

To: Members, Subcommittee on Investigations, Oversight and Regulations, Committee on Small Business
From: Committee Staff
Date: November 3, 2015
Re: Subcommittee Hearing: *Regulatory Overload: The Effects of Federal Regulations on Small Firms*

On Friday, November 6, 2015, at 2:00 p.m. at North Las Vegas City Hall, North Las Vegas, NV, the Subcommittee on Investigations, Oversight and Regulations of the Committee on Small Business will meet for the purpose of receiving testimony on the effects of federal regulations on small businesses. The existing regulatory requirements impose significant burdens on small firms that are exacerbated by the creation of new regulations. The Subcommittee will examine several federal regulations (either in development or that have been finalized) and their impacts on small businesses.

I. Introduction

Across the country, federal regulations are a pervasive issue that affects small firms across all industries. A September 2015 survey of small business owners cited government regulations and red tape (tied with taxes) as the number one issue that is facing entrepreneurs.¹ Due to their size and resources, small businesses are disproportionately burdened by regulations in comparison to their larger counterparts.² Regulations with fixed compliance costs, such as environmental regulations that require a specific pollution control device, may have a particularly disproportionate impact on small businesses.

II. Effects of Regulation on Economic Growth

As the United States continues to struggle with recovery from the Great Recession,³ one way to measure this rebound is through new firm creation. In a flexible, non-stagnant economy there are “opportunities for businesses to enter the market or expand, but it also allows businesses to fail or contract.”⁴ However, the rate of new business creation has dropped by nearly fifty percent from 1978.⁵

¹ <http://www.nfib.com/surveys/small-business-economic-trends/>.

² W. MARK CRAIN AND NICOLE V. CRAIN, NATIONAL ASSOCIATION OF MANUFACTURERS, THE COST OF FEDERAL REGULATION TO THE U.S. ECONOMY, MANUFACTURING AND SMALL BUSINESS 1(2014), available at <http://www.nam.org/Data-and-Reports/Cost-of-Federal-Regulations/Federal-Regulation-Full-Study.pdf>. Small businesses with less than 50 employees annually spend 17 percent more than an average firm to comply with federal regulations.

³ According to economists, the United States experienced an economic recession from December 2007 through June 2009. NATIONAL BUREAU OF ECONOMIC RESEARCH, BUSINESS CYCLE DATING COMMITTEE REPORT 1 (2010), available at <http://www.nber.org/cycles/sept2010.pdf>. It is important to note this organization is not affiliated with the federal government.

⁴ https://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=1532&.

⁵ IAN HATHAWAY, MARK E. SCHWEITZER, AND SCOTT SHANE, FEDERAL RESERVE BANK OF CLEVELAND, THE SHIFTING SOURCE OF NEW BUSINESS ESTABLISHMENTS AND NEW JOBS 2 (2014), available at <http://www.clevelandfed.org/research/commentary/2014/2014-15.pdf>. In 1978, there were 12 new businesses created for each existing business while in 2011 there were only 6.2 new firms created for each established business. *Id.*

Although there are many factors contributing to the decline of new business creation, regulations are a significant barrier to entry for new firms. Between 1997 and 2010, the industries with the least regulation “grew twice as fast as the most regulated industries.”⁶ Small firms have less revenue and a smaller employee base than larger firms over which compliance costs can be spread.⁷ In the United States, recent research suggests that a 10 percent increase in regulation leads to a 0.5 percent decrease in overall firm births.⁸ Notably, research comparing countries regulatory burdens found that stricter regulation of entry for firms has not led to “higher-quality products, better pollution records or health outcomes, or livelier competition.”⁹ Rather, research found that “countries with stricter regulation of entry are more likely to exhibit sharply higher levels of corruption and a larger unofficial economy.”¹⁰ Further, for established firms in highly regulated industries, evidence suggests that regulations are responsible for lower productivity.¹¹

To demonstrate the trend noted above, one only needs to look at the finance industry, which is considered one of the most highly regulated industries in the United States.¹² In response to the problems of highly leveraged banks, speculative derivatives trading, and overly lenient lending in the real estate market, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010¹³ (hereinafter “Dodd-Frank”) to prevent another collapse of the financial system. The law provides for a comprehensive reorganization of the regulatory structure surrounding the financial services industry. Dodd-Frank required nearly 400 new rules, and as of September 30, 2015, 249 rules had been implemented and 58 proposed.¹⁴

As the number of Dodd-Frank regulations increased, there has been a parallel reduction in the number of financial institutions. At the end of 2010, the Federal Deposit Insurance Corporation (FDIC) insured 7,657 commercial banks and saving institutions.¹⁵ Five years later, the number of FDIC-insured banks has dropped to 6,419.¹⁶ For credit unions, which are overseen by the National Credit Union Administration and insured by the National Credit Union Insurance Fund, the trend has been disturbingly similar, as at the end of 2010 there were 7,339¹⁷

⁶ <http://mercatus.org/publication/more-regulated-industries-experience-lower-productivity-growth>.

