Does small business need government loan guarantees?

The SBA's Justification IOU

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The promotion of small business is a cornerstone of U.S. economic policy. There are about 25 million small firms in the United States, employing almost 50 percent of all workers. Given their share of employment and the influence that many small business owners have in their communities, small businesses attract considerable political attention to their common concerns.

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 business, are often used as the quintessential illustration of a market failure that necessitates government intervention.

Encouraging lending to small business 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. President Bush's latest budget designates $605 million for the SBA, including money for counseling and training, targeted at such subgroups as women, American Indians, veterans, and Spanish speakers.

In addition, the SBA hosts many special lending programs for small businesses that might not be able to get loans from regular banks. The credit programs are authorized to guarantee $28 billion in loans this year, promising repayment of up to 85 percent if the borrower defaults.

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With taxpayers on the hook for a total of $70 billion in guaranteed loans, one must ask whether SBA loan guarantees are desirable. Should the SBA remain in the banking, credit allocation, and subsidy business, or should those activities be terminated? 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 disrupting the market?

MARKET FAILURE?

All SBA loan guarantee programs rest on the premise that small business is denied adequate credit in the free market because of some market failure. In a perfect market, creditors would increase their prices to adjust for the higher risk of loaning to smaller firms, and in equilibrium, no small businesses would be left without access to credit. But the SBA asserts that U.S. capital markets are not perfect and small businesses cannot always get the capital they need to get started or to expand.

The most-cited sources of inefficiency are adverse selection and moral hazard. In their seminal 1981 paper "Credit Rationing in Markets with Imperfect Information," Joseph Stiglitz and Andrew Weiss 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.

Credit rationing is defined as "whenever a borrower's demand for credit is turned down although this borrower is willing to pay all the price and non-price elements of the loan contract." In other words, there is rationing when credit is allocated by means other than price.

Stiglitz and Weiss note that a bank's expected return depends on the interest rate it receives on the loan and the probability of repayment, or in other words, the riskiness of the loan. Yet, different borrowers have different probabilities

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of repaying their loans. If information about borrowers is difficult to acquire, then lenders have a hard time identifying borrowers who are more likely to repay. This, in turn, gives rise to adverse selection and moral hazard.

Adverse selection affects the ability of markets to allocate credit by price because it removes the lower-risk borrowers from the set of potential borrowers. The dynamic is as follows: High-risk borrowers are more willing to agree to a higher interest rate because they perceive that their probability of repaying the loan is lower than average. In other words, those borrowers are less creditworthy. If lenders offer an interest rate that reflects the average risk of all borrowers in the market, it will attract a large share of loan applicants from the high risk/less creditworthy pool of borrowers. Given this mix of applications, the lending rate is now too low and the banks' profits will suffer. The banks thus respond by charging a higher rate of interest.

However, increasing the rate will not solve the problem. As lenders raise loan prices, they discourage low-risk borrowers from requesting loans, and the borrower pool becomes riskier and riskier. In addition, moral hazard comes into play. Because a higher interest rate reduces the expected return for projects, it encourages high-risk borrowers to enter the credit market and encourages all borrowers to engage in riskier projects — ones with lower probability of succeeding but higher payoffs when successful. Thus, the average default risk of a lender's portfolio increases with higher loan prices. Stiglitz and Weiss therefore suggest that lenders in markets with high-risk borrowers have an incentive to ration credit rather than offer higher loan prices.

According to this theory, under such conditions — the inability of banks to distinguish between high- and low-risk borrowers — the demand for credit may exceed the supply in equilibrium. The traditional solution to this problem is to increase the price of loans (i.e., increase the interest rate), which would decrease the demand for credit. But because of the two effects outlined above, this does not happen in credit markets. Instead of increasing its rate, the bank will simply ration credit and worthy projects will be denied loans.

Advocates of the SBA argue that guaranteeing a portion of a small business loan takes on some of the risk and 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 to reduce the deadweight losses associated with not funding all worthy projects.

