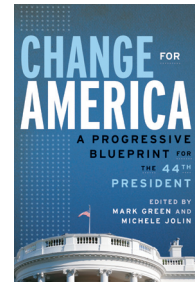




Small Business Administration

Supporting America's Engines of Growth

By Fred P. Hochberg



This chapter is part of an online effort by the Center for American Progress Action Fund and New Democracy Project to offer expert advice to the new administration as part of its *Change for America* book project.

Summary

America Online, Apple Computer, Staples, Intel, Outback Steakhouse, and Callaway Golf were once small, fledgling companies. The Small Business Administration, which was decimated by budget cuts during the Bush administration, once provided key support for young growing companies that are a fundamental part of the American economic landscape. Over the past 15 years, small businesses created over 93 percent of all net new jobs, or 22 million new jobs. Today, small businesses make up 99.7 percent of all employer firms. The best engine for job growth continues to be small business, which is why the SBA needs to be an effective tool to help revitalize the U.S. economy. With the economy contracting, many new and small businesses are increasingly vulnerable: a tight credit market, rising health care costs and increasing mortgage foreclosures hit small business entrepreneurs particularly hard.

The new administration, using the SBA's lending programs, needs to get credit flowing to small businesses once again; rebuild its downsized and demoralized staff; rethink eligibility requirements for what constitutes a "small" business; and re-establish federal guidelines for small business contracting terms with federal agencies. Additionally, restoring the agency to cabinet status by executive order will make the agency a central component of economic policy and planning. Lastly, helping individuals and business owners recover from natural disasters is a central function of the agency.

Introduction

The Small Business Administration provides four important support structures to America's small businesses—the engine that drives our nation's economy. SBA provides crucial financial assistance during the initial stages of a young company's business develop-

ment that otherwise could not be obtained. The agency provides “how-to” counseling and advice to help small businesses get off the ground and maintain success. SBA provides small businesses with access and opportunity to secure prime government contacts, especially minority and women-owned businesses. And SBA can provide long-term loans and other economic relief to small businesses, homeowners, and renters in the wake of a disaster to help them get back on their feet.

These four distinct SBA programs are needed today more than ever. Many new and small businesses face an economic climate that makes them increasingly vulnerable: a tight credit market, rising health care costs, and increasing mortgage foreclosures hit small businesses and entrepreneurs particularly hard. The new president has the opportunity to channel SBA’s business development programs and support tools to help small businesses contribute to the growth and stability of the economy. The new administration will also have to consider which SBA programs gutted or eliminated by the Bush administration should be revived or restored.

During the Clinton administration, the SBA added to the growth of the economy by focusing on underserved markets in inner cities and rural areas, where there were billions of dollars of unmet consumer and business demand. The SBA developed a program called New Markets for these growing sectors, with innovative programs that brought increased economic development to inner-city, rural, and other overlooked communities.

Under the Bush administration, the SBA lost its vision and energy. The agency’s budget was drastically cut, absorbing the greatest percentage reduction of any federal agency. Since 2001, the SBA’s budget was cut by about 40 percent, to the \$500 million range from \$918 million. Not surprisingly, staff morale also fell sharply as employment was reduced 26 percent, to 2,095 employees in 2008, from 2,860 in 2001. These significant reductions (and the subsequent strain on the remaining employees) were clearly evident in the biannual survey of federal agencies, in which SBA routinely scores lowest on measures of employee morale.¹

Not surprisingly, these budgetary cutbacks have had a profound effect on SBA. Several Government Accountability Office reports indicate that programs were curtailed, and services to small businesses deteriorated, most notably within the SBA’s flagship (General Business) Loan Program, or 7(a) program. Prior to 2005, the 7(a) program was a combination of fees paid by the borrower and congressional appropriations, which allowed for the small business owner to borrow at a more affordable rate. Today this program is funded entirely by loan origination fees and paid entirely by borrowers, without any congressional appropriation.

