses, making the SBA services a valuable resource for business success and job creation.

Respectfully,

Doreen Bolhuis
President

Statement of Peter Wong CPA, President, Roy Smith Company
Hearing on the Effectiveness of the Small Business Administration
Subcommittee on Federal Financial Management, Government Information,
and International Security
April 6, 2006

Mr. Chairman, Senator Levin, thank you for the opportunity to submit testimony for the hearing record on the Effectiveness of the Small Business Administration.

Roy Smith Company is a welding products and industrial gas distributor in Detroit, Michigan since 1924.

In 1999, when we were striving to survive and succeed in the automotive industry, we invested about $2,000,000 in our Detroit facility by adding a state-of-the-art industrial gas fill plant at our warehouse. This investment was made possible from Comerica Bank with the SBA loan guarantee program.

With this strategy, we were able to increase our market and sales during the past 6 years and were honored with the Michigan Minority Business Development Council's Supplier of the Year award for 2003 AND 2004.

Without the availability of the SBA loan guarantee program, the above achievement and our ability to progress in the market place, and our ability to provide competitive jobs/careers to our 20+ dedicated employee team would not have been successful.

Furthermore, as the President of the Asian Pacific America Chamber of Commerce, our Chamber has worked in many occasions with the Detroit SBA office in hosting seminars and workshops to educate new entrepreneurs in pursuing their strive towards the American dream of owning/running their own business, whether it be in retail, industrial or service area.

I would like to thank you again for this opportunity to express my views.

Sincerely,
Roy Smith Company

Peter Wong

Peter Wong
President/CEO
14650 Dequindre
Detroit, MI. 48212

Statement of Heidi N Jacobus, founder and CEO of Cybernet Systems in Ann Arbor, MI.

Cybernet Systems is a small high-tech business of about 50 employees in Ann Arbor, MI. I founded the company 15 years ago on the basis of a single SBIR contract. We have continued to compete for SBIR contracts in topics like automation, robotics, sensors and network systems. I am confident that without SBIR my company would not have come into existence. Having had the start with SBIR, we have created good jobs in Michigan, invented useful products and fielded our technical solutions to the military in places as far apart as McAlester, Oklahoma and in Kuwait, and have been awarded 26 US Patents.

Our technology expertise in sensors, computer vision, and robotics is typically applied to military solutions first, commercial products second. Our technology development for military customers often begins years before there is a commercial need for those products. We supply useful niche technologies like motorized joysticks for space station astronaut training or robotic "bullet sorters" for the US Army in Kuwait. Through SBIR, capable companies like mine are funded for such projects.

In the 1990's Cybernet worked closely with NASA SBIR to develop what became the first Force Feedback products in the market. Cybernet was granted several early patents in this field. NASA's interest in this pre-dated the market for commercial applications by at least 5 years. This technology has now, more than ten years later, moved from the small business arena into the main stream through patent licenses to Microsoft, Logitech, and Sony to create thousands of high tech jobs in the US and overseas. One of Cybernet's products derived from SBIR has been awarded a position in the Space Foundation Hall of Fame.

Cybernet's NASA SBIR product that received the Space Foundation award is MedStar, a telemedicine device for chronically ill patients with diabetes or chronic heart failure, to monitor their health signs while at home and send the readings over the telemedicine device to the health-care provider. MedStar sends, over an ordinary phone line, the output of their blood pressure cuffs, glucose meters, etc. to their health care provider. This SBIR derived product has received FDA 510k certification.

MedStar is installed and used by elderly patients nationwide, including many in Northeastern Oklahoma. The visiting nurses from Integris Health, Oklahoma City, use this SBIR product to care for patients with slow healing wounds (a common complication of diabetes) in more than thirty rural Northeastern Oklahoma towns: Miami, Blackwell, Tonkawa, Custer City, Madill, Alva, Ponca City, Clinton, Cherokee, Enid, Waynoka, Quapaw, Kaw City, Ringwood, Hennessey, Lahoma, Leedy, Deer Creek, Eakly, Pond Creek, Weatherfor, Billings, Hinton, Fairview, Elk City, Nardin, Hydro, Bison, Carrier, Arapaho, Medford, and Braman. The visiting nurses who care for these Oklahoman patients can provide more frequent supervision via MedStar. MedStar, a SBIR product, enables better health care for senior citizens.

The Army's Defense Ammunition Center (DAC) in McAlester, Oklahoma selected Cybernet for a SBIR Phase III project, the Automated Tactical Ammunition Classification System (ATACS). It is a 6,000 lb custom-built machine that, vernacularly, "sorts bullets."