MARKET RESPONSES TO INFORMATION PROBLEMS

Stiglitz and Weiss's main conclusion stems from the asymmetry in information between lenders and borrowers. But if that is the case, it seems that a better solution to the information problem would be a mechanism to reduce this cost, rather than one involving government becoming a supplier of capital.

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. 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.

LENDING RELATIONSHIPS One of the mechanisms that have emerged to address the information problem in capital markets is the development of "lending relationships" — familiarity, through experience, between lenders and borrowers that gives lenders a better appreciation of the borrowers' creditworthiness. In a 1965 article, Edward Kane and Burton Malkiel develop a theoretical model that describes the possibility of credit rationing but also the power of relationships to overcome rationing. Borrowers with a longer history with the bank, larger accounts, and greater expected account growth are less likely to be rationed. When evaluating long-time clients, banks will consider not only their immediate creditworthiness, but also the potential lost profits from damaging a good relationship.

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 the client already has a checking account at the bank. The information from a 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.

Using data from the National Survey of Small Business Finance, Mitchell Petersen and Raghuram Rajan (1994) find that lending relationships increase the availability of credit to small firms and have a small effect on the price of credit. Using the same data, Allen Berger and Gregory Udell (1995) find that, for bank lines of credit, small firms with longer banking relationships borrow at lower rates and are less likely to pledge collateral than other small firms. This result suggests that, over time, banks learn more about their clients and then use that information as they make loans. Finally, Rebel Cole (1998) uses richer and more recent data and finds similar evidence for the importance of relationship lending. Lenders are more likely to extend credit to borrowers with whom they have a pre-existing relationship, but, in contrast to the other studies, the length of the relationship does not matter.

CREDIT SCORING Another way to help overcome the information asymmetry in lending is credit scoring, which is more often used by larger banks. Credit scoring involves taking information from a credit applicant and using statistical methods to generate a numeric score that predicts the applicant's propensity to default or become delinquent. The data

collected may include an applicant's monthly income, outstanding debt, financial assets, length of time at current job, previous loan record, and home ownership. Credit scoring 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.

Credit scoring has been widely used for a long time in consumer lending, especially credit cards and mortgage lending. But its use in business lending is a more recent development. It was first used in small business lending in the early to mid-1990s.

The evidence suggests that credit scoring has increased the availability of credit to small firms. For instance, research by Allen Berger, Scott Frame, and Nathan Miller (2005) suggests that small business credit scoring is associated with increased small business lending, higher loan prices, and greater average loan risk. Their interpretation of these findings is that scoring increases credit availability primarily for relatively risky borrowers who will pay relatively more for loans.

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.

THE NOT-SO-RATIONED CREDIT MARKET

More importantly, a growing body of research has challenged the belief that credit rationing makes it difficult for small businesses to obtain capital. A series of papers (most forcibly in several papers by David de Meza and David Webb) questions the theoretical underpinnings of the Stiglitz-Weiss model.

In addition to the theoretical arguments, several empirical studies show that small businesses do not face significant credit constraints and that the private market seems to operate efficiently. For instance, the Federal Reserve Board's 2002 *Report to Congress on the Availability of Credit to Small Businesses* 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. The report notes that credit terms and standards at banks for small businesses were generally favorable from 1997 to 2000. Although conditions deteriorated substantially in 2001 and the beginning of 2002, small businesses did not appear to have found financing conditions onerous during the period. More importantly, it does not appear that small firms were suddenly having more difficulty accessing credit.

The Census Bureau's 1992 Characteristics of Business Owners survey shows that low sales are a much more important factor in small business failures than a lack of access to financing. (See Table 1.) Of all the unsuccessful businesses in the survey, 71.7 percent of owners cited inadequate cash flow or low sales as a reason for failure while only 8.2 percent said a lack of access to business loans/credit contributed to the end of their businesses. Minority- and women-owned businesses showed the same trend, although the percentage of owners citing lack of credit as a problem tended to be higher.

