Waste, Fraud, and Abuse in Small Business Administration Programs

Statement of Tad DeHaven, Budget Analyst, Cato Institute,

before the Senate Committee on Small Business and Entrepreneurship

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Chairwoman Landrieu and members of the committee, thank you for inviting me to testify today regarding the Small Business Administration.

Waste, Fraud, and Abuse in Government Programs

Most Americans agree that waste, fraud, and abuse in government programs is a problem. A recent poll of likely voters found that those surveyed believe an average of 42 percent of every dollar spent by the federal government is wasted. The same poll also found that 60 percent of those surveyed believe that problems with the federal budget can be solved by simply eliminating waste, fraud, and abuse. In fact, 40 percent *strongly* agreed with this position.[1]

Although the belief that the government's budget problems can be solved by making bureaucracies simply run more efficiently is erroneous, the American people are correct that Washington does a poor job of managing their money. We have documented countless examples of waste at Cato's website, www.DownsizingGovernment.org. And the newspapers seem to have fresh stories every day of federal agencies making poor financial decisions

However, most people know very little about the breakdown of the federal government's $3.8 trillion budget, and many don't accept that huge deficits are caused by programs that benefit them. For example, the same poll found that 49 percent *disagreed* that Social Security and Medicare are a major source of problems for the federal budget. Attempting to reduce waste, fraud, and abuse is fine, but it won't solve our deficit-spending problem.

Policymakers on both sides of the aisle recognize that examples of waste, fraud, and abuse do not sit well with the American people. Therefore, it is hard – if not impossible – to find a policymaker who *doesn't* tell his or her constituents that they'll work to eliminate government waste. For example, previous House Speaker Nancy Pelosi instructed her committee chairs to uncover waste, fraud, and abuse as part of an effort to "ensure fiscal discipline for the long term." The House Republicans' "Pledge to America" included a promise to "root out government waste."

What few in Washington want to acknowledge is that waste, fraud, and abuse always comes with government programs—the same way a Happy Meal always comes with a toy and a drink. This is because the federal government is a vast money transfer machine. It spends hundreds of billions of taxpayer dollars each year on programs—from the massive Medicare to hundreds of more obscure programs that most people have never heard of.

Administrators don't do enough to police these massive transfers because people always tend not to spend other people's money as carefully as they spend their own money. And on the receiving end of programs, a vast number of people use the federal budget as a cookie jar to garner benefits to which they are not entitled.[2] Families seek improper benefits through subsidies such as the school lunch program. Hospitals rip off taxpayers by double-billing Medicare and Medicaid. Criminal gangs loot subsidy programs such as food stamps. Owners of nonprofit groups that are supposed to aid the needy line their own pockets with taxpayer funds.

For decades, there have been efforts to end such abuses, but federal programs are extremely complex and they deliver benefits to thousands or millions of recipients. When it comes to waste, fraud and abuse, government programs are always chasing their tail. In the private sector, businesses have a financial incentive to stop abuses before they happen. No such incentive exists with government programs. Instead, government administrators usually only uncover abuses after the fact, and often only after outside auditors or the media have investigated.

"Small Scandal Administration"

The Small Business Administration is no stranger to waste, fraud, and abuse. Indeed, the SBA was created in 1953 after the demise of the Depression era Reconstruction Finance Corporation, which lost support after allegations of influence peddling during the Truman administration. President Dwight Eisenhower was against creating the SBA in principle, but he signed the legislation as a politically expedient move that would counter criticisms that Republicans were beholden to "big business."

The SBA's problems started right away. In 1958, Eisenhower's Budget Bureau warned that the SBA was "an uncontrollable program," but both parties wanted to convey a message that they supported the "little fellow."[3] Members of Congress enjoyed using the SBA to distribute money and favors to their constituents. Members sometimes leaned on the agency to declare a particular business "small" or have a constituent's competitor declared "not small."

The 1960s and 1970s were marked by scandals and failures, including the reported use of SBA loans to establish "front" companies for the mafia. By the mid-70s, the agency had earned the nickname "Small Scandal Administration."[4]

The SBA has become one of the government's chief instruments for pursuing affirmative action, which has led to numerous scandals. Successive administrations used the agency to direct lending and federal contracts to minority-owned firms. Although stamping out discrimination is a laudable goal, the SBA's set-asides have bred corruption and abuse. For example, President Ronald Reagan supported an expansion of SBA procurement set-asides for minority-owned firms. That decision contributed to the "Wedtech Scandal" in which government officials knowingly assisted a corrupt defense contractor that had fraudulently obtained contracts through SBA minority set-asides.

