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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, Subcommittee on Economic Growth, Tax and Capital Access
From:	Committee Staff
Date:	February 13, 2017
Re:	Hearing: "State of the Small Business Economy"

On Thursday, February 16, 2017 at 11:00 A.M., the Subcommittee on Economic Growth, Tax, and Capital Access will meet in Room 2360 of the Rayburn House Office Building for the purpose of examining the state of the small business economy. The hearing will provide the subcommittee with an opportunity to review current economic indicators that measure the health of the economy, with a specific focus on the decline in business formation and structural unemployment. The hearing also will examine the general economic concerns confronting small business owners in 2017.

I. Overall Economic Conditions

In 2016, economic activity, as measured by gross domestic product (GDP),[1] grew by 1.6 percent.[2] This number falls below the GDP growth rates of 2015 and 2014, when the growth rates were 2.6 percent and 2.4 percent, respectively.[3] Over the past eight years, GDP growth averaged just 1.5 percent.[4] By comparison, the United States averaged 3.5 percent GDP growth from 1950 until 2000.[5]

Although wage growth has recently improved, this change comes after years where wages grew significantly slower than the historical norm. September 2016 was the first month since September 2008 that the median wage growth was above 4 percent.[6] Previously, median wage growth did not fall below 4 percent from January 1997 until June 2002.[7]

Housing prices are another economic indicator that have only recently surpassed pre-recession levels. The Federal Reserve Bank of St. Louis housing price index for the third quarter of 2016 was the highest the index has been since the first quarter of 2007.[8] In other words, home prices took almost 10 years to recover from the Great Recession. Although this lack of growth in home prices meant cheaper prices for home buyers, many home owners could not rely on home

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[1] GDP is the market value of the goods and services produced by labor and property situated in the United States. *See* OFFICE OF THE CHIEF COUNSEL FOR ADVOCACY, SMALL BUSINESS GDP: UPDATE 2002-2010 at 1 (2012), *available at* http://www.sba.gov/sites/default/files/rs390_1.pdf.
[2] https://www.bea.gov/national/index.htm#gdp.
[3] *Id.*
[4] *Id.*
[5] *Id.*
[6] FEDERAL RESERVE BANK OF ATLANTA, WAGE GROWTH TRACKER, (2017), *available at* https://frbatlanta.org/chcs/wage-growth-tracker/?panel=1.
[7] *Id.*
[8] The Federal Reserve Bank of St. Louis housing price index reviews repeat mortgage transactions on single-family properties to measure the movement of single-family home prices. *See* https://fred.stlouisfed.org/series/USSTHPI.

equity lines to finance new businesses as many did before the recession.[9] This forced many would-be entrepreneurs to find alternative sources of capital or abandon their business ideas entirely.[10]

The unemployment rate fell to 4.7 percent in December 2016, drastically lower than the high of 10 percent in October 2009.[11] The latter statistic is below the lower estimate for the natural rate of unemployment, which is about 5 to 7 percent.[12] The drop in the unemployment rate was one of the primary reasons the Federal Reserve raised its key interest rate from .5 percent to .75 percent in December of 2016.[13] Although this increase in the federal funds rate is relatively small, it is a sign that the Federal Reserve has confidence in the short term outlook for the American economy. With regard to rate hikes in the future, the Board stated in in December 2016 that, "economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run."[14]

Even though there are signs that the economy is improving, the current GDP growth rate is well below historical average. Absent changes in policy direction, the Congressional Budget Office estimated in January 2017 that GDP growth is projected to be 1.7 percent from 2017-2020 and 1.9 percent from 2021-2027.[15] Therefore, it is important to examine what sectors of the American economy are trailing historical trends to see if policy changes can help improve those sectors and the economy as a whole. With small businesses comprising 42 percent of the private sector payroll, 48 percent of the workers in the private sector, and 99.9 percent of all businesses, examining the United States small business sector could provide insight to why the United States economy has experienced slower than normal growth.[16]

II. Small Business and Entrepreneurship's Role in the Economy

According to the latest statistics, there are 28.8 million small businesses in the United States.[17] Small businesses are defined by the federal government as independent businesses with less than 500 employees; however, it is important to note that 23 million, or 80 percent, of small businesses have no employees and of the 5.8 million, or 20 percent, that have paid employees, nearly 90 percent, have less than 20 employees.[18] Small businesses accounted for over 63

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[9] FEDERAL RESERVE BANK OF CLEVELAND, STATE OF SMALL BUSINESS, (2016), *available at* https://www.clevelandfed.org/newsroom-and-events/publications/forefront/ff-v7n04/ff-20161121-v7n0404-state-of-small-business.aspx.

[10] Ian Mount, *Why It's Getting Harder, and Riskier, to Bet the House*, NEW YORK TIMES, (2011), *available at* http://www.nytimes.com/2011/12/01/business/smallbusiness/why-business-owners-routinely-bet-the-house-and-why-its-getting-harder-to-do.html.

[11] https://data.bls.gov/timeseries/LNS14000000.

