Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

Memorandum

To: Members, House Committee on Small Business
From: Committee Staff
Date: January 30, 2012
Re: Hearing: "The Path to Job Creation: The State of American Small Businesses"

Introduction

At 1:00 PM on February 1, 2012, the Committee on Small Business will meet for the purpose of receiving testimony on the state of American small businesses. Witnesses will be: Dennis Jacobe, Ph.D., Chief Economist at Gallup; Peter Ferrara, Senior Fellow, Entitlement and Budget Policy at the Heartland Institute; Martin Neil Baily, Director, Initiative on Business and Public Policy, Senior Fellow, Economic Studies at the Brookings Institute, and, Mike Fredrich, President & CEO of Manitowoc Custom Moldings in Manitowoc, WI.

The purpose of the hearing is to examine obstacles to small business job creation and economic growth. On October 24, 2011, Gallup released a poll outlining the most significant concerns facing America's small businesses. This poll mirrors numerous trade association, think tank, and national media polls that point to excessive government regulation, lack of available capital, and low consumer confidence as the biggest hurdles small business must overcome. The hearing aims to set the stage for future debates within the Committee in an effort to narrow our focus to the most pertinent obstacles and to tackle the most egregious impediments to job creation and economic growth.

Economic Overview

According to the National Bureau of Economic Research, the United States economy was in a recession for 18 months from December 2007 to June 2009.[1] It was the longest and deepest recession of the post-World War II era. During the first half of 2008, the recession was not deep as measured by the decline in gross domestic product[2] (GDP) or the rise in unemployment. It

[1] NATIONAL BUREAU OF ECONOMIC RESEARCH, BUSINESS CYCLE DATING COMMITTEE REPORT 1 (Sept. 2010), AVAILABLE *at* http://www.nber.org/cycles/sept2010.pdf. It is important to note this organization is not affiliated with the Federal government.
[2] Real gross domestic product is defined as the output of goods and services produced by labor and property located in the United States.

then deepened from the third quarter of 2008 to the first quarter of 2009. The economy continued to contract slightly in the second quarter of 2009, before returning to expansion in the third quarter. When the fall of economic activity finally bottomed out in the second half of 2009, real GDP had contracted by nearly 4.0%, or about $500 billion. This recession featured the largest decline in output, consumption, and investment, and the largest increase in unemployment since the Great Depression.

While economic indicators point to the recession ending in June of 2009, economic activity has remained sluggish and erratic at best. Real GDP increased 1.8 percent in the third quarter of 2011 after increasing 1.3 percent in the second quarter, according to estimates released by the Bureau of Economic Analysis.[3] Despite the uptick in real GDP, other significant economic weaknesses remain evident:

- Consumer spending, the usual indicator of a strong economic recovery, remains tepid. In general, consumers are not optimistic about their economic prospects, as consumer confidence measures are still well below pre-recession levels.[4]

- Housing prices continued to decline, down 4.7% for the year ending October 2011.[5] Moreover, in the third quarter of 2011, the incidence of negative equity increased with an estimated 28.6% of mortgage holders currently "underwater."[6] In addition to dampening direct expenditures on housing, these factors weaken household balance sheets and dampen household spending generally.

- Employment conditions remain weak. The unemployment rate, which had peaked at 10% in October of 2009, fell only to 8.5% in December 2011.[7] Most of this improvement occurred during 2010 with essentially no net improvement through the first 10 months of 2011. Economic growth in most of 2011 has only been just fast enough to keep the unemployment rate from rising. This high rate of unemployment after more than two years of economic recovery is unusual and a source of concern.

- The level of consumer revolving credit continues to fall, down 2% in the third quarter of 2011. This weakened flow of credit to households reflects a mixture of demand and supply forces at work, with cautious behavior by both lenders and consumers playing a role.[8]

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[3] BUREAU OF ECONOMIC ANALYSIS, NATIONAL INCOME AND PRODUCT ACCOUNTS GROSS DOMESTIC PRODUCT, 3rd Quarter, *available at* http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm.
[4] UNIVERSITY OF MICHIGAN, INDEX OF CONSUMER SENTIMENT, *available at* http://research.stlouisfed.org/fred2/series/UMCSENT.
[5] NATIONAL ASSOCIATION OF REALTORS, MEDIAN SALES PRICE OF EXISTING SINGLE-FAMILY HOMES FOR METROPOLITAN AREAS, THIRD QUARTER 1 (2011), *available at* http://www.realtor.org/research/research/metroprice.
[6] ZILLOW REAL ESTATE RESEARCH, NO RESPITE FROM HOUSING RECESSION IN FIRST QUARTER, (May 2011), *available at* http://www.zillow.com/blog/research/2011/05/08/no-respite-from-housing-recession-in-first-quarter/.
[7] BUREAU OF LABOR AND STATISTICS, LABOR FORCE STATISTICS FROM THE CURRENT POPULATION SURVEY, OCTOBER 2011, *available at* http://data.bls.gov/pdq/SurveyOutputServlet.
[8] FEDERAL RESERVE, STATISTICAL RELEASE; CONSUMER CREDIT 1 (Nov. 2011), *available at* http://www.federalreserve.gov/releases/g19/current/g19.pdf.