More recently, the SBA has made headlines over abuses of its 8(a) program, which sets aside federal contracts for minority-owned or other "disadvantaged" small businesses. Alaskan Native Corporations, which were created by a federal law in 1971, were "intended to settle longstanding land claims by Alaska natives and provide economic opportunities." After Congress allowed the ANCs to participate in the 8(a) program in 1986, powerful Alaskan Senator Ted Stevens won them additional contracting privileges.

In the past couple of years, controversy has erupted over the ANCs' ability to subcontract work out to companies all over the country, including companies that are not small or "disadvantaged." Because the 2009 stimulus bill required recipients to publicly report subcontractors, researchers at ProPublica have been able to get a clearer idea of who is benefitting from the ANC privileges:

> An analysis by ProPublica, drawing on detailed reports of federal stimulus projects, shows for the first time that ANCs turned to subcontractors at twice the rate of all other federal contractors and significantly more often than other small, minority-owned firms.
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> And at least some of this work has gone to large firms—General Electric, Kiewit and Lockheed Martin—the stimulus reports show, echoing government audits that have fueled the criticism of ANCs.
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> Through September, ANCs had won stimulus contracts worth $823 million for 742 projects, according to the most recent government data. More than 350 projects**,** or nearly half**,** rely on subcontractors to do at least some of the work.
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> By comparison, all other stimulus contractors subcontracted more than 5,600 of nearly 26,000 stimulus projects, or 22 percent. Other minority-owned firms hired subcontractors on 33 percent of their projects.[5]

An investigation by the *Washington Post* found similar abuses with the ANCs and defense contracts.[6] Somewhat humorously, the SBA told the *Post* that it was the Pentagon's responsibility to monitor the contracts, while the Pentagon said the responsibility belonged to the SBA. It's a classic example of bureaucratic ineptitude and finger pointing.

It's also a good example of how well-intentioned programs invariably become corrupted as Washington insiders and well-connected special interests game the system to their advantage. However, instead of trying to "fix" the problems these privileges foster, race-based set-asides should be abolished altogether. And if policymakers want to make life easier for businesses of all races and sizes, they should concentrate their efforts on eliminating burdensome taxes and regulations.

Loan Guarantees

The SBA's flagship 7(a) loan guarantee program guarantees loans issued by private lenders for up to 85 percent of the loss in the event the applicant defaults on the loan. As a result, lenders are more willing to lend money to riskier applicants because the SBA is ultimately responsible for the bulk of any losses. To offset the costs of the SBA's loan programs to the taxpayer, the SBA charges lenders a guaranty fee and a servicing fee for each loan approved and disbursed.

The SBA is supposed to charge fees sufficient to require no annual appropriations from Congress. However, this has not been the case and the program continues to rely on taxpayer subsidies. The recent recession led to an increase in loan defaults, which forced the SBA to increase its purchases of defaulted guaranteed loans from $1 billion in 2006 and 2007 to $3.9 billion in 2009 and $4.8 billion in 2010.[7] In addition, Congress recently passed multiple increases in loans subsidies at the Obama administration's behest in an attempt to goose small business lending.

The purpose of the 7(a) program is to incentivize lenders to provide loans to small businesses that cannot obtain "credit elsewhere."[8] However, the law defines "credit elsewhere" as "the availability of credit from non-Federal sources on reasonable terms and conditions."[9] This broad definition renders false the notion that the SBA only benefits those who literally cannot obtain credit elsewhere.

A recent Government Accountability Office report found that a third of the lenders it sampled "failed to consistently document that borrowers met the credit elsewhere requirement or personal resources test."[10] The GAO noted that for approximately 20 percent of lenders that did provide documentation, "the explanations they provided were generally not specific enough to reasonably support the lender's conclusion that borrowers could not obtain credit elsewhere."[11]

Audits conducted by the SBA's Office of Inspector General have identified "high percentages" of business loans to borrowers who were "ineligible, lacked repayment ability, or did not provide the required support for loan disbursement."[12]

The SBA outsources much of its loan decision-making to private lenders. According to the inspector general, "more than 68 percent of loan dollars guaranteed by SBA are made by lenders using delegated authorities with limited oversight."[13] Not surprisingly, the inspector general reports a long-standing problem with fraud in the 7(a) program:

