United States Senate
COMMITTEE ON SMALL BUSINESS & ENTREPRENEURSHIP
WASHINGTON, DC 20510–6350

February 28, 2003

The Honorable Don Nickles
Chairman
Committee on the Budget
United States Senate
Washington, D.C. 20510

The Honorable Kent Conrad
Ranking Member
Committee on the Budget
United States Senate
Washington, D.C. 20510

Dear Don and Kent:

As the Ranking Democratic Member of the Committee on Small Business and Entrepreneurship, I submit the following views and estimates on the President's FY2004 budget request for the Small Business Administration (SBA or Agency) and other matters under the Committee's jurisdiction in compliance with section 301(d) of the Congressional Budget Act.

<u>FY2004 Budget Request Overview</u>

The Administration has requested $798 million for the SBA's FY2004 budget. This request is equal to last year's; however, it is not level funding of the Agency's programs and expenses. In fact, for the third year in a row, the SBA's core small-business programs are inadequately funded, significantly cut, or all together eliminated, while the Agency's administrative expenses have increased. To adequately fund those core programs, the budget is short about $117 million.[1]

Of the four accounts through which the SBA is funded, I am particularly concerned about the budget requests for loans under the Business Loans Program Account and for entrepreneurial development programs under the Salaries and Expenses Account.

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[1] $32 million for 7(a) Guaranteed Loans; $1.4 million for microloans; $20 million for microloan technical assistance; $15 million for PRIME; $7 million for BusinessLINC; $2.5 million for Women's Business Centers; $2 million for Native American Outreach; and $37 million for Small Business Development Centers = $116.9 million).

Business Loans Program Account

The request of funding to support $9.3 billion for the SBA's largest lending program, known as the 7(a) Loan Guarantee Program, is a vast improvement over the 57-percent cut requested for FY2003, but it is unrealistically low when compared to the past two years of lending activity and the projected volume for this year. The request repeats the funding "schemes" that the Conferees to the FY2003 Omnibus Appropriations Act opposed in the Conference Report, noting that it has left SBA "depend[ent] on [Congressional] solutions of separate authorization and appropriation measures," solutions which would not have materialized without the support of your Committee.

In review:

For FY2002, the Administration requested a reasonable 7(a) Guaranteed Loan program level of $10.7 billion, but to fund it proposed eliminating all appropriations and shifting the cost to borrowers and lenders through increased fees. This was an unworkable solution because the existing borrower and lender fees were already too high, the result of a seriously inaccurate subsidy rate. To adequately fund this critical small business lending program, and to treat its participants fairly, Congress was forced to increase the requested appropriation by roughly $100 million and to pass legislation to reduce the fees to a fairer level until the SBA corrected the subsidy rate model. Congress also had to establish and fund a separate emergency 7(a) loan program, called the STAR program, to complement the SBA's Economic Injury Disaster Loans in order to help small business victims of 9/11. Combined, $11.1 billion was loaned to more than 51,000 small businesses through 7(a) regular and STAR loans.

For FY2003, the Administration requested a program level of $4.85 billion, amounting to, as noted above, a 57-percent cut in loan dollars available to small businesses and 15 percent less in budget authority. These severe cuts to the 7(a) Loan Guarantee program had two causes: 1) the SBA did not adjust its request to accommodate the Congressionally mandated fee reductions passed the previous session, and 2) the Agency did not adequately correct the continually erroneous subsidy rate as promised to Senators Domenici and Bond, then members of the Senate Budget Committee, and instead used a dramatically increased subsidy rate of 1.76 percent for the budget request. To stretch the inadequate funding, SBA contended it could continue to serve the same number of small businesses in need of financing with large sums of carry-over and a variety of over-simplified programmatic changes, such as steering real estate loans from the 7(a) program to the 504 program and making smaller loans. As the FY2003 Omnibus Appropriations Act Conference Report notes, these schemes never materialized. To keep from running out of money, SBA put a cap on loan size, reducing from $2 million to $500,000 the maximum amount each small business could borrow. This exacerbated the rationing of capital in the private sector and prevented some small businesses from expanding and creating new jobs. In spite of the cap, loan volume for FY2003 is running ahead of the FY2002 pace, now estimated to be $11.8 billion when combined with 7(a) STAR loans, far greater than the $4.85 billion requested.