The State of Small Businesses

Small businesses, those with fewer than 500 employees,[9] are generally the creators of the most new jobs, as well as the employers of about half of the nation's private sector work force. Small businesses also account for about half of the nonfarm, private real gross domestic product. As the recession deepened in 2009, small firms accounted for almost 60 percent of the job losses.

The Bureau of Labor and Statistics releases data on quarterly net job changes by firm size in its Business Employment Dynamics series. The figure below shows net changes in employment for firms with 1 to 19, 20 to 499, and 500 or more employees from the first quarter of 2005 through the third quarter of 2011. It clearly illustrates that small firms shed a significant number of jobs during the recession. In fact, larger small businesses with 20 to 499 employees saw dramatic declines in their net employment at the end of 2008 through the first quarter of 2009. Small businesses as a whole lost more jobs than their larger counterparts in all but one quarter during the recession.[10] This makes the current recession different from the 2001 downturn, in which larger businesses experienced greater net job declines and very small businesses were quicker to recover and have net job increases.[11]

Hearing Focus

As the chart above indicates, job creation for small businesses is improving slightly. That said, economic uncertainty regarding federal regulation and tax burdens, lack of consumer

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[9] There are multiple definitions of small business and this memorandum adopts one such categorization, less than 500 employees.

[10] Sahin, Kitao, Cororaton, & Laiu, Why Small Businesses Were hit Harder by the Recession, in 17 CURRENT ISSUES IN ECONOMICS AND FINANCE, VOL. 4, at 3, *available at* http://www.newyorkfed.org/research/current_issues/ci17-4.pdf.

[11] *Id.*

confidence and lack of small business optimism still pose a significant challenge to small businesses' future growth.

On October 24, 2011, Gallup released a poll that outlined small business owners' most pressing concerns. According to this poll, small business owners are most likely to say complying with government regulations (22%) is the most important problem facing them today, followed by consumer confidence in the economy (15%) and lack of consumer demand (12%).

What do you think is the most important problem facing small-business owners like you today? [OPEN-ENDED]

	%
Complying with government regulations	22
Consumer confidence	15
Lack of consumer demand	12
Lack of credit availability	10
Poor leadership/Government/President	9
Cash flow	7
New healthcare policy	5
Competition from big business and overseas	4
Lack of jobs	4

Wells Fargo/Gallup Small Business Index, Oct. 3-6, 2011

GALLUP

Complying with Government Regulations

Small business owners face unique challenges in navigating federal regulations. According to the study "The Impact of Regulatory Costs on Small Firms" published by the SBA's Office of Advocacy in September 2010, the annual cost of federal regulation in the United States increased to more than $1.75 trillion in 2008. Had every U.S. household paid an equal share of the federal regulatory burden, each would have owed $15,586 in 2008.[12] By comparison, the federal regulatory burden exceeds by 50 percent private spending on health care, which equaled $10,500 per household in 2008. While all citizens and businesses pay some portion of these costs, the distribution of the burden is quite uneven.

The portion of regulatory costs that falls initially on businesses was $8,086 per employee in 2008. The smallest of the small businesses (those defined as 19 employees or less) bear the largest burden of federal regulations. As of 2008, small business face an annual regulatory cost of $10,585 per employee, which is 36 percent higher than the per-employee regulatory cost facing large firms (defined as firms with 500 or more employees).

The underlying force driving this differential cost burden is easy to understand. Many of the costs associated with regulatory compliance are "fixed costs," that will not vary with the size

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[12] NICOLE V. CRAIN AND W. MARK CRAIN, THE IMPACT OF REGULATORY COSTS ON SMALL FIRMS, OFFICE OF ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION, at iv 3(Sept. 2010), *available at* http://www.sba.gov/sites/default/files/rs371tot.pdf.

of the firm. As a result, large firms can spread these costs over more employees thereby gaining a cost advantage in comparison to smaller firms. An example may help elucidate this proposition. Assume that the Federal Deposit Insurance Corporation imposes a reporting requirement that banks must make and that the report costs $100,000. A bank with only 100 employees will face an additional cost of $1,000 per employee. A bank with 100,000 employees will face a cost of only $1 per employee. The reporting requirement, although nominally identical has a disparate impact on smaller banks. The smaller bank, in order to recover the cost, may have to charge higher fees than its larger competitor thereby harming the ability of small businesses to grow. Although economies of scale are generally perceived in the production of a good, these economies also exist in compliance with regulations.[13] The raft of new regulations with respect to health care, the environment, and taxes, this will exacerbate the competitive disadvantages facing small businesses. The comparative disadvantage may damper small businesses' willingness to expand thereby hindering job growth.

