

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6515

Memorandum

To: Members, House Committee on Small Business
From: Chairman Sam Graves
Date: February 9, 2011
Re: Hearing: "Putting Americans Back to Work: The State of the Small Business Economy"

Introduction

At 1:00 PM on February 16, 2011, the House Committee on Small Business will hold a hearing titled: "Putting America Back to Work: The State of the Small Business Economy." There will be four witnesses: Ms. Terry Frank, Owner of Nature's Marketplace in Oak Ridge, TN; Ms. Dixie Kolditz, Owner of Open-Box Creations in Cathlamet, WA; Mr. Bill Feinberg, President of Allied Kitchen and Bath in Ft. Lauderdale, FL; and William Phelan, President and Co-Founder of PayNet, Inc. in Skokie, IL. The purpose of the hearing is to examine obstacles to small business job creation and economic growth, with a particular emphasis on federal tax policy, undue regulatory burdens, and health care policy. Each of the witnesses has been instructed to discuss one of the three main themes so as not to have one topic dominate the discussion. The goal is to identify specific tax, regulatory, and health care policies that are inhibiting job creation and economic growth. This 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.

Overview

The 2007-2009 recession was long and deep, and according to several indicators was the most severe economic contraction since the 1930s (but still much less severe than the Great Depression). The slowdown of economic activity was moderate through the first half of 2008, but at that point the weakening economy was overtaken by a major financial crisis that would exacerbate the economic weakness and accelerate the decline.

When the fall of economic activity finally bottomed out in the second half of 2009, real gross domestic product (GDP) had contracted by nearly 4.0%, or about \$500 billion. The decline in economic activity was much sharper than in the two most recent recessions, in 2001 and 1990 respectively. The most recent recession of similar severity was in 1973 in which real GDP fell about 3.2%. (However, the recent decline falls well short of the experience during the Great Depression when real GDP decreased by 30%).

Recent evidence suggests that the process of economic recovery is occurring. However, the pace of growth is slow, much of that growth is currently sustained by transitory factors, and growth has recently shown signs of decelerating.

- The economy began to recover in mid-2009. Real GDP (i.e., GDP adjusted for inflation) increased at an annualized rate of 2.2% and 5.6% in the third and fourth quarters of 2009; and 3.7%, 1.7%, and 2.5% in the first, second, and third quarters of 2010. Of concern, however, is that in the second and third quarter of 2010, growth has slowed to around a 2% annual rate, a pace that may not be fast enough to keep the unemployment rate from rising. Moreover, without the temporary contributions of inventory adjustments and federal stimulus spending, the real economy grew only 0.5% in the third quarter of 2010. On the positive side, during 2010 the rate of consumer spending (representing nearly 70% of GDP) has increased moderately and exports have continued to grow.¹
- Manufacturing activity is increasing. By October 2010, output had increased 6.1% over a year earlier and capacity utilization has risen from a low of 65% in mid-2009 to nearly 74%.²
- Since mid-2009 employment has increased, but the gains have been modest.
- The stock market has rebounded and interest rate spreads on corporate bonds have narrowed. The DowJones stock index had plunged to near 6500 in March 2009 but has risen substantially since then. Spreads on investment grade corporate bonds, a measure of the lenders' perception of risk and credit worthiness of borrowers, have fallen from a high of 600 basis points in December 2008 to less than 100 basis points by mid-2010.³
- China and Asia's other emerging economies are having strong recoveries and the large advanced economies of Germany, France, and Japan have recently recorded

¹ Department of Commerce, Bureau of Economic Analysis, <http://www.bea.gov/national/index.htm#gdp>.

² Board of Governors of the Federal Reserve System, *Statistical Release G.17*, <http://www.federalreserve.gov/releases/g17/>.

³ Data on spreads found at <http://www.bloomberg.com/apps/quote?ticker=.TEDSP%3AIND>.

positive output growth. Recovery in the rest of the world would likely transmit a positive impulse to the United States by boosting demand for U.S. exports.