Given that SBA's programs are counter-cyclical, growing in demand when the economy is weak and the private sector is tightening or rationing credit, it is not surprising that the projected demand for 7(a) loans in FY2004 is up to $12.5 billion; small businesses need access to long-term loans because their monthly payments are lower, enabling them to manage in leaner times. To adequately address the projected demand for small business capital in FY2004, and to keep from repeating the problems of the past two years, particularly implementation of another loan cap which has a negative impact on the subsidy rate, I respectfully request an additional $32 million, for a total $127 million, to support a program level of $12.5 billion in 7(a) loan guarantees to small businesses.

I have two additional concerns about the 7(a) Loan Guarantee Program: 1) the Agency's apparent inaction on the application of the new econometric subsidy rate model to the 7(a) STAR loan program, and 2) the Administration's lack of cooperation with Congress and the General Accounting Office (GAO) in our efforts to review and verify the model. The STAR program is a 7(a) loan program. Therefore, when Congress passed S. 141 on February 11, 2003, allowing the Administration to use the new econometric model in the FY2003 budget retroactive to October 1, 2002, it intended for the model to be applied to both the regular 7(a) program and the 7(a) STAR program. The purpose was to put in place as soon as possible a more predictive model that would calculate a more accurate subsidy rate, leading to more reasonable fees for borrowers and lenders and freeing up much-needed budget authority that could be used to fund critical small business loans for the balance of this fiscal year or carried forward and made available for much need capital next year. To date, neither the SBA nor the OMB have responded to inquiries from the Senate Committee on Small Business and Entrepreneurship and the small business community regarding application of the econometric model to the STAR program. I ask for your support and help in achieving the intent of S. 141: implementation of a revised score for the STAR program using the new subsidy rate model as of October 1, 2002. I also ask that you join me and the bi-partisan leadership of the House Committee on Small Business in urging the Administration to cooperate with GAO in its review of the econometric model. While the post-econometric model subsidy rate seems more reasonable, and we appreciate the work of the SBA, the OMB and the Office of Federal Housing Enterprise Oversight (OFHEO) on the model, withholding information from the GAO, the Congress and the public about how the model was developed creates questions about the accuracy of the model and the methods used to develop it and perpetuates the serious lack of trust between SBA and the small business community. Further, the public deserves to know what it paid for.

Also problematic is the FY2004 budget request for the SBA's direct microloan program level of $17 million, down from $26.5 million requested last year and almost $29 million provided for in the FY2003 Omnibus Appropriations Act Conference Report. The budget authority required to fund these levels is very little, and yet, for the second year in a row, the SBA has requested more money for its travel budget than for microloans. The FY2004 request is a 36-percent cut compared to last year's request and a 42-percent cut compared to what was provided for in the FY2003 Omnibus Appropriations Act Conference Report. These cuts represent a serious disconnect between the SBA's historical goal of making more small loans and reaching more women and minorities.

On February 26, 2003, SBA Administrator Hector Barreto testified before the House Committee on Small Business that the FY2004 "budget proposal demonstrates that SBA, in line with the President's management agenda, is looking for ways to serve the Nation's small businesses more efficiently and to ensure economic security by creating jobs." He then went on to say that the SBA is focusing on smaller loans because a report by the Department of Labor found loans of $14,000 create more jobs than larger loans. However, the FY2004 SBA budget drastically cuts the very program that makes the smallest loans, averaging $12,000. The SBA justifies the cut by contending it can accommodate the same borrower through the less expensive 7(a) program. What this analysis does not include, and what the budget document neglects to disclose, is that 7(a) lenders themselves refute the contention that their loans are appropriate for the very small microloan borrowers who often lack experience with credit and that the microloan subsidy rate is inaccurate. Last year, even though the program had not experienced any loss of direct loan funds since its creation in 1992, the microloan subsidy rate doubled from 6.78 percent to 13.05 percent.