Lack of Consumer Confidence and Consumer Demand

Consumer confidence plummeted during the 2007-2009 recession. Prepared monthly by the Conference Board,[14] the Consumer Confidence Index® (CCI)[15] is an economic metric used to gauge how people feel about the future of the economy and their own financial situation. In the most simplistic terms, when their confidence is trending up, consumers spend money–indicating a healthy economy. When confidence is trending down, consumers are saving more than they are spending–indicating the economy is in trouble. The idea is that the more confident people feel about the stability of their incomes, the more likely they are to make purchases.

In November of 2007 (right before the recession began) the CCI was near 90 (1985=100). It then dropped to a low near 15 at the end of 2008. Over the past three years, the CCI has risen, albeit erratically, and in December 2012 the CCI reached 64.5.[16] While consumer confidence appears to be improving, like nearly every other economic indicator, it still needs significant gains to reach pre-recession levels.

Lack of Credit Availability

Lending to small businesses slowed considerably during the recession.[17] The resulting downturn left slow growth and high unemployment throughout the country. The banks, in part due to lack of confidence in the economic outlook and partially in response to stricter oversight

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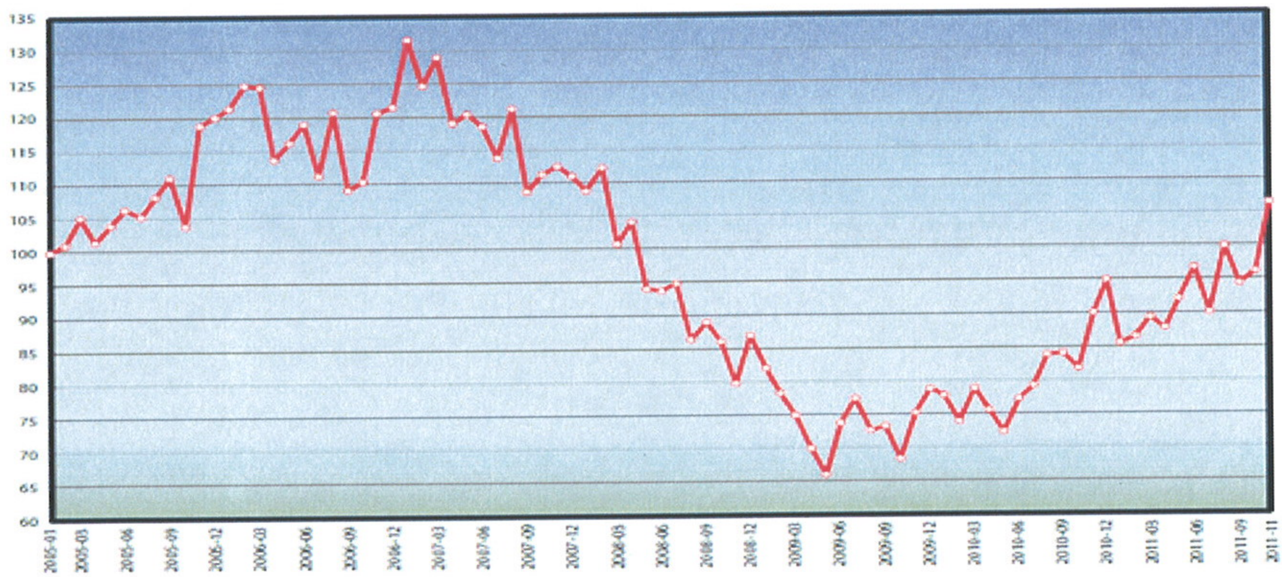
[13] *Id.*
[14] The Conference Board is a global, independent business membership and research association working in the public interest. For more information, please see http://www.conference-board.org.
[15] The index is based on approximately 3,000 completed questionnaires reflecting consumers' perceptions of current business and employment conditions, as well as their expectations for six months hence regarding business conditions, employment, and income.
[16] Conference Board, *The Conference Consumer Confidence Index Improves Again* (Dec. 2011), *available at* http://www.conference-board.org/data/consumerconfidence.cfm.
[17] OFFICE OF THE CHIEF COUNSEL FOR ADVOCACY, UNITED STATES SMALL BUSINESS ADMINISTRATION, LENDING BY DEPOSITORY LENDERS TO SMALL BUSINESSES 2003 TO 2010 8 (2011), *available at* http://www.sba.gov/sites/default/files/rs380tot.pdf.

by regulators, tightened credit. From 2008 to 2010, small business lending by depository institutions declined by 8.3 percent to $652 billion.[18]

Overall, financing for small businesses is showing modest improvements.[19] The Thompson Reuters/Paynet Small Business Lending Index[20] measures the volume of new commercial loans and leases to small businesses and is indexed so that January 2005 equals 100. Because small businesses generally respond to changes in economic conditions more rapidly than larger businesses do, the SBLI serves as a leading indicator of the economy. The chart below again shows that while conditions appear to be improving, conditions must continue to improve greatly to reach pre-recession levels.

