NATIONAL ASSOCIATION OF Manufacturers

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Testimony

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Before the Small Business Subcommittee on Contracting and Workforce

On the Decline in Business Formation: Implications for Entrepreneurship and the Economy

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COMMENTS OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE

SMALL BUSINESS SUBCOMMITTEE ON CONTRACTING AND WORKFORCE

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Chairman Hanna, Ranking Member Meng and members of the Small Business Subcommittee on Contracting and Workforce, thank you for the opportunity to testify on the issue of business formation and policies that can help to increase overall economic activity. I will be tackling these issues from a manufacturing perspective.

The National Association of Manufacturers (NAM) is the nation's largest industrial trade association and voice for more than 12 million men and women who make things in America. The NAM is committed to achieving a policy agenda that helps manufacturers grow and create jobs. Manufacturers very much appreciate your interest in and support of the manufacturing economy.

I. Recent Economic Trends for Manufacturers

Over the past five years, as the economy has begun to recover, the manufacturing sector marks one of the bright spots. While economic growth has often been less than desired, there is a general sense that manufacturing in the United States has turned a corner, with more investment flowing into the sector and a renewed appreciation of the economic benefits. Indeed, manufacturing value-added reached $2.08 trillion last year, an all-time high representing 12.4 percent of gross domestic product (GDP). This continues an upward trend, with value-added measuring $1.56 trillion in 2000 and $1.70 trillion in 2005. Manufactured goods exports also hit record levels in 2013 ($1.38 trillion), even as their rate of growth has decelerated in the past couple of years.

Manufacturers have added 681,000 net new workers since 2009, only partially offsetting the 2.3 million employees lost during the Great Recession. Fortunately, as estimated by the Boston Consulting, the sector could add roughly 600,000 to 1.2 million workers between now and 2020.[1] Much of this additional hiring stems from America's newfound energy advantages, improvements in product quality and technologies that have allowed the sector to become globally competitive. This has helped to drive additional investments into the United States, especially among energy-intensive manufacturers, and it should help increase output, employment and exports moving forward.

This year, we have begun to finally emerge from the recession, with many indicators reaching levels not seen since 2008 or earlier. For instance, in June, manufacturing output

[1] *The U.S. as One of the Developed World's Lowest-Cost Manufacturers*, Boston Consulting Group, August 2013, available at www.bcgperspectives.com/content/articles/lean_manufacturing_sourcing_procurement_behind_american_export_surge/#chapter1.

surpassed pre-recessionary levels for the first time, a feat that took an extraordinarily long 70 months to achieve. Much has been made of the depth of the Great Recession, and the fact that it took 70 months to recover helps illustrate that. As a reference, it took 31 months for industrial production to recover from the last recession in 2001. Fixed investment, nonfarm payrolls, consumer confidence and a host of other economic data points have also reached pre-recessionary highs this year. One of the exceptions is manufacturing employment, which remains 11.5 percent lower today than in December 2007, the first month of the recession.

Moving forward, manufacturers are mostly upbeat about the second half of this year, with demand and production improving from softness in earlier months. The latest NAM/*IndustryWeek* Survey of Manufacturers, which was released on Monday, found that 87.3 percent of respondents were either somewhat or very positive in their company's outlook right now.[2] In addition, average sales, capital spending and employment expectations over the next 12 months are at paces not seen since early 2012, when the sector was expanding more robustly. This data aligns with manufacturing output growth of 3.1 percent over the next two quarters, with the prospects for 2015 also quite favorable.

II. Manufacturing Business Formation Rates

The mostly positive outlook stands in contrast to the perceptions that many might have had about manufacturing just a few years ago. Indeed, taken from an historical context, the sector is clearly undergoing major changes, some of which are the basis for this hearing. Manufacturing comprises a smaller share of GDP, yet total manufacturing output has continued to grow, reaching new highs just last year, with the drop in share due largely to the resurgence in service-sector activity.

The number of manufacturers has also fallen dramatically over the past decade, from 354,498 establishments in 2000 to 295,643 establishments in 2011, the most recent year with available data.[3] The rate of manufacturing establishment start-ups has also declined, according to Business Employment Dynamics (BED) data from the Bureau of Labor Statistics, off from 2.25 percent of all establishments in the sector in 1995 to 1.45 percent in 2013.[4] In terms of raw numbers, there were roughly 8,000 manufacturing start-ups per quarter in 1995, with around 5,000 per quarter in the 2011 to 2013 time frame. It is also clear that closures have exceeded start-ups in the manufacturing sector since 1999.

At least part of this trend could be explained by the tremendous consolidation that we have seen in the manufacturing sector. Yet, the churn rate for manufacturers is significant because it mostly mirrors other data. Economists Ian Hathaway and Robert E. Litan found that the pace of new firm formation has steadily dropped over the past few decades, a disturbing finding suggesting reduced entrepreneurial activity and less dynamism in the economy.[5] The

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[2] *NAM/*IndustryWeek *3Q 2014 Survey: Confidence, Investment on the Rise*, Chad Moutray, *IndustryWeek*, Sept. 4, 2014, available at www.industryweek.com/regulations/namindustryweek-3q-2014-survey-confidence-investment-rise.