Defense Ammunition Center was called on by Camp Arifjan, Kuwait, to find a solution to a problem. There were large quantities of turned in small caliber ammunition to sort and inspect. If the process was done well, re-claimed ammunition could be utilized. The traditional method is to pick up one piece of ammunition at a time and visually inspect and sort it for dings, dents, rust, etc. This operation separates illegal (hollow points, AK47 rounds, etc.) from legal rounds and good rounds from bad ones (presumed to not meet the Army's specifications). This operation was being done in a completely manual fashion by hand!

Cybernet's solution for DAC started as an Army SBIR. That SBIR technology was to automatically identify ordinance as it is loaded into a non-line-of-sight (NLOS) mortar. It is critical for battle effectiveness and soldier safety that weapons that can be used to launch many different types of ammunition be loaded with the correct ordinance. If mistakes are made in the loading process, the outcomes can be very bad.

The Army DAC in McAlester asked if Cybernet could adapt its SBIR ordinance identification technology into a very high-speed (100,000 rounds in an 8 hour shift) inspection and sorting machine. We evaluated the specifications and said yes. Based on the prior SBIR technology, combined with Southeast Michigan automotive parts handling automation, we put a machine in Kuwait in 60 days. The entire company participated in putting an enormous amount of energy into getting the job for DAC done, re-doubling, tripling, doing what it took, to get that job done in the short time span in front of us.

This machine has saved the Army over $25 million in 4 months of operation based on deferred costs savings alone. It helps to put our soldiers in the field instead of overseeing back lot operations. One machine is in operation today in Kuwait, and a second one is at DAC in McAlester, Oklahoma.

This successful SBIR project highlights the benefits small agile businesses bring in innovation, cost efficiency and speed to the military.

SBIR solely enabled these results. Surely defense technology base readiness is improved by having SBIR companies ready to meet challenges quickly and efficiently. Cybernet's SBIR products provide benefits to a range of citizens, military and civilian. It allows small, agile, technically capable businesses to do what larger businesses do not want to do. It also directly generates good new jobs.

SBAM
Small Business Association of Michigan

Senate Committee on Homeland Security & Government Affairs. Subcommittee on Federal Financial Management, Government Information, and International Security.

Testimony presented April 6, 2006 by Barry Cargill, Vice President for Government Relations of the Small Business Association of Michigan regarding the effectiveness of the Small Business Administration.

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Chairman Colburn, Senator Levin and members of the Subcommittee, on behalf of the Small Business Association of Michigan (SBAM), thank you for the opportunity to submit testimony into the record regarding the effectiveness of the Small Business Administration (SBA).

It has been brought to our attention that this issue may have been placed onto today's agenda as part of a planned effort to abolish the SBA. In that regard, SBAM strongly supports continuation of the SBA and the critical small business services it provides. I would also like the record to reflect our appreciation to Senator Levin for informing the small business community of the subject of today's hearing and the work he does for Michigan.

Before I comment on our support for the vital services of the SBA, let me first express concern regarding the subject of today's hearing. We are strong in our belief that the issue of abolishing the SBA is not appropriate jurisdiction for the Subcommittee on Federal Financial Management, Government Information, and International Security. Neither do we believe the subject is appropriate jurisdiction for the Senate Committee on Homeland Security & Government Affairs. This committee serves a vital role in the security of our country and we suggest that today's subject does not respect the purpose for which the committee was established.

The SBA provides important services for Michigan's small business community. Three specific examples are the 1) 7a loan program, 2) advocacy and research support of the SBA Office of Advocacy and 3) critical funding for the Small Business & Technology Development Centers.

7 a Loan Program. The 7a program provides a loan guarantee program that permits small businesses to qualify for business financing when conventional financing is unavailable

Office of Advocacy. The SBA office of Advocacy provides small business research and advocacy for small business. Of particular benefit is the advocacy support in forcing the government to comply with the Federal Regulatory Flexibility Act. Small business pays as much as $7,800 per employee to comply with federal regulations. The Office of Advocacy not only calculated the cost of federal regulation but also through its efforts has substantially reduced regulatory costs and fights side by side with the small business community to reduce unreasonable regulation at all levels of government.

The Small Business & Technology Development Center (SBTDC). The SBTDC network is funded by the SBA and provides vital services to start up small businesses that are unavailable or unaffordable to them in the private sector. Due to the assistance of the SBA funding for SBDC's, hundreds of small businesses are growing and creating jobs in Michigan.

In regards to the American Enterprise Institute for Public Policy Research. We agree with the reports contention that gazelle small businesses are responsible for leading the small business segment in creating jobs. SBAM works closely with start up companies to access federal research grants to commercialize research into fast growing companies. Gazelle's pay an important role in job creation. Where we differ with the report is our belief that "Main Street" and start up businesses establish a critical foundation to Michigan's economic recovery. The SBA and its programs are an important economic investment regardless if a business is a corner hardware store or a high technology venture.