Thomson Reuters/PayNet
Small Business Lending Index



Federal Debt/Eurozone Debt

Although not touched on by the Gallup poll, many economists and analysts cite the federal debt as a significant impediment to economic growth and the overall economy. The budget deficit (the difference between outlays and revenues) each year from 2009 to 2011 has been the highest ever in dollar terms and significantly higher as a share of GDP than in any other year since World War II. While there has been no difficulty financing the deficit to date, at some point, investors could refuse to continue to finance deficits that they believe are unsustainable. The total U.S. federal debt currently stands at $15.2 trillion.

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[18] *Id.*

[19] BRIAN HEADD, OFFICE OF THE CHIEF COUNSEL FOR ADVOCACY, UNITED STATES SMALL BUSINESS ADMINISTRATION, SMALL BUSINESS QUARTERLY BULLETIN, THIRD QUARTER 2011, *available at* http://www.sba.gov/sites/default/files/SBQB_2011q3.pdf .

[20] THOMPSON REUTERS/PAYNET, SMALL BUSINESS LENDING INDEX (November 2011), *available at* http://thomsonreuters.com/content/financial/pdf/i_and_a/indices/small_business_lending_index_1111.pdf.

Since the global financial crisis of 2008-2009, public debt in advanced economies around the world has increased substantially. A number of factors related to the financial crisis have fueled the increase, including fiscal stimulus packages, the nationalization of private-sector debt, and lower tax revenue. Even if economic growth reverses some of these trends, such as by boosting tax receipts and reducing spending on government programs, aging populations in advanced economies are expected to strain government debt levels in coming years.

High levels of debt in advanced economies are a new global concern. High public debt levels have become unsustainable in a number of Eurozone economies: Greece, Ireland, Italy, Portugal, and Spain. These countries turned to the International Monetary Fund (IMF) and other European governments for financial assistance in order to avoid defaulting on their loans.

To date, many advanced-economy governments have embarked on fiscal austerity programs (such as cutting spending or increasing taxes) to address historically high levels of debt. This policy response has been criticized by some economists as possibly undermining a weak recovery from the global financial crisis. Others argue that the austerity plans do not go far enough, and do not share the burden of adjustment with creditors who, they argue, engaged in reckless lending.

Some economists[21] and Members of Congress fear that, given historically high levels of U.S. public debt, the United States is headed towards a debt crisis similar to those experienced by some Eurozone countries. Others[22] argue that important differences between the United States and Eurozone economies, such as growth rates, borrowing rates, and type of exchange rates put the United States in a different, if not much stronger, position.

How other advanced economies address their debt levels has implications for the United States economy. Currently, most advanced economies are focused on austerity programs to lower debt levels. This could slow growth in advanced economies (including our own) and, because they are among the United States' main trading partners, depress demand for U.S. exports.[23] If advanced economies shift to restructuring debt, U.S. creditors exposed overseas could face losses on their investments.[24] As is the case in most situations, large swings in economic activity worldwide tend to impact (either positively or negatively) small businesses faster and more deeply than larger businesses.

Conclusion

One of the most important things Congress and the Administration can provide small business owners is a sense of certainty in their regulatory and tax structures. It remains difficult for entrepreneurs to plan more than a short time into the future due to continuing uncertainty in the U.S. economy. This hearing represents an opportunity to hear testimony from experts on the

[21] *Hearing before the Subcommittee on Security and International Trade of the Senate Committee on Banking, Housing, and Urban Affairs on The European Debt and Financial Crisis:* Origins, Options, and Implications of the United States and Global Economy, Testimony of J.D. Foster, Ph.D. at 4 (Sept. 2011) (Foster Testimony).
[22] See Paul Krugman, Opinion, *We're Not Greece,* N.Y. TIMES, May 14, 2010, at A27 *available at http://www.nytimes.com/2010/05/14/opinion/14krugman.html.*
[23] Foster Testimony at 4.
[24] Foster Testimony at 4, 5.

world and national economy and small business owners on the most pressing impediments to job creation and economic growth in the U.S. small business sector as well as to listen to potential solutions to those problems.