[3] See www.census.gov/econ/susb/, accessed Sept. 4, 2014.

[4] See www.bls.gov/bdm/bdmind.htm, accessed Sept. 4, 2014. The annual figures average the quarterly data. The 2013 average birth rate shows improvement from the 1.20 percent pace observed in 2009.

[5] *Declining Business Dynamism in the United States: A Look at States and Metros*, Brookings Institution, May 2014, available at www.brookings.edu/~/media/research/files/papers/2014/05/declining%20business%20dynamism%20litan/declining_business_dynamism_hathaway_litan.pdf.

BED data also show this, with the private-sector establishment start-up rate of 3.28 percent in 2005 falling to 2.90 percent in the fourth quarter of 2013. Moreover, employment growth from these start-ups has also declined, down from an average of 1.20 percent in 1995 to 0.70 percent at the end of last year. The numbers are perhaps more pressing, with new establishment start-ups creating an average of 1.16 million employees in 1995 relative to an average of 0.86 million in 2013.

III. Understanding the Challenges That Might Hamper Economic Activity

A number of factors might help to explain reduced business formation rates. First and foremost, economic growth has also been slower more recently. Real GDP growth averaged 3.8 percent between 1992 and 2000. While the sector experienced modest growth after the 2001 recession, the economy grew by an average of 2.7 percent between 2002 and 2007. Since the Great Recession of 2007–2009, real GDP growth has averaged just 2.2 percent. Indeed, the consensus forecast for 2015 is for roughly 3.0 percent growth; if true, it would be the first annual growth rate of 3.0 percent or better since 2005.

This more-sluggish economic activity likely serves as a disincentive for new business creation, or for existing firms, potentially dissuading investments in new capital spending or hiring. Along those lines, nonresidential fixed investment has also increased at a much slower pace, down from an average of 8.6 percent in the 1990s to 5.4 percent and 5.1 percent, respectively, in the 2003–2007 and 2010–2013 time frames. Employment growth has also decelerated, with nonfarm payrolls increasing by an average of 2.7 million per year in the 1990s versus 1.9 million per year in the 2000s for the 2004–2007 and 2010–2013 periods. In this most recent recovery, nonfarm payroll employment took 77 months to reach its pre-recessionary levels, a threshold met in May of this year.

Economic and political uncertainty also contributed to slower growth, reducing business leaders' outlook and complicating their ability to plan. In general, because uncertainty is difficult to measure, economists often do not give it much credence. One survey of business economists conducted in 2011 suggested that uncertainty is often used as a proxy for other frustrations, and that "once the economy starts to improve, such anxieties will go away."[6] Nonetheless, a study conducted last year suggested that fiscal policy uncertainties, particularly during recent budget stalemates, reduced GDP by as much as one full percentage point,[7] and another working paper reported that these uncertainties reduced business investment, hiring and production.[8]

One must also look at the overall business environment as a possible source that might discourage more firm formation or economic investment. Businesses consistently mention it as a top concern in a number of surveys. In the most recent NAM/*IndustryWeek* survey, for example, nearly three-quarters of those responding cited an "unfavorable business climate" as a primary challenge for them. This included the need for comprehensive tax reform and a desire to reduce regulatory burdens, among other issues. Perhaps more astonishingly, in a 2012

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[6] Economic Policy Survey, National Association for Business Economics, August 2011, available at http://nabe-web.com/publib/pol/11/08/misc.html.
[7] *The Cost of Crisis-Driven Fiscal Policy,* Peter G. Peterson Foundation and Macroeconomic Advisors, LLC, Oct. 13, 2013, available at http://pgpf.org/special-reports/the-cost-of-crisis-driven-fiscal-policy.
[8] *Measuring Economic Policy Uncertainty*, Scott R. Baker, Nicholas Bloom and Steven J. Davis, Stanford Centre for Economic Performance, June 13, 2013, available at http://web.stanford.edu/~srbaker/Papers/BakerBloomDavis_PolicyUncertainty.pdf.

survey, 55 percent of small businesses and manufacturers said they would not start a business today given the current business climate—a chilling prospect and a striking commentary on their frustrations with government.[9]

Indeed, manufacturers in the United States face a significant disadvantage in the global competition for investment and jobs. In fact, it is 20 percent more expensive to manufacture in this country compared to in our major trading partners' countries, excluding the cost of labor.[10] Taxes drive this cost disadvantage. To improve our competitiveness, the United States must overhaul our tax system at the corporate and individual levels, particularly now that it has the dubious distinction of having the highest corporate income tax rate among the nations in the Organisation for Economic Co-operation and Development (OECD). Around the world, countries are lowering corporate tax rates, often dramatically, and most of our competitors have moved to a territorial tax system. Overall, manufacturers large and small have faced both an uncompetitive and an uncertain tax code.

Meanwhile, the United States has not significantly improved our tax laws in almost three decades, and in 2013, marginal rates increased on the most successful flow-through businesses, which now face a top marginal rate of 39.6 percent. With nearly two-thirds of manufacturers being organized as a flow-through business, it is essential that Congress also addresses marginal rates for these businesses.