⁷ OFFICE OF MANAGEMENT AND BUDGET, 2014 DRAFT REPORT TO CONGRESS ON THE BENEFITS AND COSTS OF FEDERAL REGULATIONS AND UNFUNDED MANDATES ON STATE, LOCAL, AND TRIBAL ENTITIES 39 (2014), available at http://www.whitehouse.gov/sites/default/files/omb/infocore/2014_cb/draft_2014_cost_benefit_report-updated.pdf.

⁸ JAMES BAILEY AND DIANA THOMAS, MERCATUS CENTER, GEORGE MASON UNIVERSITY, REGULATING AWAY COMPETITION: THE EFFECT OF REGULATION ON ENTREPRENEURSHIP AND EMPLOYMENT 11 (2015), available at <http://mercatus.org/sites/default/files/Bailey-Regulation-Entrepreneurship.pdf>.

⁹ *Id.* at 5.

¹⁰ *Id.*

¹¹ <http://mercatus.org/publication/more-regulated-industries-experience-lower-productivity-growth>.

¹² <http://media.ibisworld.com/2013/09/17/10-increasingly-regulated-industries/>.

¹³ Pub. L. No. 111-203, 124 Stat. 1376.

¹⁴ DAVIS POLK, DODD-FRANK PROGRESS REPORT 4 (3rd Qtr. 2015), available at http://www.davispolk.com/sites/default/files/Q32015_Dodd.Frank_Progress.Report.pdf.

¹⁵ FDIC, 2010 ANNUAL REPORT 124 (March 2011), available at <https://www.fdic.gov/about/strategic/report/2010annualreport/AR10final.pdf>.

¹⁶ FDIC, STATISTICS AT A GLANCE (March 2015), available at <https://www.fdic.gov/bank/statistical/stats/2015mar/industry.pdf>.

¹⁷ NCUA, 2010 YEARNED STATISTICS FOR FEDERAL INSURED CREDIT UNIONS 1, available at <http://www.ncua.gov/Legal/Documents/Reports/CUStat2010.pdf>.

and by March 2015 their number had dropped to 6,206.¹⁸ Further, the rate of new bank growth has slowed dramatically, resulting in only 4 new banks from 2011 through 2013, a stark contrast from 2002-2008 where they were more than 100 new banks started.¹⁹ The factors that lead to new entrants in the market are varied, but research suggests that after the financial crisis the additional regulatory hurdles imposed by Dodd-Frank “may be particularly burdensome for small banks that are just getting started.”²⁰

III. Regulatory Flexibility Act

While the aforementioned discussion highlighted one regulated industry, the issue of the effect of regulation on small firms has been a longstanding concern for Congress. In 1980, recognition that one-size-fits all regulation can impose significant burdens on small business and that small firms were underrepresented in the federal rulemaking process spurred Congress to enact the Regulatory Flexibility Act, 5 U.S.C. §§ 6012-12 (RFA).²¹ The RFA requires agencies to identify and account for the potentially excessive costs and disproportionate impacts of regulations on small businesses and examine ways to reduce unnecessary regulatory burdens.

Federal agencies must comply with the requirements of the RFA for every rule, both proposed and final, for which they must conduct notice and comment rulemaking²² as required by § 553 of the Administrative Procedure Act (APA) or any other law. The RFA requires agencies to evaluate their regulatory proposals to ensure that, while accomplishing their statutory mandates, the ability of small businesses to invent, produce, compete, and expand is not hindered.

Before an agency issues a proposed rule, it must conduct a threshold analysis of the economic impact of the proposed rule. If the agency determines that the proposed rule will have a “significant economic impact on a substantial number of small entities,” it must prepare an

¹⁸ NCUA, OVERALL TRENDS 1 (June 2015), *available at* <http://www.ncua.gov/Legal/Documents/Reports/FT20150331.pdf>.