Michigan is facing a fundamental change in our economy with the loss of manufacturing jobs. When you exclude the state of Mississippi and Louisiana, which suffered hurricane devastation, Michigan leads the nation in unemployment and lost manufacturing jobs. Small business is rebuilding our state economy and the services of the SBA are necessary to keep our re-growth on track. Thank you for this opportunity to express the support of the small business community in Michigan for the SBA and its effective programming.

Constituent

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Web Mail Message

Web Mail Subject: cf_email issue

Regarding: issue

Response: Yes

Dear Senator Levin,

As you prepare for your upcoming hearing, "The Effectiveness of the Small Business Administration," I would like to comment on the report, "Are Small Businesses the Engine of Growth?" by one of your scheduled witnesses, Veronique de Rugy.

As a small business owner and a member of the Small Business Association of Michigan I resent the remarks made by the author of the article submitted to Forbes Magazine. Michigan currently faces economic hardships in major manufacturing not felt by the rest of the country. As Michigan faces the challenges put forth by these economic hardships, I know it will be small business owners who will serve as the "Engine to Economic Growth and Recovery."

Many small and start-up businesses may lack the assets necessary for a traditional bank loan, forcing many to use credit cards, along with their traditionally high interest rates, as their primary financing tool.
Additionally, the majority of small business loans being made are less than $150,000. This relatively low dollar amount is generally less profitable for banks and typically has higher default rates, thus exacerbating the problem small businesses face.

It was because of these many problems small businesses faced in getting needed capital that the SBA was formed more than 50 years ago. In fact the flagship program for the SBA has traditionally been the 7(a) loan guarantee. Due to a calculation flaw in determining the subsidy rate, small businesses actually overpaid in fees, netting the U.S. treasury more than $1 billion since 1992.

Another challenge small businesses face is in navigating the complex web of federal regulations. Small business faces a 45-percent greater burden than their larger business counterparts. By their very nature, unnecessary federal regulation and paperwork burdens discriminate against small businesses. Without large staffs of accountants, benefits coordinators, attorneys, or personnel administrators, small businesses are often at a loss to implement or even keep up with the overwhelming paperwork demands of the federal government.

Senator Levin, I would like to ask you to submit my remarks to the record of the committee and it's Chair. Thank you for your time and support.

RESPONSES TO QUESTIONS FROM MR. BARRETO

Hector Barreto, Administrator, SBA

SBA Strategic Goals

1. **SBA strategic goal 2.1.3 seeks to see SBA-assisted start-up businesses be more successful in their first year than un-assisted businesses. Why is only one year being tracked? Since loans extend for longer than one year, shouldn't SBA track businesses over the life of the loan?**

   Response: The one year target was selected to measure the initial impact of the SBA assistance. It was also selected because statistical data is available about the success of small businesses one year after their creation. However, the Urban Institute is currently performing a study of the 7(a), 504, SBIC and Microloan programs. They are studying the performance of small business that utilized one of these programs at various time points after receiving the assistance. At the end of the study, a timeline for measuring the outcome will be selected.

2. **Strategic goal 2.2.1 works to "increase the number of existing small businesses receiving SBA assistance." Does this refer to increasing the number of loans? If so, why is it desirable that more small businesses receive guaranteed loans?**

   Response: Outcomes need to be read within the context of their corresponding Strategic Goal. Strategic Goal 2 refers to increasing the success of those small businesses not able to compete effectively because of opportunity gaps in the market. The outcome 2.2.1 as it refers to the SBA lending programs measures the increase of small businesses receiving guaranteed loans. However, as established by law, those loans would be only to businesses that meet the no credit elsewhere test.

3. **Strategic goal 2.2.4 states that, "By FY 2008, the number of SBA-assisted small businesses will exceed the national average rate for revenue growth by small firms." Wouldn't profitability be a better measure of success than revenue growth since many companies generate revenue without making a profit?**

   Response: Revenue generation is a more positive measure given that a company may be making little or no profit but still generate a lot of buying and selling in the economy. That revenue traffic reverberates throughout the economy creating more revenue generation. If you track only the most profitable companies you lose the benefits of the firms that are creating a supply and demand for goods.

   Additionally, when the SBA established its current Strategic Plan, it selected measures for which there was a reasonable expectation that a comparison group could be established. The current study being performed by the Urban Institute will establish which are indeed the proper outcomes by which to measure the SBA's impact. However, it should be noted that data availability has been a concern, revenue and receipts are obtained directly from the economic census in years ending in 02 and 07.