As a result, fees on loans of up to \$150,000 are now \$2,000—double their prior rate. For larger loans, the increase in fees is approximately 20 percent. While there is now no limit to the number of loans or total amount the SBA can provide in one year since

they are no longer constrained by the annual appropriation, the fees are too high for the loans to be accessible to many borrowers. And the key issue in this economy is likely to remain access to capital.²

In addition, SBA's microloan program, which serves very small businesses with a \$35,000 lending cap and which is widely utilized by minority business owners and entrepreneurs, was flat-funded in the Bush years. One result: the share of SBA loans to minorities stagnated, compared to the almost four-fold jump in loans to minorities between 1993 and 2000 under the Clinton administration.

Cuts to SBA's budget also hampered the agency's ability to monitor contract bundling (when more than two goods or services are combined into one contract) which make it difficult for small businesses to compete for contracts. Currently there are 51 procurement center representatives who monitor the federal procurement process, although only 30 of these positions are full time. This falls far short of the 100 full-time procurement center representatives called for by Congress to oversee nearly \$400 billion in federal contracts.

With reduced staffing in this critical area, federal procurement has fallen below the federally mandated level of 23 percent. On October 23, 2008, the New York Times reported a contracting level of 22 percent, which many critics believe to be inflated, including Democratic Congresswoman Nydia Valazquez and Republican Senator Olympia Snowe.³ Additionally, since overseas contracts are excluded, the contracting level is likely to be even lower.⁴

Failing to meet small business contract quotas isn't the only issue, however. As early as last July, The New York Times reported that, "contracts listed as going to small businesses went to a dozen Fortune 500 corporations, including the Xerox Corporation and the John Deere Company." This, according to the article, amounted to millions of dollars in federal contracts.⁵ Additionally, current federal law does not include any enforcement mechanism to ensure that statutory levels are met.

The Bush Administration's effective flat funding of Small Business Development Centers and Women's Business Centers, has translated into real reductions for business training services after inflation is taken into account. These entrepreneurial development programs are intended to provide small businesses with the practical knowledge and "best practices" guidelines needed to succeed. There are long-standing questions about the effectiveness of the centers, yet the Bush-run SBA never explored these questions, and instead just cut staff and funding.⁶

More critically, funding and staffing reductions have severely affected the agency's ability to provide proper oversight of its lending programs. One result: In January of 2007 federal agents uncovered the largest SBA loan fraud in history. An executive vice president of Business Loan Express in Detroit, a subsidiary of private finance industry leader Allied

Capital of Washington, D.C., defrauded SBA's 7(a) loan program for at least \$76 million, and perhaps as much as \$96 million.

According to Sen. John Kerry (D-MA), chairman of the Senate Committee on Small Business and Entrepreneurship, SBA mismanagement and newly imposed lender oversight fees have contributed to 300 lenders leaving the program over the last two years. With fewer SBA lenders and a tightened credit market, the remaining SBA lenders could become flooded with borrowers now unable to obtain credit without the assistance of the SBA. As it stands today, with drastic reductions in staff and budget, the SBA's ability to respond to a significant increase in borrowers would most likely be hampered.

The new administration needs to position the SBA once again as an innovative and relevant federal component in the revitalization and stability of our economy. Similar to what made the Clinton administration's New Markets vision a success, a new strategy for entrepreneurship and new job growth should be guided by three endeavors: increased access to financial capital; investment in human capital; and investment and support for innovation.

SBA agenda for the first 100 days

In order for SBA to be a more effective tool for the vitality and growth of our economy, it should be restored to cabinet status by executive order. SBA participation in cabinet proceedings allows for input on a broad range of economic policy and budget decisions. Being a part of the cabinet also means inclusion in policy formation by the National Economic Council.

SBA will bring its much-needed experience and perspective to the table through cabinet proceedings and at the NEC. In the 1990s (when the head of SBA was a member of the cabinet) much of the economic growth came from the small business sector, aided by innovative financing tools. It is also critical there be a cabinet-level advocate for small businesses and entrepreneurship in a crisis. As seen in the aftermath of Hurricanes Katrina and Rita, the government's failure to respond to disasters has a large effect on the public's evaluation of government capabilities. Having a direct line from the SBA to the president strengthens the government's ability to respond quickly to help small businesses recover from disasters.