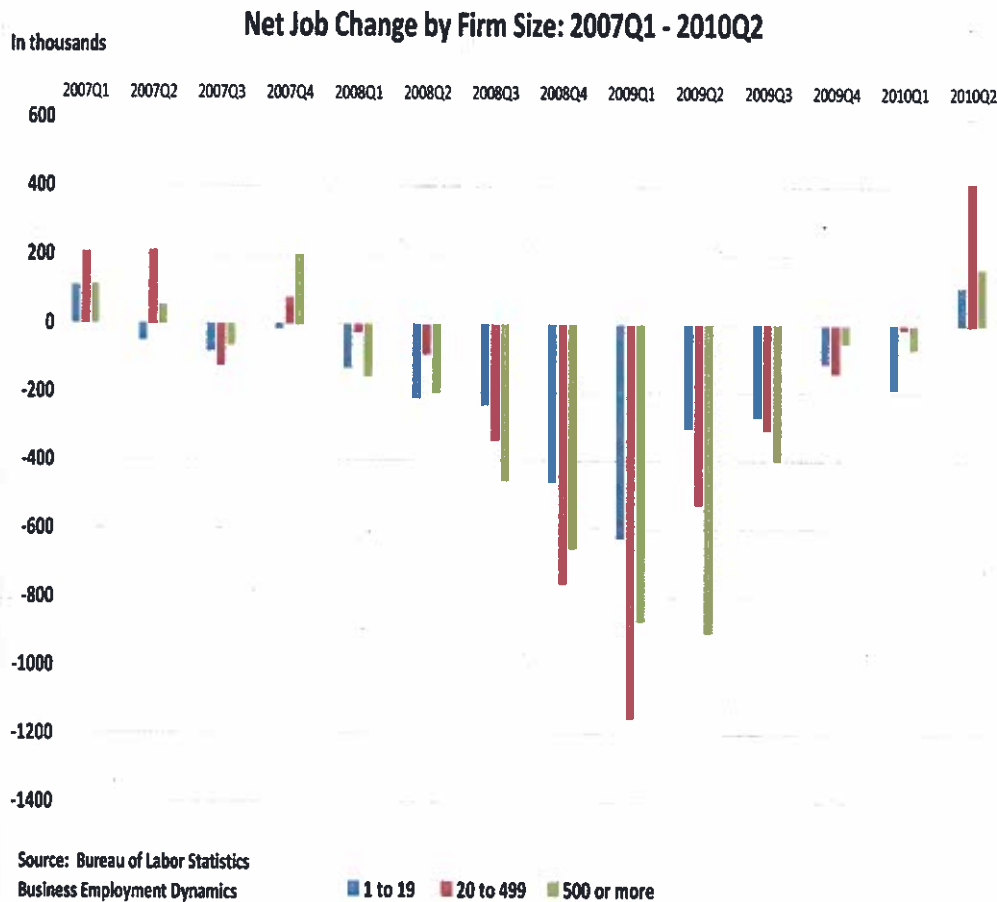
On the other hand, significant economic weakness remains evident.

- Consumer spending, although improving, remains tepid.
- Employment gains are only keeping pace with growth of the labor force, leaving the unemployment rate historically high at 9.0%.
- The housing market remains weak. Mortgage loan foreclosures continue to rise. House prices are still falling, continuing to have an adverse effect on the balance sheets of households and banks, and dampening the recovery of aggregate spending.
- Despite low interest rates, the Fed reports that credit conditions remain tight, making getting loans difficult for consumers and businesses, and limiting many types of credit supported expenditures.

The State of Small Businesses

Small businesses—those with fewer than 500 employees—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, as well as half of the nonfarm, private real gross domestic product. But just as small firms lead when the economy is gaining jobs, in some recessionary periods they experience greater job losses when the economy is shedding jobs. As the recession deepened in 2009, small firms accounted for almost 60 percent of the job losses.

The Bureau of Labor and Statistics release data on quarterly net job changes by firm size in its Business Employment Dynamics series. The figure on the next page shows net changes in employment for firms with 1 to 19, 20 to 499, and 500 or more employees from the first quarter of 2007 through the second quarter of 2010. 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. 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.



Hearing Focus

As the chart above indicates, the job creation, and therefore economic, outlook for small businesses is improving. The second quarter of 2010 showed the first real employment gains in two and a half years. That said, economic uncertainty regarding federal regulation and tax burdens and health insurance costs still pose a significant challenges to small businesses' future growth. Although financing continues to be a concern for small businesses, there does appear to be a slight thawing as the number of businesses unable to get adequate financing and those that report being impacted by the credit crunch is at its lowest point since December 2010.⁴

The National Small Business Association's (NSBA) recently released its 2010 Year End Economic Report. Among the issues small business owners ranked as top

⁴ National Small Business Association 2010 Year End Economic Report
http://www.nsba.biz/docs/2010_ye_economic_report.pdf

issues for Congress and the administration should address, only reducing the national deficit (23 percent) outpaced the traditional concerns of reducing the tax burden (19 percent), reigning in the costs of health care reform (17 percent) and reducing the regulatory burden (17 percent).

Taxes

Small businesses consistently rank reducing the tax burden among their top issues for Congress and the administration to address. Although the actual out-of-pocket cost is significant, the sheer complexity of the tax code has been an ever-increasing burden for small business. According to the NSBA survey, 43 percent of respondents said they spend more than \$5,000 to prepare their taxes and 60 percent said they spend more than 40 hours.