4. **Strategic goal 2.2.3 states that "For FY 2008, SBA-assisted small businesses will exceed the national average rate for job creation by small firms." Why do you feel that job creation is a good measure of success for SBA programs? Do you believe that government-induced job creation alone is an appropriate end for public policy?**

Response: Job creation is only one of the parameters for measuring success of the SBA programs. Regardless, the creation of jobs has an impact in the tax revenues and in the economy in general by augmenting the consumer base size. Since one of SBA's statutory functions is to maintain and strengthen the nation's economy, job creation is appropriately one of the SBA's performance indicators.

5. **Strategic goal 2.3.4 states that by FY 2008, small businesses helped by SBA will exceed the national average for survivability within two years of receiving assistance. How does survivability prove the success of the program?**

   Response: Since so many small businesses fail in the first two years, survivability is one of the best indicators that the SBA assistance is working. However, this outcome measure needs to be seen within the context provided by the corresponding Strategic Goal, Long-Term Objectives and other outcomes.

6. **Does SBA assistance help companies enter into the private credit market without needing SBA guarantees? In other words, how does SBA measure the future creditworthiness of companies that were assisted by SBA when they were un-creditworthy?**

   Response: SBA is exploring the possibility of tracking credit scores for a sub-sample of firms that have received financial assistance.

7. **Do you believe that it is appropriate to classify a business of 500 people as a "small business" when it is larger than 99.7% of all businesses in the country?**

   Response: SBA's size standards vary by industry depending on the characteristics of firms comprising the industry. For instance, an auto manufacturer is small by industry standards with 500 employees while a retail dress shop with that same number of employees would be considered large. SBA has established size standards for more than 1,100 industries. For most industries, the size standard is based on either number of employees or average annual receipts. The table below lists the most common size standards established by SBA. These six size standard levels apply to approximately three-fourths all industry size standards.

Industry Group	Size Standard
Manufacturing and Mining	500 employees
Wholesale Trade	100 employees
Agriculture	$750,000
Retail Trade	$6.5 million
General & Heavy Construction (Except Dredging)	$31.0 million
Dredging	$18.5 million
Special Trade Contractors	$13.0 million
Travel Agencies	$3.5 million
Business and Personal Services,	$6.5 million
Except:	
Architectural, Engineering, Surveying, and	$4.5 million

Mapping Services Dry-cleaning and Carpet Cleaning Services	$4.5 million

* Dollar Amounts are Reciept Figures

For some industries, 500 employees is an appropriate size standard to reflect the small business segment of an industry. Most firms in the economy are very small, with 20 or fewer employees accounting for almost 90 percent of all firms. The percent of firms is one way of evaluating size standards.

A more meaningful measure is the percent of industry sales generated by firms of varying sizes. While about 90 percent of firms have 20 or fewer employees, they cumulatively generate less than 14 percent of total sales. For the economy has a whole, firms with 500 or fewer employees generate about 39 percent to total sales.

SBA gives considerable weight to the cumulative sales generated by firms of varying sizes, along with other relevant industry characteristics, in evaluating an appropriate size standard for an industry. This statistic varies significantly among industries, and consequently, influences the size standard SBA establishes for a particular industry.

8. **When will SBA be changing its size standards to not include a business of 500 people?**

   Response: A 500-employee size standard applies primarily to firms engaged in manufacturing and mining. SBA periodically reviews size standards and makes adjustments as supported by analysis of an industry's characteristics. SBA rarely receives a request from the public to indicate that a 500-employee size standard is inappropriate for these industries.

9. **One of SBA's key statutory missions is to "maintain and strengthen the nation's economy" [15 U.S.C. §631(a)]. How do you measure whether or not SBA is achieving this mission?**

   Response: The SBA measures it success in achieving its mission by measuring its contribution to the creation and success of new businesses, and to the success of existing ones.

10. **Specifically, how do you link your agency's outputs (ie – number of loans helped, number of contracts awarded, etc.) to the success of the economy? What economic indicators do you use, and what is the peer-reviewed, literature-supported link between the outputs and your indicators?**

    Response: Any SBA program that establishes an output to measure its performance, needs to establish a linkage of the output to any of the Agency's outcomes (jobs, revenue and longevity). This is done through the use or Data Validation Tables. These tables can be found in the CD included in the FY 2006 Performance and Accountability Report. The study being conducted by the Urban Institute has as one of its objectives the formal and systematic evaluation of the linkages of the outputs to the outcomes and of the outcomes to the impact of the Agency in the economy.