By examining the connection between wealth and business formation rates, Erik Hurst and Annamaria Lusardi (2004) debunk the traditional liquidity constraint argument that households are unable to borrow to finance their entrepreneurial projects. They explain that because small business ownership is a risky venture, households with higher tolerance for risk should be more likely to become business owners, all else equal. High-wealth households display a higher propensity to take risk, yet data from the Panel Study of Income Dynamics show that wealthier people do not have a higher probability to start a business. In fact, Hurst and Lusardi demonstrate that, except for the very wealthy, there is no relationship between household wealth and the probability of starting a business.

This is not to say, however, that all potential entrepreneurs have unlimited access to affordable credit. Rather, it means that even if some people wanting to start small businesses are currently liquidity-constrained, the constraints "are not empirically important in deterring small business formation in the United States." In other words, the evidence suggests that being poor does not hinder one's ability to start a business.

Research by Alec Levenson and Kristen Willard (2000) supports this finding. They argue that to measure credit rationing, it is necessary to count not only firms that are denied credit but also firms that are discouraged from applying for credit because they fear denial. Using data from the 1988 National Survey of Small Business Finance, they estimate that only 2.14 percent of small businesses did not obtain the funding for which they applied in 1987–1988, and 4.22 percent of firms were discouraged from applying. Thus, at most, only 6.36 percent of firms were credit-rationed in 1987–1988. They emphasize that this is an upper bound estimate, since they cannot distinguish between non-creditworthy firms, which were

Table 1

Why Businesses Fail

Reasons given by business owners for the failure of their firms, 1992 (in percent)

	Inadequate cash flow or low sales	Lack of access to business loans/credit	Lack of access to personal loans/credit	Other reasons	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

NOTE: *Owners could give more than one reason*
SOURCE: *Bureau of the Census, "1992 Economic Census: Characteristics of Business Owners"*

appropriately denied credit, and creditworthy firms, which were legitimately credit-constrained.

DISADVANTAGED GROUPS A more refined version of the capital access argument is that women- and minority-owned businesses have difficulties accessing credit and thus they are the ones who require preferential treatment. Though there may be no failure in the credit market for small businesses in general, there may be a role for the SBA in the market for credit for businesses owned by women and minorities.

However, controlling for many factors, the economics literature finds that women-owned small businesses do not face significantly higher loan denial probabilities than white-owned small businesses. For instance, empirical work by Ken and Linda Cavalluzzo (1998) demonstrates that white men and women can expect similar treatment in credit markets. Furthermore, their results suggest that there even are some advantages for female-owned firms located in concentrated banking markets.

However, a later article by the Cavalluzzos and John Wolken (2002) finds that minorities fare worse than whites. David Blanchflower, Phillip Levine, and David Zimmerman (2003) show that "black-owned small businesses are about twice as likely to be denied credit even after controlling for differences in creditworthiness and other factors." Ken Cavalluzzo and John Wolken (2005) control specifically for differences in personal wealth and still find a higher denial rate for black business owners. And Raphael Bostic and Patrick Lampani (1999) show that adding controls for local geography reduces the black/white difference, but does not eliminate it.

More recent findings, however, suggest that inefficiencies in the financial market for minority-owned small businesses do not require government-sponsored loans or other preferential treatments. An SBA-sponsored 2005 study by Karlyn Mitchell and Douglas Pearce finds that while minority small business owners have more difficulty accessing credit than white owners, the credit constraints vary across different loan and lender types. In other words, discrimination may be confined to only some segments of the loan market. 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 loans from non-banks such as The Money Store or AT&T Small Business Lending Corp.

USE OF CREDIT It is important to realize that bank loans only represent one of many ways to acquire credit. The Federal Reserve's 1998 Survey of Small Business Finance, which sampled approximately 3,500 nationally representative firms with fewer than 500 employees, illustrates this point.

Table 2

Different Sources of Credit

Percentages and demographics of small firms that used different types of 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

NOTE: *Data collected as part of the Federal Reserve's 1998 Survey of Small Business*
SOURCE: *Small Business Administration, "Financing Patterns of Small Firms" (2003)*

Table 2 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. "Traditional credit" is defined as lines of credit, mortgages, and vehicle, equipment, leasing, and other loans. "Non-traditional" sources of finance include loans from the owner and business or personal credit cards, while "non-financial institution" sources of finance include loans from family and friends, the government, or other businesses. For sole proprietorships, "loans from owner" are not included because they are considered equity, not debt.