Yesterday, the NAM released a study on total federal regulatory compliance costs by W. Mark Crain and Nicole V. Crain.[11] This analysis updated the authors' prior work for the U.S. Small Business Administration's Office of Advocacy, where I used to be the chief economist and director of economic research (2002–2010). This report found that businesses spent $2.028 trillion in 2012 to comply with federal regulations. More importantly, compliance costs for business in the United States averaged $9,991 per employee that year, with manufacturers incurring a per-employee cost of nearly double that amount—$19,564 per employee. Small manufacturers with less than 50 employees spent a whopping $34,671 per employee, illustrating the massive burden we are placing on many of these firms.

Manufacturers believe that regulation is critical to the protection of worker safety, public health and our environment. At the same time, our regulatory system is in need of improvement. We need smarter regulations that minimize unnecessary burdens and better balance benefits and costs, eliminating redundancies wherever possible. Regulations are allowed to accumulate with no real effort to evaluate or clean up the outdated and obsolete rules already on the books. It is imperative that policymakers and regulators understand the cumulative burdens that their rules are placing on businesses and enact policies that minimize those costs that do not contribute to the realization of regulatory objectives.

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[9] *Small Businesses and Manufacturers: Government a Barrier, Not a Help, to Economic Growth*, National Association of Manufacturers and the National Federation of Independent Business, Sept. 25, 2012, available at www.nam.org/Communications/Articles/2012/09/Small-Businesses-and-Manufacturers-Government-a-Barrier-Not-a-Help-to-Economic-Growth.aspx.

[10] *The Structural Cost of Manufacturing in the United States,* Manufacturing Institute and the Manufacturers Alliance for Productivity and Innovation, 2011, available at www.themanufacturinginstitute.org/Research/Structural-Cost-of-Manufacturing/2011-Structural-Cost-Report/2011-Structural-Cost-Report.aspx.

[11] *The Cost of Federal Regulation to the U.S. Economy, Manufacturing and Small Business,* W. Mark Crain and Nicole V. Crain, National Association of Manufacturers, Sept. 10, 2014, available at http://nam.org/CostofRegulation.

The Crain and Crain report also illustrates how regulatory relief can be an economic development issue. In a survey conducted by the pair, 85 percent of manufacturers responded that they would invest more in their businesses, both in their workers and in capital equipment, if their compliance costs could be lessened. These business leaders hope that policymakers look at the larger regulatory landscape before imposing new burdens that will stifle growth and dissuade new investments.

Beyond regulatory compliance, other burdens placed on firms might discourage them from starting up or from hiring additional workers. For example, rising health care costs topped the list of primary business challenges in the latest NAM/*IndustyWeek* survey. While most firms probably do not have actual premium data yet for next year, the fact that more than half of them predict increases of at least 10 percent is concerning. While evidence shows overall medical inflation slowing more recently, premium costs continue to rise, increasing per-worker expenses for businesses. Using data from the Kaiser Family Foundation, for instance, we see that the average annual cost of a family plan for manufacturing employees was $15,082 in 2013, representing a 38.1 percent and 9.9 percent increase from 2005 and 2010, respectively.[12]

IV. Conclusion

Chairman Hanna, Ranking Member Meng and members of the subcommittee, thank you for your leadership on these issues and for holding this hearing. Manufacturing activity has seen a resurgence since the end of the recession, and manufacturers have a mostly upbeat outlook for the coming months and the next few years, yet they have also been frustrated with the slowness of the recent recovery, making business leaders more cautious in their assessments than they might otherwise be. A number of downside risks impact growth in the coming months, including geopolitical events, the prospect of rising interest rates and softness in several key export markets. At the same time, manufacturers of all sizes and in a wide swath of industries have expressed concern about skills shortages.

This hearing has focused on slower business formation rates, and like the broader economy, new manufacturing establishment start-up rates have fallen since the 1990s. Much of this could be the result of a drastically changed sector. Still, additional factors could negatively impact the pace of new start-ups, including slower economic activity overall, rising health insurance costs and the business climate. Data released yesterday continues to show that small businesses and manufacturers face disproportionate burdens when it comes to complying with federal regulations, and new rules are forthcoming from the Administration that will further widen these costs. In addition, the United States has the highest tax rates in the world, which serves to make investments abroad more attractive than here.

Beyond these issues, the best way to increase firm formation is to have a growing economy. Policymakers need to adopt pro-growth measures that will enable manufacturers and other businesses to expand, to hire more workers and to invest in more capital spending. A healthy economy will encourage more participants, and that should spur more entrepreneurship and innovation. The pro-growth priorities of manufacturers include, but are not limited to: passing comprehensive tax reform, providing regulatory relief, expanding trade opportunities,

[12] *Employer Health Benefits: 2013 Annual Survey*, Kaiser Family Foundation and Health Research and Educational Trust, September 2013, available at http://kaiserfamilyfoundation.files.wordpress.com/2013/08/8465-employer-health-benefits-20131.pdf. Comparative data for 2005 and 2010 come from the annual surveys from those years.

enacting sensible energy policies, investing in more infrastructure, encouraging research and development, and developing the next generation of workers.