11. **Does SBA link its goals and results to its operating costs? How so?**

Response: Yes, SBA does link its goals and results to its operating costs. Through use of its activity based costing model, SBA measures the full costs of its programs including direct, indirect, and overhead costs. These costs can be found on pp. 21 -22 of SBA's FY 2008 Congressional Budget Submission. These costs are linked directly to performance goals in the tables which appear in our Performance Plan (see pp. 28 – 108). For example, on page 51 of the Budget, the performance goals (actuals for the past, goals for the current and budget year) for Financial Assistance Programs (e.g,. 7a, 504, Microloans, etc.) for small business start-ups can be found. Page 52 shows the resources devoted to achieving these goals. The resources also show unit costs. For example, on p. 52, on the fifth line of the table, you can find the cost of funding one 7a loan. In FY 2002, that cost was $3,545. In FY 2005 that cost was $559. The same information appears for other financial assistance programs in the same table. Other tables provide that information for technical assistance and procurement programs.

12. **What reforms are you seeking as part of your reauthorization package?**

    Response: A copy of SBA's Statement of Needs and Purposes of the Legislative Package is attached for your review.

13. **On your Executive Branch Management Scorecard, the SBA gets a "RED" for "financial performance." Can you explain this?**

    Response: In order to achieve a yellow or a green on financial performance, an agency must have a clean audit opinion with no material weaknesses. SBA's FY 2005 audit opinion was in fact clean, a major improvement over FY 2004, which was qualified. In FY 2004 we had two material weaknesses. In FY 2005, we reduced that to one weakness – in financial reporting. SBA has an audit remediation strategy, which includes addressing each of the items cited by the auditors which together created that material weakness. Our plan is to eliminate that material weakness in FY 2006.

14. **In your latest Program Assessment Rating Tool (PART), SBA programs scored high in purpose, but low in results. Can you explain why SBA received a 53% in the 'Results' column for its 7(a) Guaranteed loan program?**

    Response: The 7(a) program is currently undergoing a program evaluation, which should provide the information required to improve its score in this section.

15. **Why did SBA get a score no higher than 67% in any category in the results column?**

    Response: The SBA is undergoing systematic independent evaluations of its programs. As these evaluations are concluded, the necessary data will be available to improve these scores.

16. **At the hearing, you disagreed with various portions of the testimony given Dr. Veronique de Rugy, Research Fellow, American Enterprise Institute. Please provide as detailed a response to her testimony as you feel is necessary to support your objections to her research with documented refutation of her analysis.**

    Response: The SBA does not wish to further respond to Dr. de Rugy's testimony at this time.

7(a) Program

17. **Do you believe that there is a market failure in the credit market demonstrating the need for the government to step in and provide loan guarantees for small businesses? If so, please provide a detailed analysis to support your conclusion.**

    Answer: The SBA believes that the 7(a) program addresses a demand for credit from small businesses that is not being addressed by the private sector. The evidence is the approval of almost 100,000 loans to small businesses in FY2005. There are no taxpayer dollars used to fund the losses in this program. The losses experienced in the program are funded by fees that are paid by the small businesses receiving loans. Clearly, if credit was available on a conventional basis, these small businesses would choose not to pay the SBA fees and obtain credit without the benefit of the Section 7(a) program. Additionally, in accordance with the statutorily required "no credit elsewhere test," lenders are required to certify that they would not lend to those small businesses without a SBA guaranty.

18. **The SBA Inspector General has serious concerns that 7(a) loans are made by private lenders with little or no oversight by the SBA. What reforms are you putting in place to resolve these concerns?**

    Answer: SBA established the Office of Lender Oversight in 1999 for the purpose of supervising SBA participating lenders. This office performs reviews of the SBA guaranteed loan portfolios of participating lenders. Lender Oversight acquired loan and lender monitoring services from Dun and Bradstreet two years ago. GAO, in an audit of the services obtained, noted that the risk analysis program being implemented at SBA represented industry best practices in the field of risk management. The services also include a predictive model that shows the relative level of risk that each lender that participates in SBA's 7(a) and 504 loan programs. SBA is in the process of formalizing a regulatory framework that includes disciplinary actions against those lenders that are not using the program properly. We believe that the current measures in place and those that will be implemented in the next several months will provide SBA with a first rate lender oversight program.

19. **If you discovered that SBA's calculation for loan fees was incorrect and did not cover defaults, would you recommend increasing fees or returning to a taxpayer subsidy?**

    Answer: The Small Business Act requires that the fees for the 7(a) program cover anticipated losses. If SBA discovered that the calculation was incorrect, it would either increase or decrease fees (depending on the direction of the error) or make program changes that would bring the program back to a self funding level.

Contracting Programs

20. **What is the economic rationale for setting aside 23% of all federal prime contracts for small businesses and/or "disadvantaged"?**

    Response: Section 15(g)(1) of the Small Business Act establishes statutory goals not set asides.

21. **Given our nation's $600 billion deficit this year, is it economically justified to allow any factor other than best value to trump in the contracting process for almost a quarter of the government's business?**

    Response: Section 15(g)(1) of the Small Business Act establishes statutory goals not set asides.