¹⁹ ROISIN MCCORD, EDWARD SIMPSON PRESCOTT, AND TIM SABLİK, FEDERAL RESERVE BANK OF RICHMOND, EXPLAINING THE DECLINE IN THE NUMBER OF BANKS SINCE THE GREAT RECESSION 2 (March 2015), *available at* https://www.richmondfed.org/~media/richmondfedorg/publications/research/economic_brief/2015/pdf/eb_15-03.pdf. Please note the term new as used in this memo refers to a de novo entrant, which is a newly formed bank rather than a bank converting its charter, opening a new branch, or a bank that was part of holding company spinning off into independent status.

²⁰ *Id.* at 4.

²¹ The RFA uses the term “small entities,” which includes small businesses, small not-for-profit organizations, and small governmental jurisdictions. *See* 5 U.S.C. § 601(6). For the sake of simplicity, the memo will use the term “small business.”

²² Notice and comment rulemaking is the process by which regulated entities can provide input to regulators on rules that are under development. The agency must publish a notice of proposed rulemaking in the Federal Register that includes relevant information including: how individuals can submit written data, view or arguments; deadlines; the legal authority under which the rule is proposed; and the proposed rule itself. 5 U.S.C. § 553(b)-(c). The number days for comment are not specified and the period can go from 7 days to 4 months. Agencies must provide and wait at least 30 days after a final rule is published before it becomes effective. *Id.* at § 553(d). There are exceptions to these requirements that are not relevant for this hearing.

“initial regulatory flexibility analysis” (IRFA).²³ If the agency determines the proposed rule will not have a “significant economic impact on a substantial number of small entities,” the agency head may certify to such a conclusion and need not prepare an IRFA.²⁴ The certification statement must include a “factual basis for the certification.”²⁵ An agency is required to prepare a final regulatory flexibility analysis (FRFA) if it determines that a final rule will have a “significant economic impact on a substantial number of small entities.”²⁶

The RFA also requires agencies to conduct outreach to small businesses when a rule will have a “significant economic impact on a substantial number of small entities.”²⁷ The Environmental Protection Agency (EPA), the Occupational Safety and Health Administration (OSHA), and the Consumer Financial Protection Bureau (CFPB) have an additional outreach requirement for any proposed rule that requires preparation of an IRFA. Pursuant to § 609(b) of the RFA, the aforementioned three agencies must convene a small business advocacy review (SBAR) panel²⁸ before the rule is published in the Federal Register to receive input from small businesses.²⁹

The critical element of a regulatory flexibility analysis is consideration of alternatives. Alternatives contemplated by the authors of the RFA may include separate reporting requirements or compliance standards to take account of the limited resources of small businesses. The agency may ultimately develop a tiered regulation with different requirements for entities of different sizes or decide not to regulate small businesses because they only contribute to a small portion of a problem that the agency is trying to ameliorate. Consideration of these alternatives does not require the adoption of any particular regulatory alternative. An agency may adopt a regulatory strategy that imposes substantial burdens on small businesses as long as the agency has complied with the RFA’s analytical requirements.

²³ *Id.* at § 603. An IRFA must describe the small businesses that will be affected, the impact of the proposed rule on small businesses, the compliance burdens imposed and any significant alternatives that could minimize any significant economic impacts. *Id.* at § 603(a)-(c).

²⁴ *Id.* at § 605(b).

²⁵ *Id.*

²⁶ The FRFA must describe the small businesses that will be affected, the impact of the proposed rule on small businesses, the compliance burdens imposed, the significant issues raised in public comments in response to the IRFA, any comments by the Chief Counsel for Advocacy on the proposed rule, and any changes the agency made to the rule in response to the Chief Counsel’s comments. *Id.* at § 604(a)(1)-(5). It also must describe the steps an agency has taken to minimize the significant economic impact on small businesses and why each alternative that would lessen the economic impact was rejected. *Id.* at § 604(a)(6). A certification at the proposed rule stage does not mean that the agency is entitled to certify at the final rule stage. Data obtained during the notice and comment process may force an agency to rethink its decision to certify. If sufficient information is submitted to the agency that demonstrates a significant economic impact on a substantial number of small businesses, then the agency is required to prepare a FRFA.

²⁷ *Id.* at § 609(a).

²⁸ The panel is comprised of a representative of the covered agency (EPA, OSHA or CFPB), a representative of the Small Business Administration’s Office of the Chief Counsel for Advocacy, and a representative from the Office of Management and Budget’s Office of Information and Regulatory Affairs. *Id.* at § 609(b)(3).