In a period of competing demands for public resources, it will take leadership to advocate for additional appropriations for the severely depleted SBA staff. For that reason, the SBA administrator and other key leadership should be appointed early in the new administration. Senior SBA officials will then need to mend relationships with small companies, entrepreneurs, Congress, and the small business lending community. Under the Bush administration, the White House Office of Management and Budget pushed the SBA around in such a way that the agency had to become more and more responsive to administration bureaucrats—and more and more isolated from small business and lending communities, as well as from key members of relevant congressional committees.

This isolation hurt the relationships upon which the agency had relied upon in the past to provide services to America's small businesses. Consider, for example, the lack of both innovation in existing programs and of new approaches to help new "knowledge economy" small businesses. Coupled with the drop in federal contracting procurements for small businesses, the SBA needs to take the initiative in mending all of these relationships.

Holding a "Listening Tour" or hosting other forums with small business owners across the country would give SBA officials a fresh opportunity to work with small business constituents to understand their needs and opportunities in America's blossoming knowledge economy sector. Additionally, SBA's Office of Advocacy should be an integral part of this process by providing in-depth economic analysis to quantify the issues identified and to help substantiate the solutions proposed as a result of the forums.

Given all of the enormous and serious challenges facing the SBA in 2009 and beyond, the next SBA administrator should also establish a thorough review and mapping of the agency needs and challenges during the first 100 days of the new administration. The review should evaluate staffing requirements, funding issues, pending or requested legislative changes, actions pending on individual constituent cases, recent hearings or recent reports from the Government Accountability Office, and any outstanding items related to Congress. The review also should document those areas where reduced staffing puts the agency and government at a risk of loss, including lending oversight, procurement of contracting representatives, and disaster and preparedness.

The first-year agenda

The SBA needs to develop new financing tools and conduct an assessment of risk tolerance in its lending programs. The SBA has statutory authority to provide a continuum of financial services intended to fill the gaps left by the private sector in meeting the capital needs of small businesses at multiple stages of development. These loans include the Microloan Program, which provides loans in amounts up to \$35,000 along with technical assistance, and the General Business Loan Program, also known as 7(a), which provides loans up to \$2 million.

Two smaller programs target more specific small business needs: The Certified Development Company Program, also known as the 504 program, which provides loans up to \$4 million for the acquisition of fixed assets, such as land, buildings, and long-term capital equipment, specifically for businesses that meet the program's economic development public policy guidelines; and the Small Business Investment Companies, or SBIC program, which provides long-term loans and equity capital to small firms so that they can make investments for the long term. Regrettably, the Bush administration has curtailed the SBIC or venture capital program, depriving small business access to these financial tools.

These programs are delivered through a network of public-private partnerships that provide the financings supported by SBA's guarantees or, in the case of the microloan program, by funds loaned by the agency to its non-profit partners. SBA has historically helped banks and other institutions provide credit and funding that would otherwise not be made available to U.S. small business owners. This is done through a system of federal guarantees that induces those institutions to extend credit and, in the event of a default, to cushion losses.

This willingness to assume risk is under threat at the SBA. The agency is no longer taking the risk needed to make the economy grow. A loan program without risk will not allow for the necessary and important investment in promising new sectors, the potential of which would not be realized without such risk. Therefore, a full assessment of risk tolerance needs to be undertaken to help determine what is needed so that the agency can help to fill gaps left by the private sector.

The current level of service that SBA provides is also insufficient. Many of the programs and products that fill an important need have been discontinued; relationships with SBA's preferred lenders and the lending community in general have eroded. In short: The "financing ladder" has been interrupted through the flat funding of the microloan program and the curtailment of SBA's participating securities venture capital program, as well as other tools for businesses at the very early stages of development.

In addition, the General Business Loan 7(a) program is more costly to many small business borrowers. As we move rapidly to a knowledge economy, the SBA has yet to sort out how to finance businesses that do not have hard assets to back their debt obligations. To stop this erosion, SBA quickly needs to develop new financing tools to compete in the 21st-century global economy, and evaluate risk tolerance appropriate for a government-supported program designed to expand the amount of financial capital available to America's small businesses.