> For more than a decade, OIG investigations have revealed a pattern of fraud in the 7(a) business loan guaranty program by loan packagers and other for-fee agents. Fraudulent schemes have involved hundreds of millions of dollars, yet SBA oversight of loan agents has been limited, putting taxpayer dollars at risk.[14]

The inspector general has repeatedly found deficiencies in the SBA's oversight of lenders, although it recently noted improvement. Ominously, the inspector general notes that "high-risk lenders now account for more than 80 percent of SBA's 7(a) outstanding portfolio."[15]

The share of guaranteed loans outstanding that the SBA is responsible for currently amounts to over $70 billion.

The inspector general also notes that the SBA "has not aggressively pursued recovery of improper payments."[16] Worse, the SBA appears to be intentionally understating its improper payments problem. For example, the SBA reported an improper payment rate in 2008 of 0.53 percent, but the inspector general found that it was actually 29 percent.[17]

Abolish the Small Business Administration

The Government Accountability Office recently counted 80 economic development programs at four agencies: the SBA, HUD, USDA, and Commerce.[18] The SBA administers 19 of these 80 programs. The four agencies administer a staggering 54 programs involved in "entrepreneurial efforts" alone.

The GAO summarizes its findings as follows:[19]

- The design of each of these economic development programs appears to overlap with that of at least one other program in terms of the economic development activities that they are authorized to fund;

- Commerce, HUD, SBA, and USDA appear to have taken actions to implement some collaborative practices but have offered little evidence so far that they have taken steps to develop compatible policies or procedures with other federal agencies or to search for opportunities to leverage physical and administrative resources with their federal partners; and

- The agencies appear to collect only limited information on program outcomes—information that is necessary to determine whether this potential for overlap and fragmentation is resulting in ineffective or inefficient programs.

The federal government clearly has a problem with duplication and inefficiency with regard to economic development programs. As I discussed, however, government programs and waste go hand-in-hand. Generally speaking, the more the government spends, the more taxpayer dollars will be wasted. Therefore, the best way to rein in waste and inefficiencies is to rein in the size and scope of government.

Economic development subsidies are not a proper role of the federal government. Indeed, what policymakers innocuously refer to as "economic development" is just a form of central planning. In other words, policymakers are substituting their decisions for market decisions on business lending and business investment.

Attempts by policymakers to direct economic activity through the use of subsidies and other privileges granted to particular interests and industries yield political benefits, but they don't benefit the general public. For example, the recent housing collapse and economic downturn was a direct result of distortions in the housing market fostered by government policies.[20]

In addition to the taxpayer costs, the following are some of the problems associated with SBA-style economic development or "corporate welfare:"

1. **Creates an Uneven Playing Field**. By aiding some businesses, corporate welfare puts other businesses at a disadvantage, which distorts markets. That distortion causes resources to flow from higher-valued to lower-valued uses in the economy, which reduces the nation's output.

2. **Duplicates Private Activities**. Many federal programs duplicate activities that are routinely provided in private markets, such as insurance, loans, and marketing. If such commercial-oriented activities are useful, then private markets should be able to perform them without government help.

3. **Harms Businesses and Consumers**. Government support for some businesses damages other businesses and consumers. For example, small businesses that don't receive a loan backed by the SBA are disadvantaged because they must compete against a business that did receive government backing.

4. **Picking Winners Is a Losing Game**. Washington politicians are no more clairvoyant about market trends and scientific breakthroughs than anyone else. Thus, when the government starts choosing industries and technologies to subsidize, it often bets on the wrong horses at taxpayer expense. Note that businesses and venture capital firms make many investments that turn sour as well, but their losses are private and not foisted involuntarily on other people.

5. **Fosters Corruption**. Corporate welfare generates an unhealthy relationship between businesses and the government. As I noted in my testimony, the SBA has a history of scandals that resulted from the government being too cozy with private interests.

Small Business Administration activities – particularly its guaranteed loan programs – display all of these undesirable qualities.

Another undesirable quality is the emergence of special-interests that work to protect their government-granted privileges. Privileged interests have a strong incentive to build organized groups to lobby Congress to expand their benefits. These groups set up camp near Capitol Hill to advocate their issues, and many policymakers become convinced of the merits of special interest causes after hearing about them year after year.