²⁹ *Id.* at § 609(b)-(d). The panel provides small entity representatives (SERs) with a draft of the proposed rule as well as any analysis of small entity impacts and regulatory alternatives, and collects advice and recommendations from the SERs. The panel then must report on the SERs’ comments and its findings. The report is made part of the rulemaking record. *Id.*

The Chief Counsel for Advocacy of the United States Small Business Administration (SBA) is responsible for monitoring agency compliance with the RFA and must annually report to the President and the Committees on Small Business and the Judiciary of the United States House of Representatives and Senate.³⁰ Although agencies have been required to comply with the RFA for nearly 35 years, compliance is still inadequate. According to the Chief Counsel for Advocacy, the two most frequent problems with RFA compliance that prompted the office to file public comments on regulations in fiscal year 2014 were inadequate analyses of small business impacts and inadequate consideration of regulatory alternatives.³¹ This is particularly problematic because evaluating small business impacts and regulatory alternatives provides agencies with the information necessary to increase the cost-effectiveness of their regulatory proposals through reduction of unnecessary burdens on small businesses.

IV. Recent Challenges with Agencies' Use of RFA

In recent years, agencies' ability to comply with the RFA has created further difficulties for small business. For example, agencies frequently publish IRFAs and FRFAs that have significant flaws in the economic impact analyses or lack a discussion of significant alternatives that reduce impacts on small businesses. Agencies also certify rules as not having a significant economic impact on a substantial number of small businesses but fail to provide a factual basis as required. Sometimes agencies do not conduct the kind of affirmative outreach that is required under § 609 of the RFA and accordingly limit the opportunity for small businesses to provide adequate input in the rulemaking process.

A. Regulatory Flexibility Analyses and Consideration of Alternatives

There are three key elements to an agency's compliance with the RFA's regulatory flexibility analyses requirements. They are: 1) identification of the affected small businesses; 2) estimate of the costs; and 3) development of less burdensome alternatives. Unfortunately, there are instances where agencies do not adequately identify the small businesses that will be affected by the rule and do not adequately estimate the costs associated with the rule. If an agency does not identify the costs and impacts of the rule on small business, the agency may lack the information it needs to develop significant alternatives that can accomplish the objectives of the rule while minimizing the costs on small business.³²

For example, on September 12, 2013, OSHA issued a proposed rule to amend its standards for occupational exposure to respirable crystalline silica to substantially reduce adverse health risks associated with workers inhaling very fine particles of crystalline silica.³³ OSHA

³⁰ *Id.* at § 612(a).

³¹ REPORT ON THE REGULATORY FLEXIBILITY ACT, FY 2014 at 25 (2015), available at <https://www.sba.gov/sites/default/files/advocacy/FY2014%20RFA%20Report.pdf>.

³² An agency need not examine every alternative or every alternative that significantly reduces adverse consequences or provides maximum benefit to small business. See *Associated Fisheries of Maine v. Daley*, 127 F.3d 104, 115 (1st Cir. 1997).

³³ OSHA, Occupational Exposure to Respirable Crystalline Silica, Proposed Rule, 78 Fed. Reg. 56,274 (Sept. 12, 2013). Quartz, the most common form of crystalline silica, is found in sand, stone, rock, concrete, brick and mortar.

estimates the rule will cost \$637 million annually³⁴ and 470,000 small businesses will be affected.³⁵ OSHA determined that the proposed rule will have a “significant economic impact on a substantial number of small entities” under the RFA and held a SBAR panel in 2003 to receive input directly from affected small businesses before proposing the rule and publishing an IRFA.³⁶ The IRFA, which assesses small business impacts, was published with the proposed rule. However, the use of ten-year-old data and input from small businesses raises serious questions about the adequacy of the rulemaking process, which the Committee addressed in a letter to OSHA in 2013.³⁷ Furthermore, comments submitted by the Chief Counsel for Advocacy raised concerns about the risk assessment, technological feasibility, significant alternatives considered for small businesses, and small business participation in the rulemaking process, including the failure to conduct a new SBAR panel.³⁸ OSHA is still analyzing the comments it received on the rule, and it is unclear whether the silica rule will be finalized this year.