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, accounting for 57 percent of the total outstanding debt for all small firms. A firm's likelihood of using credit increased with firm size. This was true for most credit types and sources, but not for personal credit cards. The smallest firms may rely more heavily on personal credit cards because they are not able to access more traditional forms of financing, but more information on owner characteristics is necessary before drawing that conclusion.

The survey also showed that small minority- and women-owned businesses differed from small businesses in general. Compared to all small businesses, a lower percentage of small minority- and women-owned firms used any kind of credit (77 percent and 78 percent, as compared to 83 percent). Among firms that used credit, minority- and women-owned small firms were less likely to use commercial banks and business credit cards, and more likely to use personal credit cards and non-financial institutions such as family and friends. Women-owned firms were more similar to minority-owned firms than small businesses in general. A notable difference, however, is

that women-owned firms were much more likely than minority-owned firms to use non-traditional sources of credit. Those results may suggest that women and minorities have difficulty accessing credit, but again, more information is necessary.

More information about small business financing comes from a 2005 U.S. Chamber of Commerce survey of 1,080 small business owners. 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. While about a third of all small business owners in the survey reported start-up costs of $5,000 or less, nearly half of both women and blacks were in that category. By a margin of 2:1, women were more likely than men to be in the service sector, which has lower start-up and ongoing financing needs. Men-owned firms were more likely to be in industries that require more capital, such as manufacturing and construction. In addition, 75 percent of black-owned businesses had less than $100,000 in revenues, compared to about 40 percent or less for whites, Hispanics, and Asians.

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. Minorities and women were more likely to use credit cards for initial and ongoing funding, while men were more likely to use bank loans.

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

It should also be noted that several economists are questioning the idea that even if it were the case that asymmetry of information led to fewer startups than under public information, it by no means follows that policy should attempt to reverse the situation (see for instance de Meza (1999), Cressy (1996)). Finally, even if efficiency gains are in principle possible, the case that bureaucrats can identify them and then act appropriately is far from clear.

DOES THE SBA DO WHAT IT CLAIMS?

The economic justification for any government-sponsored lending or loan guarantee program must rest on a well-established failure of the private sector to allocate loans efficiently. Absent such a private sector deficiency, the SBA's activities would simply be a wasteful, politically motivated subsidy to this sector of the economy. As demonstrated in the previous section, the private sector does not seem to suffer from such deficiencies, which suggests that there is no economic justification for SBA loans.

Yet many argue that some public policy objectives require the sacrifice of marketplace efficiency. It is an accepted feature of modern American government that some public interests or social policy gains can outweigh economic losses and hence are worth selective override of our free-market values. In the case of the SBA, its lending programs could fulfill specific public policy objectives that the marketplace on its own would not otherwise serve or would supply at suboptimal levels. But does it?

In describing its role in the economy, the SBA proclaims that small is beautiful:

> *Small business is where the innovations take place. Swifter, more flexible and often more daring than big businesses, small firms produce the items that line the shelves of America's museums, shops, and homes. They keep intact the heritage of ingenuity and enterprise and they help keep the "American Dream" within the reach of millions of Americans. Every step of the way,* SBA *is there to help them.*

From this belief, it follows that we need more small businesses around and should implement policies that will increase the number of small businesses.

Glorifying small businesses also leads to the idea that small business owners deserve assistance because they are morally admirable and more deserving than big business owners. They create more jobs and economic growth than larger firms while facing what looks like unfair competition from big business. Along the same lines, the SBA points to racial and gender disparities as a justification for assistance to disadvantaged groups in particular.

The SBA can thus be judged based on its ability to meet these public policy goals — namely, to fill the gap between supply and demand of small business loans, particularly for women- and minority-owned small businesses. To measure the SBA's results, I looked at the SBA's flagship loan guarantee program, the 7(a) program. I analyzed the flow of SBA credits to evaluate who receives them and whether the SBA is meeting its stated policy objectives.