22. **The SBA Inspector General has repeatedly issued warnings to SBA because contracts intended for small businesses keep going to medium and large businesses. What is SBA doing to resolve this problem?**

    Response: To date, SBA's ongoing review of the underlying data shows that the firms identified by the studies hold contracts awarded to legitimate small businesses that grew or were acquired by large businesses over the life of the contract.

    - SBA size rules state the size of a business is determined at time of award, because it is SBA's hope that government contracts will help these businesses grow, and because the agencies did award the contracts to small businesses without knowledge of what mergers or acquisitions might take place in the future. However, SBA size rules also require businesses that received contracts as small businesses and then need to novate their contracts, usually due to being purchased by another firm, to recertify their size.

    - SBA implemented an automated logic model that reviews a registrant's small business status based on the NAICS codes supplied by a firm when profile information is entered into or revised in the Central Contract Registry (CCR). This logic performs comparisons of the employment and revenue information entered into CCR by the firm against the size standard for each NAICS code to determine which NAICS codes the firm qualifies as a small business. Firms are required to update this information annually. Failure to do so results in the firm being dropped from CCR.

Regulatory Assistance

23. **Why is SBA setting its regulatory assistance goals for FY2006-07 at lower levels than have been achieved in the previous four years?**
    Advocacy's goals were established as part of a 5-year plan in 2002. The cost savings goal, which cannot be predicted with any accuracy from one year to the next, is purely an estimate. We averaged the first three years cost savings were calculated, subtracted outliers, and we have a goal of a 10% annual increase. One year, our intervention in a single EPA rule resulted in $18 billion in cost savings, but that was clearly an outlier. Because we have no control over the cost of regulations agencies propose from year to year, or whether our intervention will result in savings, we can only provide an estimate. Frankly, savings may decrease if agencies begin to institutionalize the Regulatory Flexibility Act training provided by our office. That is, if agencies proposed better rules in the first place, the cost savings may decrease.

    Advocacy has a goal of having all 50 states consider regulatory flexibility legislation or executive orders. That process is ahead of schedule, and since there are a finite number of states, fewer states are included in Advocacy's goal for 06-07. The same is true of

Advocacy's goal to train agencies to comply with the Regulatory Flexibility Act. Advocacy identified 66 federal agencies that promulgate regulations which impact small businesses the most. The remaining agencies will be trained by 06-07.

Advocacy has a goal of inserting its research into the curricula at 80 of the top 100 universities with major entrepreneurship programs. The top 100 were identified in Entrepreneurship magazine and used for our goaling purposes. Advocacy set a goal of 16 universities per year for 5 years, and we are on target for achieving our final goal.

Advocacy has a new goal of producing 25 research reports annually. This number was recently increased from the original goal of 20 because additional in-house reports are produced on a regular basis, including a quarterly indicators document which is published 4 times per year and lists data from different government and private sources relevant to small business. Most of Advocacy's research is contracted out through a competitive process. The number of reports produced annually depends on Advocacy's annual budget and the type of research produced. If a survey is involved, then the research tends to be much more expensive and fewer research solicitations are issued that year.

24. **Why does SBA dedicate little more than 1.5% of its budget to advocacy efforts that result in meaningful regulatory assistance to *all* small business? Would SBA be able to achieve more regulatory assistance for small business if more of its budget were dedicated to the task?**

SBA has budgeted almost $10 million for it's advocacy program for FY 2007. As to whether Advocacy could achieve more regulatory assistance if our budget were increased, it is difficult to answer that question. Perhaps the office could produce additional research reports and speed up accomplishing some of its goals, but small business cost savings may or may not increase as a result of increasing Advocacy's budget. As previously discussed, cost savings cannot be predicted with accuracy. Currently, Advocacy is nearly fully staffed for the first time in a number of years. As such, the office has been able to work with great efficiency toward providing regulatory assistance for small businesses, within its budget of $10 million.

RESPONSES TO QUESTIONS FROM MR. SHEAR

GAO Responses to Followup Questions
Hearing on Small Business Administration (held 4/6/06)
Subcommittee on Federal Financial Management, Government Information and International Security
Senate Homeland Security and Governmental Affairs Committee

1. Has GAO work identified a market failure in the private credit market that would indicate the need for government intervention on behalf of small businesses?

GAO response: We have not conducted work that addresses this issue; however, we are aware of studies that have focused on whether inefficient rationing of small business credit has occurred. We would welcome the opportunity, if requested, to address this issue.

2. As you know, part of SBA's statutory mission is to "maintain and strengthen the nation's economy" (15 U.S.C. §631(a)). Does SBA have measures in place to indicate if it is accomplishing that central goal? Are the measures adequate?

GAO response: As discussed at the hearing, we have not conducted work recently addressing how well SBA has fulfilled its mission. Again, we would welcome the opportunity to address this issue if requested.