Conventional sources of business credit, such as bank financing, are often beyond the reach of microentrepeneurs, and the SBA's microloan program successfully fills a critical role in solving this problem by funding community-based intermediaries to gain access to credit for the nation's smallest businesses. I certainly support efforts to reasonably reduce program costs, but this is nothing more than another problematic funding scheme, and it sends the wrong message to the women, veterans, African-Americans and Hispanics who are the main borrowers of SBA microloans. Further, on page 25 of SBA's budget, the Agency itself supports the need for increased, not decreased, microloan funding: "The demand for microlending has increased because of the weakening economy and the increased awareness among potential entrepreneurs of the benefits of this program." Consequently, level with my request of last year that was included in the FY2003 Budget Resolution, I respectfully request an additional $1.4 million for a total $3.34 million in order to fund a microloan program level of $35 million. I also request your support in directing the SBA to develop a more accurate subsidy rate model for its microloan program in time for the FY2005 budget submission.

Unfortunately, the SBA's inaccurate subsidy rates undermine not just the SBA microloan program, but most of the Agency's lending and investment programs, making for an inefficient appropriations process, tying up scarce lending dollars, and significantly overcharging small-business borrowers and lenders through excessive fees. Last year our committees were forced to address this issue and worked closely to correct the subsidy rate models for both the 7(a) Loan Guaranty Program and the 504 Lending Program. Though we tried to pass legislation through the various continuing resolutions and S.3172 in order to improve the 504 subsidy rate model by using correct data and to direct the Administration to develop a better model, our efforts were blocked. In the Committees' negotiations with the Administration, we were told that, unlike its efforts with respect to the 7(a)loan program, the SBA could not develop a model for the 504 program in time to be used in the FY2003 or FY2004 budgets. However, the Agency committed to develop an econometric model to be used in the FY2005 budget, just as it did in a letter to Congressman Frank Wolf, Chairman of the House Appropriations Subcommittee on Commerce, Justice and State, dated February 15, 2002. The letter to Chairman Wolf also committed to developing an interim model for use in the FY2004 budget for the 504 program. The letter is attached.

SBA's FY2004 budget breaks those commitments: It does not include an interim change, and it changes the delivery date of an econometric model to FY06. This is unacceptable. Small-business borrowers and lenders have already paid more than $400 million in excess fees to participate in the 504 program because the subsidy rate is inaccurate. Delaying implementation by one year is estimated to cost the small business community at least $100 million in excess fees on loans approved in FY2005, which on an individual basis would amount to about $15,000 per loan. Small businesses in Oklahoma, North Dakota and throughout the country have much better uses for that money.

As you may know, the small business community was taken by surprise in the FY2004 budget hearing held before the House Committee on Small Business when Administrator Barreto said that SBA would not contract with OFHEO to develop the 504 econometric model because the Office was not "well-suited" to do it. This is the Agency's position despite the fact that it touted OFHEO's reliability and expertise in developing the 7(a) program's econometric model. This sudden rejection of their subsidy model expertise was alarming and raised further concerns about SBA's and OMB's lack of cooperation with GAO in reviewing the development of the econometric model for the 7(a) loan program. I thank you for your help and commend your tremendous progress on this issue last year. I also and ask that you once again work with our Committee to make sure the next subsidy rate model corrected for the SBA is for the 504 program.

The SBA's FY2004 budget fails to recognize the increased loan demand for the SBA 504 Loan Program, SBA's program to spur economic development by helping small businesses buy or expand their plants or equipment. The program is growing, up 30 percent in lending dollars, with the possibility that more small businesses could turn to this program if banks ration credit further. The small business community has requested an increase in the 504 authorization from the President's request of $4.5 billion to $5 billion. As you know, these loans have long terms and fixed rates, and cannot be used for working capital. It is a proven job-creation program that by law requires a business to create one job for every $35,000 loaned, and it is funded entirely through borrower and lender fees. Last year, small businesses borrowed $3.2 billion in SBA 504 loans and created an estimated 91,000 jobs. I strongly disagree with the SBA's budget proposal to merge this program with the 7(a) program, on the allegation that it is duplicative, and request that the budget resolution recognize the value of this assistance and increase the program level from $4.5 billion to $5 billion for FY2004.