At the same time, average citizens do not have a strong incentive to battle against particular subsidies because each program costs just a small part of their total tax bill. Besides, when average citizens do speak out against particular programs, they are outgunned by the paid professionals who defend each program. These professionals are experts at the complex features of programs, and they are skilled at generating media support for their causes. One technique they use is to cloak the private interests of subsidy recipients in public interest clothing—for example, when government-guaranteed lenders speak of the value of the SBA's 7(a) program to "the small business community" while downplaying the program's value to the lenders' bottom lines.[21]

Another reason it is hard for average citizens to challenge special interest spending is that lobby groups, Congress, and federal agencies rarely admit that any program is a failure or unnecessary. The people in these organizations never admit failure because they become vested in the continued funding of programs since their careers, pride, and reputations are on the line. They battle against any cuts to programs at a personal and emotional level.

The National Association of Government Guaranteed Lenders certainly isn't here today to tell the committee that the 7(a) program ought to be scrapped. It is interesting, though, to note though that the bank lobby was opposed to the government's involvement in business lending back in the 1950s when the SBA was created. The bank lobby eventually had a change of heart after the SBA shifted from directly lending to businesses to guaranteeing loans issued by banks.

Many of the problems with the SBA that have been discussed today have been discussed for decades. There is only one way to eliminate those problems: abolish the Small Business Administration. The United States grew to become the economic envy of the world with a small central government that largely left business development to the private sector. The dramatic ascent of the American economy did not come about as a result of small business subsidies and central planning of economic development from Washington. We should dispense with government favoritism to small businesses and large businesses, and allow America's entrepreneurs to compete on a level playing field to serve consumers, not plunder taxpayers.

Thank you.

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[1] See http://www.politico.com/static/PPM191_poll.html.
[2] See http://www.downsizinggovernment.org/fraud-and-abuse.
[3] For a detailed history of the SBA, see Jonathan J. Bean, *Big Government and Affirmative Action: The Scandalous History of the Small Business Administration*, (Lexington, KY: University Press of Kentucky, 2001).
[4] Bean, p. 89.
[5] Michael Grabell and Jennifer LaFleur, "Alaska Native Firms Shift Stimulus Work to Outsiders," *ProPublica*, January 27, 2011, http://www.propublica.org/article/alaska-native-firms-shift-stimulus-work-to-outsiders.

[6] Robert O'Harrow Jr., "D.C. Insiders Can Reap Fortunes from Federal Programs for Small Businesses," *Washington Post*, March 12, 2011, http://www.washingtonpost.com/investigations/dc-insiders-can-reap-fortunes-from-federal-programs-for-small-businesses/2011/02/09/AB1NRJS_story.html.
[7] Small Business Administration, p. 15.
[8] 15 U.S.C. 636(a)(1)(A).
[9] 15 U.S.C. 632(h).
[10] Government Accountability Office, "Small Business Administration: Additional Guidance on Documenting Credit Elsewhere Decisions Could Improve 7(a) Program Oversight," GAO-09-228, February 12, 2009, p. 4, http://www.gao.gov/new.items/d09228.pdf.
[11] Ibid.
[12] Small Business Administration, "Agency Financial Report – Fiscal Year 2010," p. 101, http://www.sba.gov/sites/default/files/afr_2010_final.pdf.
[13] Ibid., p. 97.
[14] Ibid., p. 99.
[15] Ibid., p. 97.
[16] Ibid., p. 101.
[17] Small Business Administration Office of Inspector General, "Semiannual Report to Congress," Fall 2009, p. 5, http://www.sba.gov/office-of-inspector-general/867/12348.
[18] See Government Accountability Office, "Economic Development: Efficiency and Effectiveness of Fragmented Programs are Unclear," GAO-11-651T, May 25, 2011, http://www.gao.gov/new.items/d11651t.pdf.
[19] Ibid., p. 2.
[20] See Lawrence H. White, "Housing Finance and the 2008 Financial Crisis," Cato Institute, August 2009, http://www.downsizinggovernment.org/hud/housing-finance-2008-financial-crisis.
[21] See Veronique de Rugy, "Banking on the SBA: Big Banks, Not Small Businesses, Benefit the Most from SBA Loan Programs," Mercatus Center, Mercatus on Policy no. 2, August 2007, http://mercatus.org/sites/default/files/publication/Mercatus_On_Policy_Banking_on_the_SBA.pdf.