My main findings are the following:

- No more than 1 percent of small business loans each year are SBA loans. The private sector finances most loans without government guarantee and, hence, the SBA is largely irrelevant in the capital market.
- Each year, 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.
- Each year, 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.
- There is no shortage of firms or new startups in America. The data suggest that new businesses would be started at the same rate without the SBA's 7(a) loan program.
- 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.

■ The overwhelming bulk of SBA 7(a) loans — 75 percent — flows to a small fraction of firms in the service, retail, and wholesale sectors. Yet there is an overwhelming number of firms, a large amount of competition, and no empirical evidence that the market is being underserved in these areas.

Taking a closer look at the data is useful. Table 3 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

Table 3

Who Receives SBA Loans?

The top 25 industries receiving SBA 7(a) loans, FY 2002

INDUSTRY	SBA LENDING				INDUSTRY CHARACTERISTICS		
	Number of loans	Share of SBA total[1]	Loan amount ($1,000s)	Share of SBA total[2]	No. of small business establish-ments[3]	SBA loan ratio[4]	Market concentration (top 8 share, by sales)
Full-service restaurants	3,240	6.3%	$770,370	6.3%	210,837	1.5%	11.0%
Limited-service eating places	2,563	5.0%	491,930	4.0%	215,964	1.2%	12.8%
Automotive repair and maintenance	2,482	4.8%	686,515	5.6%	429,573	0.6%	2.8%
Offices of other health practitioners	1,355	2.6%	184,748	1.5%	385,541	0.4%	4.5%
Personal care services	1,267	2.5%	134,103	1.1%	757,064	0.2%	12.8%
Gasoline stations	1,208	2.3%	676,454	5.5%	93,233	1.3%	15.3%
Services to buildings and dwellings	1,060	2.1%	133,046	1.1%	869,558	0.1%	10.8%
Grocery stores	1,018	2.0%	282,416	2.3%	114,539	0.9%	43.4%
Traveler accommodation	987	1.9%	765,969	6.3%	77,741	1.3%	27.8%
Other special trade contractors	929	1.8%	188,049	1.5%	N/A	N/A	N/A
Drycleaning and laundry services	900	1.7%	238,570	2.0%	76,578	1.2%	25.9%
Other amusement and recreation industries	834	1.6%	253,038	2.1%	173,074	0.5%	12.9%
Offices of dentists	821	1.6%	247,771	2.0%	149,874	0.5%	2.1%
Offices of physicians	769	1.5%	193,160	1.6%	365,264	0.2%	4.3%
Other professional, scientific, and technical services	748	1.4%	195,601	1.6%	835,976	0.1%	10.7%
Computer systems design and related services	703	1.4%	93,685	0.8%	373,771	0.2%	21.7%
Other miscellaneous store retailers	700	1.4%	95,321	0.8%	195,517	0.4%	17.1%
Architectural, engineering, and related services	667	1.3%	111,706	0.9%	310,853	0.2%	11.8%
Specialty food stores	645	1.2%	104,084	0.9%	61,444	1.0%	9.2%
Child daycare services	642	1.2%	209,567	1.7%	682,303	0.1%	21.4%
Clothing stores	621	1.2%	69,041	0.6%	109,069	0.6%	38.7%
General freight trucking	614	1.2%	87,502	0.7%	410,351	0.1%	18.5%
Management, scientific, and technical consulting services	610	1.2%	56,617	0.5%	577,383	0.1%	15.1%
Sporting goods, hobby, and musical consulting services	608	1.2%	82,492	0.7%	98,912	0.6%	32.9%
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	100%	12,208,027	100%	23,818,871	0.2%	

NOTES: 1 *Share of total 2002 SBA 7(a) loan approvals.* 2 *Share of total 2002 SBA 7(a) loan guarantees.* 3 *For research purposes, the SBA defines small business as an establishment with fewer than 500 employees, including establishments with no paid employees.* 4 *SBA loans divided by total number of small business establishments in the industry.*

SOURCES: *Small Business Administration; U.S. Census Bureau's 2002 Statistics of U.S. Businesses and 2002 Economic Census*

guarantees, the eight-firm market concentration ratio was 20 percent or less. Conversely, the most concentrated business sectors received less than a third of the loans that the least concentrated sectors received. (See Table 4.) Clearly, the bulk of subsidized SBA loan guarantees is 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 3). 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.