Without question, the best way to help small businesses during an economic crisis is to make sure there continues to be access to credit. A reconsideration of the SBA fee structure should be undertaken. The credit crunch is already more acute for small businesses, particularly for small start-ups. Fees for banks and borrowers should be reconsidered with an emphasis on reducing them where it will lead to a loosening of credit. In terms of federal guarantee levels, the bulk of SBA loans are made at the 75% level. Moving the guarantee to 80 percent or perhaps even 90 percent, which only a few specialized loans come with today, should also be considered.

There should also be strong consideration to increase the maximum loan amount from \$2 million to \$3 million. The current maximum of \$2 million is long over due for reassessment, again, made even more important in the context of a global economy and the current crisis.

The SBA also needs to beef up its oversight capabilities. A review is needed to determine the tools and staffing required to provide appropriate lender oversight to public-private lending partners, and to establish service standards in terms of backlogs and response time that are up to the standards demanded by the private sector.

Update the criteria for the size of a small business

The threshold question for determining eligibility for participation in SBA's programs is whether a business is small. This designation determines whether small businesses are eligible to obtain other benefits from the federal government, such as federal prime contract and sub-contracts from federal agencies and financing programs. Over the years SBA has established and revised size standards, primarily relying on the principal industry of the business, but more generally based on either average annual receipts or the number of employees. More recently, SBA has also developed alternative size standards for use in determining eligibility for specific SBA programs.

The problem is that current size standards are overly complex and out of step with a global economy. The complexity makes it difficult to determine whether a particular business qualifies as small, and thus makes SBA vulnerable to criticism about whether benefits intended for small businesses are actually going to eligible recipients. Case in point: Today a small business with a tangible net worth that is no more than \$7.5 million and an average net income of no more than \$2.5 million qualifies for a 504 program loan, but would not be considered small for a 7(a) loan because eligibility size standards are more stringent for general business purpose loans versus loans intended to spur economic development.

SBA needs to re-examine current size standards with the twin goals of simplifying the standards to enhance ease of use for both small businesses and federal officials, and better serving SBA's mission of fostering entrepreneurship and economic development in a global economy. Agency leadership should increase the size standards and make them consistent throughout the agency in order for businesses to easily understand the SBA services for which they are eligible.

Contracting

The 8(a) or Business Development Program is designed to help small businesses owned by socially and economically disadvantaged individuals grow and become competitive in their market by helping them procure government contracts. The program's duration is nine years, or until a business exceeds the size standards of the program. Additionally, the federal government is required by statute to award 23 percent of contracts to small businesses. Most recently, the House alone passed legislation that would increase this percentage to 30 percent.⁶

But many businesses do not have the size or experience needed to continue to grow their companies once they graduate from the Small Business Development Program. Termination means that businesses not only lose contracting opportunities but also a very critical support network of counseling, mentoring, assistance in meeting federal contracting requirements, and assistance in understanding which SBA loans they are eligible for. These businesses are often forced to sell out to a larger enterprise rather than continue independently, or in some cases fail. Small, high-tech companies are a good example: Once they are terminated from SBA programs they face a marketplace with giants such as IBM, EDS, and Unisys, a big step up in terms of competition: “Many of these companies become too large to be considered small, yet too small to compete with the giants.” (Career official at the SBA)

Consequently, the SBA should work with the new president and Congress to create a “postgraduate” 8(a) program by setting aside an additional percentage of contracting for such companies to allow them to bridge the gap from 8(a) to a competitive size. This program would essentially provide a transition period, allowing for continued access to services and to compete for contracts with other companies within the postgraduate program.

Another complication, as mentioned earlier, is that many government agencies—especially those that offer a high volume of government contracts such as Department of Defense—neglect to meet their small business contracting goals. Yet the only statutory requirement is to report that information to SBA. There is no enforcement mechanism in place to ensure contracting goals are met. As a cabinet agency in the new administration, SBA would have more stature and influence, and thus may be better able to prevail upon other agencies to meet contracting goals.