Simplicity in the tax apparatus is critically important for both large and small businesses. Complexity can often lead to errors, which increases costs above and beyond what would normally be required. Additionally, small businesses, many of whom have limited resources, are forced to spend their time attempting to comply with their tax obligations. According to the Internal Revenue Service itself, the tax code today is 3.8 million words compared to 1.4 million in 2001.

According to a Taxpayer Advocate Service analysis of IRS data, U.S. taxpayers and businesses spend about 6.1 billion hours a year complying with the filing requirements of the Internal Revenue Code. And that figure does not include the millions of additional hours that taxpayers must spend when they are required to respond to IRS notices or audits.

Health Care Costs

Health care benefits is one of the most expensive benefits provided by employers or purchased by small business owners. These plans are critical to small firms interested in attracting and retaining productive workers and competing with larger businesses. Firms can purchase health insurance in the marketplace from private providers and insurers or they can self-insure and provide their own benefits package. Even though small business are providing jobs for large segments of the labor force, most small businesses are likely to offer fewer and less comprehensive benefits than larger businesses.

Job-based health insurance costs have substantially outpaced inflation and wage increases over the past decade. The Kaiser Family Foundation reports that the average cost of a family premium for employer-sponsored health insurance increased 114 percent between 2000 and 2010. These premiums have forced small business owners to make numerous changes in the coverage they offer their workers. Changes include sharing the

costs of such coverage with their employees, pursuing lower-cost options such as consumer-driven plans, choosing not to offer coverage at all, or cutting back on other employee benefits.

Virtually all employers with 200 or more employees offer health insurance benefits to their workers. In contrast, 68 percent of those with fewer than 200 employees offered such benefits in 2010. For very small firms with 3 to 9 employees, the offer rate was 59 percent.⁵

On March 23, 2010, President Obama signed the Patient Protection and Affordable Care Act (PPACA) into law. Most small business trade associations have said that PPACA greatly complicates life for a small business owner, stating it adds costs and red-tape and undermines the ability of businesses to gauge its future costs and those of its competitors. Among the various mandates contained in the bill, the five most often cited provisions as being particularly burdensome are the employer mandate, the benefit mandate structure and process, the 1099 requirement, excessive administrative discretion and the two new payroll and income taxes that begin in 2013.

Regulatory Burden

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 2008.⁶ 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 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,” which is to say a firm with five employees incurs roughly the same expense as a firm with 500

⁵ Kaiser Family Foundation and the Health Research & Educational Trust (2010). 2010 Kaiser/HRET employer health benefits survey.

⁶ “The Impact of Regulatory Costs on Small Firms” by Nicole V. Crain and W. Mark Crain, Lafayette College for the SBA Office of Advocacy, September 2010.

employees. In large firms, these fixed costs of compliance are spread over a large revenue, output, and employee base, which results in lower costs per unit of output as firm size increases. This is the familiar empirical phenomenon known as economies of scale, and its impact is to provide a comparative cost advantage to large firms over small ones.⁷

Complying with the ever-increasing regulatory burden is similar to that of compliance with the tax code. Of course, there are specific and direct monetary components (i.e., a business purchasing new equipment because the old equipment has been deemed harmful or unsatisfactory) but there are also non-direct costs. Small businesses often do not have legal departments that monitor the Federal Register and seek out new regulations that they must comply with; they often pay someone to do it for them. Adding to the out of pocket expense is simply understanding the regulations once they have been identified. This takes time, which is time that an entrepreneur could be spending doing his or her chosen trade.

Federal spending by regulatory agencies on regulatory activity reached \$47.8 billion in fiscal year 2008. By comparison, federal agencies only spent \$20.9 billion of regulatory activities in fiscal year 1990⁸. While the number of federal regulations has remained somewhat constant over the previous thirty years, averaging between 3,000 and 4,000 per year, the undue strain on the economy due to the massive amounts of paperwork is palpable.

With concerns over new major environmental, health care, and tax regulations suggested by the administration, the disparities shown above could continue to worsen.

Conclusion

One of the most important things Congress and the administration can provide small business owners is certainty. It remains difficult for entrepreneurs to plan more than a short time in the future due to fluctuating tax rates, uncertainty with the regulatory process, and apprehension regarding the new health care law. Small businesses are struggling to create jobs and grow their businesses amid threats of higher taxes and more unmanageable federal mandates and regulations.

This hearing represents an excellent opportunity to hear testimony from small business owners on the most pressing impediments to job creation, as well as listen for potential solutions to those problems.

⁷ Ibid.

⁸ Ibid.