

“Who Needs the SBA?”

An Historical Perspective on The Small Business Administration”

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

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

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

Overview

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

Yet what is "small" business? Is it really a group with interests separate from "big" business? The latter question is of great importance, as we usually assume that our modern federal bureaucracy embodies the influence—past and present—of organized interest groups. The Small Business Administration challenges this assumption. Support for the agency came from members of Congress rather than small business owners, who were unorganized and considered economic conservatives opposed to the welfare state. The small business community falls into the category of a large group with conflicting internal interests. What did a "Mom-and-Pop" grocery have in common with a "small" manufacturer employing hundreds of people in a high-tech industry? At what point did a "small" business become a "big" business? The one thing that many small business

owners had in common was a resentment of government interference. For a minority of business owners--those who joined national associations--this resentment overcame the "free rider" problem inherent in organizing a political lobby. The welfare state was anathema to these small companies, since it legitimized laws, regulations, and taxes that hit the business owner particularly hard. Here we confront a fundamental paradox: could a federal agency represent the interests of a group that rejected the underlying premise of our welfare state?

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

During the past half-century, the SBA has experienced remarkable growth. Established as a tiny lending agency in 1953, the SBA mushroomed into a financial institution with a significant presence in credit markets. New programs were later established to provide venture capital to growth-oriented companies, assist minority

entrepreneurs, and lend management assistance to firms struggling to survive. By the 1990s, the SBA had become a conglomerate agency pursuing multiple policy objectives.

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

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

In sum, the SBA was and is an affirmative action agency for small and minority enterprise. By discriminating in favor of ill-defined interest groups, the SBA has become

embroiled in constant controversy. Yet, these programs continue to grow and have become entrenched. Nevertheless, periodic scandals and policy failures fuel the continued debate over this troubled agency. Moreover, controversy continues to surround the existence and nature of the small business interest. Do small business owners want more or less government, and what role, if any, should the Small Business Administration play in fostering their interests?

Critical Findings: Who Needs the SBA?

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

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

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

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

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

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

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

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

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

The consequences of the 8(a) program were perverse. A few well-connected firms received the bulk of the set-asides while others received nothing. Obsessed with quotas, the SBA provided little practical assistance. Not surprisingly, most 8(a) firms never developed into viable enterprises. In a classic case of robbing Peter to pay Paul, the SBA took contracts from some of the least advantaged white companies and gave them to minority firms. The agency also applied its eligibility criteria inconsistently, admitting

affluent immigrant groups with dark skin and denying the applications of disadvantaged light-skinned peoples. The program provoked conflicts among African-Americans, whites, women, Jews, and other ethnic groups. Political favoritism and corruption were rampant. The original targets of aid, African Americans, saw their share of the 8(a) pie dwindle as Asians and Hispanics gobbled up set-asides.

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

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

economy. A third party—the not-so-small company—lost business to compensate for the alleged discrimination of procurement officials.

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

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

The problems associated with government growth have raised concerns about the desirability of big, bureaucratic government. Conservatives and libertarians view the federal leviathan as a threat to individual freedom. As government grows, people become less self-reliant, more dependent and more likely to view themselves as victims of

circumstances beyond their control. Moderates and liberals have also expressed concern that government agencies become sclerotic and therefore fail to adjust to changing circumstances. The asymmetry of government growth—with births greatly outnumbering deaths—creates an imbalance between organized interest groups and a diffuse opposition. The fragmented structure of American government further frustrates efforts to repeal programs that have outlived their usefulness.

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

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

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

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

Notes

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

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

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

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

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

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

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

8. Carl S. Shoup, foreword to Joseph D. Phillips, Little Business in the American Economy (Urbana: University of Illinois Press, 1958), v.

9. Between 1958 and 1996, very small businesses (0-19 employees) saw their share of total receipts decline from 31% to 16.8%. Table 2.13, "Distribution of Sales and Employment by Employment Size of Firm, 1958-77," U.S. President, The State of Small Business: A Report of the President Transmitted to the Congress (Washington, DC: GPO, 1982), 92; SBA, Office of Advocacy, "Employer Firms, Establishments, Employment, Annual Payroll and Estimated Receipts by Firm Size, 1988-1996," http://www.sba.gov/advo/stats/us88_96.pdf; Star, Concentration. See also: Table 2.14, "Share of Employment and Sales of Zero-Employee Firms, 1967, 1972 and 1977," U.S. President, The State of Small Business: A Report of the President Transmitted to the Congress (Washington, DC: GPO, 1983), 96.

10. Jonathan J. Bean, "'Burn, Baby, Burn': Small Business and the Urban Riots of the 1960s," The Independent Review 5, no. 2 (Fall 2000): 165-88.

11. Addison Parris, The Small Business Administration (New York: Frederick A. Praeger, 1968), 167; Howard Kurtz. "SBA Entrenched As Petty Cash Drawer." Washington Post, 11 February 1985, A12.

12. Anthony Chase, quoted in Karen DeWitt, "The Small Business Administration," Black Enterprise (January 1975): 27.

13. James Q. Wilson, Bureaucracy: What Government Agencies Do and Why They Do It (New York: Basic Books, 1989), 189-91.

14. Lawrence D. Brown and Brookings Institution, New Policies, New Politics : Government's Response to Government's Growth (Washington: Brookings Institution, 1983).

15. Jonathan R. T. Hughes, The Governmental Habit Redux: Economic Controls From Colonial Times to the Present (Princeton, NJ: Princeton University Press, 1991), 215.

16. Steven Kelman, Making Public Policy: A Hopeful View of American Government (New York: Basic Books, 1987); David Osborne and Ted Gaebler, Reinventing Government: How the Entrepreneurial Spirit Is Transforming the Public Sector (Reading, MA: Addison-Wesley, 1992).

17. David Vogel characterizes business as the only interest group with "an underlying suspicion and distrust of government." He notes the "remarkable consistency of business attitudes toward government over the last one hundred and twenty-five years." David Vogel, "Why Businessmen Distrust Their State: The Political Consciousness of American Corporate Executives," British Journal of Political Science 8, no. 1 (January 1978): 45-46. See also Robert Carlton Gibson, "Political Attitudes of Selected American Business Periodicals, 1930-1955" (Ph.D. diss., The Ohio State University, 1961).

18. Ninety-eight percent favored "cutting or slowing the growth of federal spending." Eighty-two percent supported greater deregulation. Richard I. Kirkland, Jr., "The New GOP to Big Business: Drop Dead!," Fortune, 6 February 1995, 53. In an earlier survey, 87 percent of the CEOs described themselves as "somewhat" or "strongly" conservative on economic issues. Susan Caminiti, "A Bright Future for Conservatism," Fortune, 2 July 1990, 92. See also Thomas Moore, "The New Libertarians Make Waves," Fortune, 5 August 1985, 74-78.

19. Richard Leshner [President, U. S. Chamber of Commerce], Meltdown on Main Street: Why Small Business Is Leading the Revolution Against Big Government (New York: Dutton, 1996).

20. Richard Hofstadter, "What Happened to the Antitrust Movement?" chap. in The Paranoid Style in American Politics and Other Essays (New York: Alfred A. Knopf, 1966), 88.