B. Inadequate Support for Certification

The RFA provides no exception to the requirement that an agency either publish an IRFA or a certification statement with a factual basis. Too often agencies will certify a rule as not having a significant economic impact on a substantial number of small businesses but fail to include a factual basis for the certification. If an agency lacks the information needed to complete its threshold analysis of the proposed rule, the notice of proposed rulemaking will not provide adequate information upon which the regulated entities may comment. More importantly, it fails to alert small businesses that the proposed rule may be of consequence to them, thereby undermining the outreach requirements of § 609(a) of the RFA.

A recent example of this occurred with the controversial “Waters of the United States” or WOTUS rule. On April 21, 2014, the EPA and United States Army Corps of Engineers (Corps) proposed a rule change the scope of waters subject to federal jurisdiction under the Clean Water Act.³⁹ The EPA and Corps certified that the proposed rule would not have a “significant economic impact on a substantial number of small entities.” However, the agencies failed to provide any factual basis for the certification, as required by the RFA, despite the potential

<https://www.osha.gov/dsg/topics/silicacrystalline/>. The proposed rule includes two standards. One standard is for the construction industry. The other standard is for general industry and maritime. *Id.* at 56,274. The agricultural industry is not covered. *Id.* at 56,442. OSHA has proposed a new permissible exposure limit (PEL) for respirable crystalline silica, which is a regulatory limit on the amount of a substance in the air. *Id.* at 56,276. OSHA has also proposed an “action level,” which is half of the PEL. *Id.* at 56,281. The action level is an airborne concentration of respirable crystalline silica that triggers certain regulatory requirements. *Id.*

³⁴ *Id.* at 56,338.

³⁵ *Id.* at 56,411.

³⁶ *Id.* at 56,276.

³⁷ Letter from the Hon. Jim Risch, Chairman, Committee on Small Business and Entrepreneurship, United States Senate, and the Hon. Sam Graves, Chairman, Committee on Small Business, United States House of Representatives, to the Hon. David Michaels, Ph.D., Assistant Secretary of Labor for Occupational Safety and Health (Dec. 19, 2013) (on file with the Committee).

³⁸ Letter from the Hon. Winslow Sargeant, Ph.D., Chief Counsel for Advocacy, SBA, to the Hon. David Michaels, Ph.D., Assistant Secretary of Labor for Occupational Safety and Health (Feb. 11, 2014), *available at* <https://www.sba.gov/content/2112014-comments-ohsa%E2%80%99s-proposed-occupational-exposure-respirable-crystalline-silica-rule>.

³⁹ Definition of “Waters of the United States” Under the Clean Water Act, 79 Fed. Reg. 22,188 (Apr. 21, 2014).

consequences for small businesses.⁴⁰ The final rule became effective on August 28, 2015,⁴¹ but on Oct. 9, 2015, the Sixth Circuit Court of Appeals blocked implementation of this rule.⁴²

V. Conclusion

While certain regulations may be required by statute and well-intended, it is imperative that agencies properly assess the effects on small firms as well as consider significant alternatives that would still permit them to achieve their public policy objectives without unduly burdening small businesses. Agencies' failure to do so forces small firms to encounter serious challenges complying with rules and means that rules may be subject to litigation. Improving the rulemaking process to ensure that regulations are well-designed and not unnecessarily burdensome would create an environment in which small businesses are able to comply with regulations and remain competitive in the global marketplace rather than the current scheme, which appears to lead to a decline in new firm growth and productivity of existing firms.

⁴⁰ *Id.* at 22,220. For more comprehensive discussion of this rule and its effect on small firms, please see the Committee's hearing memorandum on *Will EPA's "Waters of the United States" Rule Drown Small Businesses Before the H. Comm. on Small Business*, 113th Cong. (May 29, 2014), available at http://smbiz.house.gov/uploadedfiles/5-29-2014_revised_hearing_memo.pdf, and the Committee's regulatory comment letter explaining that the proposed rule would have direct impacts on small businesses that must obtain permits from EPA or Corps for waters they would not have otherwise needed to do under the prior definition, available at http://smbiz.house.gov/uploadedfiles/11.14.2014_wotus_comment_letter_to_epa_and_corps.pdf.

⁴¹ Clean Water Rule: Definition of "Waters of the United States," 80 Fed. Reg. 37054 (June 29, 2015).

⁴² *State of Ohio, et al. v. U.S. Army Corps of Engin'rs, et al.*, 2015 Fed App. 0246P (6th Cir.), available at <http://www.ca6.uscourts.gov/opinions.pdf/15a0246p-06.pdf>.