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.

My research leads to another important conclusion: because the small distribution of SBA loans 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 unleveled playing field and hurt non-SBA firms.

A close examination demonstrates that neither stated SBA policies nor the agency's actual lending patterns provide evidence that SBA loan guarantees serve any focused or rigorously defined public policy purpose at all. Even if we assume,

Table 4

Market Concentration

SBA 7(a) loans to most- and least-concentrated industry sectors

Description	Loan amount ($1,000s)	Share of SBA total[1]	Market concentration (top 8 share, by sales)
15 most concentrated industry sectors			
Department stores	$1,300	0.0%	88.8%
Other general merchandise stores	32,709	0.4%	87.9%
Amusement parks and arcades	12,476	0.1%	74.3%
Motor vehicle, motor vehicle parts, and supplies wholesale	55,326	0.6%	67.4%
Book, periodical, and music stores	11,127	0.1%	61.2%
Waste collection	16,195	0.2%	60.8%
Special food services	54,634	0.6%	60.5%
Drugs and druggists' sundries wholesale	10,315	0.1%	57.6%
Waste treatment and disposal	11,136	0.1%	53.5%
Health and personal care stores	76,620	0.8%	53.0%
Shoe stores	14,164	0.2%	52.4%
Electronics and appliance stores	57,297	0.6%	51.4%
Office supplies, stationery, and gift stores	46,280	0.5%	49.6%
Building material and supplies dealers	101,561	1.1%	45.3%
Facilities support services	6,701	0.1%	43.9%
SUBTOTAL	$507,840	5.6%	
15 least concentrated industry sectors			
Offices of dentists	$247,771	2.7%	2.1%
Florists	27,432	0.3%	2.4%
Automotive repair and maintenance	686,515	7.6%	2.8%
Drinking places (alcoholic beverages)	85,166	0.9%	2.9%
Legal services	66,794	0.7%	3.2%
Office administrative services	3,729	0.0%	3.6%
Offices of other health practitioners	184,748	2.0%	3.9%
Individual and family services	16,269	0.2%	4.1%
Offices of physicians	193,160	2.1%	4.3%
Specialized design services	32,694	0.4%	4.4%
Civic and social organizations	100	0.0%	4.5%
Business, professional, labor, political, and similar organizations	1,483	0.0%	4.8%
Other motor vehicle dealers	44,955	0.5%	6.1%
Independent artists, writers, and performers	4,331	0.0%	6.2%
Automobile dealers	84,292	0.9%	7.2%
SUBTOTAL	$1,679,437	18.5%	
TOTAL	$9,077,434		

NOTE: 1 *Share of total 2002 SBA 7(a) loan approvals to service, wholesale, and retail industry sectors*
SOURCES: *Small Business Administration; U.S. Census Bureau's 2002 Economic Census*

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.

But you would never know this from the SBA's evaluations of its programs. The agency 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.

But the evidence suggests that it is unlikely that SBA loans create enough value to compensate for the risk taken by taxpayers. First, default rates on SBA loans are extremely high (7.4 percent in 2005 as opposed to 1.5 percent for FDIC-insured banks). Second, the SBA cannot point to success stories other than marginal examples that would compensate for the cost to taxpayers. In addition, for each SBA success story, thousands of small firms prospered without the SBA loans. The SBA's case rests mainly on anecdotes of small firms staying afloat thanks to its programs. 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 establishment size.

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 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 demonstrate that even if credit were a serious problem for small firms, SBA loans would not 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 those loans face significant risk of default, costing taxpayers large amounts of money. In addition, poor oversight by the SBA of it lenders has led to waste, fraud, and abuses. Evidence shows, for instance, that 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. R

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