Disaster program

SBA failed to respond to the needs of those devastated by Hurricane Katrina and Rita. Because of Bush administration budget choices and shortsighted cost-saving plans, the over-reliance on temporary staff, and the insufficient management of information technology contractors, the SBA was unable to provide a timely response to the victims of Hurricanes Katrina and Rita in 2005.

Largely due to a new and untested information technology system designed to coordinate disaster response, the Office of Inspector General found that thousands of Katrina victims were mistakenly denied SBA loans for which they qualified, often without even being told.⁷ Additionally, a short-staffed SBA was ill prepared, not having fully participated in agency training exercises. Then when disaster struck, employees were pressured to clean up the backlog of loan applications quickly, which led to more mistakes and confusion. The result: Not only were eligible recipients denied loans, but thousands of unqualified recipients, often without the requisite collateral and documentation, were granted them. Eight years of budget and staffing cuts were partly to blame for the inadequate response.⁸

These extreme and devastating outcomes also raise the question of whether SBA's direct disaster loan program is the most effective way of providing assistance to disaster victims. Since all disaster lending is conducted on a direct-lending basis, SBA is frequently required to depend on a temporary workforce to handle the enormous volume of requests, leading to significant delays in getting victims needed assistance.

Historically this program provides three types of direct-lending programs that do not partner with the private sector. The first is Home Disaster Loans, or loans to homeowners or renters to repair or replace disaster damages to real estate or personal property owned by the victim. Renters are eligible for personal property losses; home loan amounts are limited to \$200,000. The second is Business Physical Disaster Loans, or loans to business to repair or replace disaster damages to property owned by the business, including real estate, machinery and equipment, inventory, and supplies. Businesses of any size are eligible. Non-profit organizations such as charities, churches, and private universities are also eligible. (Business loan amounts are limited to \$1.5 million.)

The third type of direct lending program is Economic Injury Disaster Loans, or loans for working capital to small businesses and small agricultural cooperatives to assist them through the disaster recovery period. EIDL assistance is available only to applicants with no credit available elsewhere, for example if the business and its owners cannot provide their own recovery from non-government sources. These loans are also capped \$1.5 million.

One way to make the SBA more responsive to disaster victims would be to partner with the private sector as it does with other loan programs. The private sector, however, in recent years has shied away from 30-year, fixed-rate loans. There is no easy solution here. It will require the new administration to determine the best way to provide disaster assistance, and if the private sector is to be a partner, it will require imagination and creativity to make it work. Government guarantees may not be enough to induce the private sector.

Additionally, the cap on home disaster loans needs to be updated to more accurately reflect current market standards. Performance standards also need to be established for loan approval and closing to ensure that citizens who have been affected by a disaster know that they have a government they can rely upon.

Integrate counseling and assistance programs

Because counseling and assistance programs were created at different junctures in the history of SBA in response to the needs of various constituencies, such as women, start-ups, and minority business owners, none of these programs are linked or integrated. To bring these programs together is now much more difficult due to a strong network of trade associations behind each program, along with their strong allies in Congress.

Additionally, funding has been essentially flat in total dollars and thus has declined on an inflation-adjusted basis. The programs affected by these budget decisions are: Service Corps of Retired Executives, a volunteer program of 10,500 volunteers in 800 locations that provides entrepreneur education, business counseling, and training; Small Business Development Centers; and Women's Business Centers. A new SBA administrator needs to conduct an overall review of all counseling and assistance programs with an emphasis on the effectiveness of the programs. An outcome-driven program will need to track business results for three to five years to determine effectiveness. These reviews can set the stage for funding decisions in future years as the program currently lacks the rigor to encourage increased federal funding.

For example, simply tracking the number of clients served, though easier to measure, does not necessarily translate into long-term financial results. A focus on outcomes and results will enable policymakers and legislators to direct federal dollars where they can do the most good. Sen. Kerry, chairman of the Senate Committee on Small Business and Entrepreneurship, echoes this sentiment: "The [Bush] administration tends to focus on output without really focusing on what is really needed in the market to grow the economy and create jobs." The new administration can do much better.

About the author

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Endnotes

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