3. Is SBA's mission statement something that can reasonably be measured, or is it too vague?

GAO response: Broadly addressing this question could be related to, among other considerations, whether SBA's programs address any potential failure in the market for small business loans and how well SBA fulfills its statutory mission. We recognize there are challenges in establishing meaningful outcome rather than output measures for SBA's programs. If requested, we would welcome an opportunity to address these issues.

4. Does the head of the Office of Capital Access review the performance of the head of the Office of Lender Oversight? Does this arrangement pose a challenge to the independence of the Office of Lender Oversight?

GAO response: The deputy head of the Office of Capital Access appraises the performance of the head of the Office of Lender Oversight (OLO). SBA's Chief Operating Officer serves as the reviewing official for the rating of the head of OLO. This arrangement could pose a challenge to the independence of the OLO, however, as mentioned in my written statement submitted at the hearing (page 6), SBA has taken several steps to address our previous recommendation that SBA make lender oversight a separate function from the Office of Capital Access (OCA). For example, SBA established a Lender Oversight Committee (comprised of a majority of senior SBA officials outside of OCA) with responsibilities for reviewing reports on lender-oversight activities; OLO recommendations for enforcement action; and OLO's budget, staffing, and operating plans. While these measures appear to provide the opportunity for more independence for OLO, we have not evaluated how the measures are actually working. Therefore, we do not know the extent to which the performance review arrangement poses a challenge to the independence of the Office of Lender Oversight.

GAO response to questions 5 – 11: We have not done work to address or evaluate policies or procedures regarding liquidations under the 7(a) or 504 loan programs, but would be pleased to do so if requested.

Loan Liquidations - 7(a) Guaranteed Business Loan Program

5. How are loan liquidations managed under the 7(a) program?

6. Do you know what the average recovery is for a 7(a) loan liquidation?

7. Does the SBA have the policies and procedures in place to maximize recoveries for 7(a) loans that are guaranteed by the Taxpayers?

Loan Liquidations - 504 Certified Development Company loan program

8. Please describe the process for liquidating 504 loans that are in default.

9. Which party - the bank or the SBA - recovers its losses first?

10. Can you describe the process SBA follows after a 504 borrower goes into default?

a. If recovering from the second position, what steps should the SBA take to ensure it recuperates losses?

b. If the lender recovers in excess of what it is owed from the borrower, is the lender obligated by law to turn the excess over to the SBA?

11. What is the average recovery on a 504 loan that goes into default?

RESPONSES TO QUESTIONS FROM MS. DE RUGY

Dr. Veronique De Rugy, American Enterprise Institute

1. You have contested the SBA's use of data from the Bureau of Labor Statistics to show that small businesses created 65% of all jobs over the previous decade. Can you explain why you object to SBA's methodology in this regard?

Labor economists have shown that this oft-quoted SBA claim is a meaningless statistic that relies on analytical and statistical fallacies. One problem is that it is calculated using *net* job creation, which obscures important dynamics. *Gross* job flow figures confirm that small businesses create a lot of jobs, but add that they also destroy a lot of jobs. Both gross job creation and gross job destruction rates are higher for smaller businesses. For illustrations of this and other problems with the SBA's calculation, please see my paper "Are Small Businesses the Engine of Growth?" at http://www.aei.org/publications/pubID.23537/pub_detail.asp.

2. Do you feel that job creation is a good measure of success for SBA programs? Do you believe that job creation alone is an appropriate end for public policy?

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.

3. What do you feel has been the impact of subsidies targeted at small, medium and large businesses?

Targeted policies tend 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.

4. Would you propose an alternative model to the current one with so many targeted subsidies?

Instead of preferential policies, the government can best help small business—and other segments of the economy—by creating an environment conducive to productive behavior. Policymakers should establish a tax and policy environment that encourages small and mid-size firms with strong growth potential to evolve into successful large enterprises. And they should establish an environment where firms of all size can thrive. This means low tax rates, low levels of regulation, and a stable legal structure that protects property rights.

No particular class of employers deserves special government handouts. To the extent that a preferential treatment—such as lower tax rate—has been identified as promoting the economic health of a given industry or a particular class of employers, then it would be reasonable to extend it to all classes.

5. In your research, what do you believe is the extent to which small businesses in general benefit from programs offered at the SBA? Who are the biggest beneficiaries of SBA programs?