Salaries and Expenses Account

For the third year in a row, the SBA budget request for non-credit programs and initiatives provided for under this account is not adequately funded, contradicting statements throughout the budget and the SBA Administrator's recent testimony before Congress regarding the correlation between small business success and access to training and counseling. These services become more important during a weak economy when managing a business becomes harder and the vulnerability to bankruptcy is higher. The budget references information from the Ewing Marion Kauffman Foundation and Dun & Bradstreet that indicates "80 percent of new businesses discontinue operation within five years because of lack of 'knowledge' of key business skills." Cuts to or inadequate funding of the SBA's entrepreneurial development programs are routinely attributed to vague and unfounded claims of duplication. Such claims mistake a common mission of training and counseling for duplication, ignoring the reality that small businesses vary greatly and have different needs. Just as it would be ineffective to only have one type of loan or venture capital financing structure for the 25 million small businesses in this country, it would be ineffective to water down specialized management and training programs to impose a one-size-fits-all approach.

These programs are cost-effective, returning much more to the economy in taxes and job creation than the Federal investment. Most of these programs have cost-sharing components with state and local entities, such as matching grants, so they leverage more for small businesses than the face value of the Federal grant. Moreover, where these small businesses have the SBA guaranteed loans, business training and counseling protects the taxpayer investment because the borrower is more likely to operate a successful business and to repay a loan. A good example is the SBA's Microloan Technical Assistance Program, which has a necessary and complementary technical assistance component and has had no losses to the taxpayer since the program was established in 1992.

Unfortunately, the FY2004 SBA budget request of $15 million for the technical assistance component of the microloan program is not adequate to meet the demand for assistance from micro-borrowers. If implemented, the FY2004 budget will once again have the effect of reducing access to microloans because without a sufficient ratio of lending to technical assistance, the lender's exposure becomes too risky and it cuts back or stops lending. To service borrowers with outstanding loans and also those seeking new loans, the SBA's Microloan Technical Assistance must be funded at $35 million. I, therefore, respectfully request an additional $20 million for SBA Microloan Technical Assistance.

As important as capital is to entrepreneurs, debt is not always the answer. According to the well-respected Aspen Institute, 90 percent of micro-entrepreneurs do not seek microloans but instead training, technical assistance and access to market services. The Program for Investment in Micro-entrepreneurs (PRIME) fills this need by providing grants to micro-enterprise development organizations to offer training and counseling to entrepreneurs, 50 percent of which must be used to help low-income entrepreneurs, regardless of whether they seek access to capital. For the third year in a row, the budget eliminates all funding for this program. I request the full authorized amount of $15 million for the PRIME program.

Other necessary non-credit programs for small businesses were cut or all together eliminated. For BusinessLINC I request $7 million, for Women's Business Centers I request $14.5 billion, and for the Small Business Development Centers I request $125 million. The Administration requested $88 million for the Small Business Development Centers(SBDCs) program. An increase of $37 million for a total $125 million in grants to states is substantial, but it is necessary to compensate for funding losses caused by the 2000 Census and to restore matching funds from the states. Twenty-four states have seen their Federal SBDC funding reduced. They did not lose funding because they had lost population but because the population in those states did not grow as fast as the national average.

Last year I supported the President's request of $1 million for Native American Outreach, and I am disappointed that this year the Administration eliminated all funding for it. With an average unemployment rate on reservations as high as 43 percent, it is inconceivable that one year of outreach is sufficient to have met our shared goal of building sustainable economic opportunities in those communities. In the FY2003 Omnibus Appropriations Act Conference Report, the Conferees provided $2 million for Native American Outreach and said in the Explanatory Report that they "expect the SBA to develop a strong outreach capacity with this initiative to ensure that underserved Native American tribes have the opportunity to participate in this program and other SBA non-credit and loan programs." Consistent with the level provided for in the FY2003 Omnibus Appropriations Act Conference Report, I respectfully urge you to provide $2 million for the Native American Outreach program in the FY2004 budget.

Separate from the training and counseling programs but still funded under the Salaries and Expenses Account, the Administration has requested a combined amount of more than $20 million to implement a plan to restructure the Agency's workforce and improve service to small businesses. While I support genuine, reasonable, and affordable improvements to the Agency, I do not support this plan in its current form and am skeptical of its cost-estimate because it has varied widely from $15 million to $55 million. Furthermore, the SBA should adequately fund its core small business programs before funding special projects.

Thank you for the opportunity to comment on the FY2004 budget request as it affects programs within the Committee's jurisdiction, and thank you for support of small business assistance, particularly all your help last year with the SBA's budget and subsidy rate problems. I look forward to your continued support and to working with you to develop this portion of the Budget Resolution for FY2004.

Sincerely,

John F. Kerry
Ranking Member