The SBA's loan guarantee programs benefit a few at the expense of the many. Looking specifically at the SBA's flagship program, the 7(a) loan guaranty program, less than 1 percent of all small businesses receive 7(a) loan guarantees each year. The percentages for minority- and women-owned small businesses, which the SBA specifically targets, are not much higher. These small numbers of firms are advantaged over their competitors, who must pay the full market price for loans. Since most SBA-guaranteed loans go to highly competitive market sectors—75 percent of 7(a) loans go to the service, retail, and wholesale business sectors; 10 percent go to restaurants alone—any advantage can make a big difference to a firm's ultimate success. In effect, the government is picking winners. It does not make sense that a very small fraction of small businesses that are not creditworthy—who cannot prove to lenders that they will be able to make a profit—not only have the privilege of having the taxpayers stand behind them but also compete with unsubsidized firms in naturally competitive, healthy markets.

Since the SBA's assistance serves only a tiny fraction of the nation's small businesses and likely has a high cost for taxpayers, one must ask who is really benefiting from the loan programs. One major beneficiary is SBA lenders. The SBA does not provide loans directly; rather, borrowers have to apply to an SBA-certified bank.

On average, the government guarantees 80 percent of each loan made in the 7(a) program. Because of this high guarantee rate, banks bear only a small fraction of the responsibility for any losses from defaults. They therefore have a strong incentive to issue more SBA loans.

The first way banks benefit from SBA programs is that by participating in the SBA's guarantee programs, banks are able to increase their lending at the same profitability as the rest of their business.

The second is that when there is a default, the bank doesn't have to pay most of the cost. Even though SBA borrowers are more risky than others, the downside risk to the bank is only 20 percent of what it would be otherwise. In other words, even though business owners applying for SBA loans are intrinsically more risky than others, the loan guarantee might make the risk for SBA lenders lower for SBA loans than for traditional loans.

In addition, through the SBA's Secondary Market Program, lenders have other ways to reduce their risk even further and also to increase their lending capability. This program allows lenders to sell the guaranteed portion of SBA-guaranteed loans to investors. By doing so, lenders can improve their liquidity and free up more capital for new loans. 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.

The best evidence of the high profitability of SBA loans for lenders can be found on the website of the National Association of Government Guaranteed Lenders (NAGGL). NAGGL is a national trade organization comprised primarily of lenders participating in the 7(a) guaranteed loan program. NAGGL members originate approximately 80 percent of all 7(a) loans.

On the NAGGL website, one learns that "The 7(a) loan program can do much more than improve your CRA rating. Used properly, it can increase your profitability, liquidity, and competitiveness in the increasingly hostile battle to court the small business borrowers that tend to become big time accounts." The website adds that "For lenders, the 7(a) loan program has the potential to:

1. Increase the Size of Your Portfolio—The mitigated risk provided by federal guarantees allows you to comfortably expand your customer base by servicing a wider range of small business firms by offering long-term loans.
2. Increase Liquidity—7(a) loans can be readily sold on the program's healthy secondary market.
3. Increase Regulatory Loan Limits—Only the unguaranteed portion of an SBA loan counts against your regulatory loan limit per customer.
4. Increase competitiveness—The ability to offer terms as long as 25 years gives you a more desirable product line to offer prospective and existing customers."

In the end, this program amounts to corporate welfare for SBA-certified lenders while creating adverse consequences and increasing the risk to taxpayers.

RESPONSES TO QUESTIONS FROM MR. POINTER

John Pointer

1. In your opinion, what is the best thing the federal government can do to help small business owners? How about disadvantaged small business owners?

Subject: Response to Chairman Tom Coburn

Dear Chairman Coburn,

I will respectively decline to respond to the Chairman's first question. In all due respect to the Senator, I will only answer the question concerning small disadvantaged business and possible enhanced business development opportunities and relations. Federal programs have run astray with laxity within federal and state government agencies that administers as well as monitors these programs.

First, I disclaim the classification for business concerns of being identified by the federal government as socially, educationally and economically disadvantaged, just because my classification is listed as a Minority citizen.

And with my being a Whistle blower stopping well over a half of a billion dollars in two federal programs to aid disadvantaged businesses, it should be required that the federal government stops illegal use of wrongful actions such as retaliation.

The Small Business Administration (SBA) programs do a grateful harm to legitimate businesses that are annually adhering to all federal and lawful requirements that Congress and the Senate had originally set as mandates. If reports continue to display a low turnout of minority business participation to Congress and to the Senate, then they both could possibly move forward to proclaim that these types of programs are simply "pork barrels" or over expenditures.

I personally ask for financial restitution from the Chairman and the Sub-committee members with my actions to stop waste. Next, I ask that there be an oversight committee to be developed with experts from the private sector, such as myself. This committee would be heavily involved with the Senate's ongoing committees, especially with disaster relief that are highly critical issues, presently. And lastly, all federal government agencies' Office of Inspector General (OIG) should be more independent in monitoring these small and disadvantaged programs, both federal and state. I have often found that the OIG is more concerned of being a protector of the particular agency instead of acting as an independent investigator.

I thank you for your considerations and remain to be of public service.