[12] STUART WEINER, THE NATURAL RATE OF UNEMPLOYMENT: CONCEPTS AND ISSUES, ECONOMIC REVIEW, (1986) FEDERAL RESERVE BANK OF KANSAS CITY, *available at* https://www.kansascityfed.org/~/media/files/publicat/econrev/econrevarchive/1986/1q86wein.pdf.

[13] https://www.federalreserve.gov/newsevents/press/monetary/20161214a.htm.

[14] *Id.*

[15] CONGRESSIONAL BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK 2017 TO 2027 117 (2017), *available at* https://www.cbo.gov/sites/default/files/52370-Outlook_OneColumn_0.pdf.

[16] SMALL BUSINESS ADMINISTRATION, OFFICE OF THE CHIEF COUNSEL FOR ADVOCACY, FREQUENTLY ASKED QUESTIONS 1 (2016), *available at* https://www.sba.gov/sites/default/files/advocacy/SB-FAQ-2016_WEB.pdf.

[17] *Id*.

[18] *Id*. Of the total number of employers in the United States, 89.49 percent have less than 20 employees. This figure was calculated by using the firm data in the United States Census Bureau's 2013 Statistics on U.S. Businesses. https://www.census.gov/econ/susb/.

percent of jobs created from 1992 to 2013.[19] In 2013 alone, small businesses created 1.1 million jobs.[20]

New and small businesses are much more efficient at creating innovation than old and large businesses, and innovation is a key driver of economic growth.[21] According to a report issued by the Small Business Administration Office of Advocacy, in 2002 small businesses invented and managed an average of 10.01 products, and large businesses invented and managed an average of 21.44 products.[22] Although larger businesses invented roughly twice as many products, the products-to-employee ratio was significantly higher for small businesses than their larger counterparts. In terms of the number of patents obtained per dollar spent on research and development (R&D), small-young businesses obtained 2.41 times more patents than large-young businesses for every dollar spent on R&D, and small-young businesses obtained 2.5 more patents than small-old businesses.[23] This means that larger and older businesses have to invest more in research and development to produce the same amount of innovation as smaller and younger businesses.

Job growth is also primarily driven by new and small businesses. Employment by startups from 1980-2005 was about 3 percent per year.[24] If the job creation by startups was excluded during that time period, there would have been a net decline in jobs in the United States.[25] Furthermore, in all but eight of the years between 1988 and 2012, businesses more than five years old destroyed more jobs than they created.[26]

Despite the fact that newer and smaller businesses are key contributors to innovation, economic growth, and job creation, the recent decline in new business formation may help explain why several economic indicators have fallen below their historical averages. In the 1970s, the United States created over 95 new businesses per billion dollars of GDP.[27] During the Great Recession and the recovery period, that number decreased to 25 businesses per billion dollars of GDP. [28] The rate of business formation in the United States has dropped by almost 50 percent since 1978.[29]

It is even more startling that the recent startup rate also significantly trails contemporary statistics. The share of entrepreneurs ages 20-34 decreased from 35 percent in 1996 to 23

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[19] *Supra* note 16.
[20] *Id.*
[21] Harvard Professor Aghion's model suggests that without innovation, the economy cannot grow. Innovation increases the productivity of capital, and without that innovation, there is a point in the production function where the economy cannot increase marginal output without more innovation. Philippe Aghion, *Entrepreneurship and growth: lessons from an intellectual journey*, 48 SMALL BUS. ECON. 9 (2017) 48.
[22] JOSE PLEHN-DUJOWICH, PRODUCT INNOVATIONS BY YOUNG AND SMALL FIRMS, SBA OFFICE OF ADVOCACY, (2013), *available at* https://www.sba.gov/sites/default/files/files/rs408tot.pdf.
[23] *Id.*
[24] EWING MARION KAUFFMAN FOUNDATION, BUSINESS DYNAMICS STATISTICS BRIEFING: JOBS CREATED FROM BUSINESS STARTUPS IN THE UNITED STATES (2009), *available at* http://www.kauffman.org/what-we-do/research/business-dynamics-statistics/business-dynamics-statistics-briefing-jobs-created-from-business-startups-in-the-united-states.
[25] *Id*.
[26] EWING MARION KAUFFMAN FOUNDATION, YOUNG FIRMS DRIVE JOB GROWTH, ACCORDING TO NEW KAUFFMAN POLICY DIGEST (2014), *available at* http://www.kauffman.org/newsroom/2014/09/young-firms-drive-job-growth-according-to-new-kauffman-policy-digest.
[27] *Supra* note 24.
[28] *Id.*
[29] 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. 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* https://www.clevelandfed.org/newsroom-and-events/publications/economic-commentary/2014-economic-commentaries/ec-201415-the-shifting-source-of-new-business-establishments-and-new-jobs.aspx.

percent in 2013.[30] From 1992 to 1996, 420,850 new businesses were created, and 50 percent of those businesses were created in 125 counties located throughout the United States. However, from 2010 to 2014, only 166,460 businesses were created, and half of those businesses were established in only 20 counties.[31] That is a difference of more than a quarter of a million new businesses, and does not even take into consideration that the United States population in 1992 was only 83 percent of the United States population in 2010.[32] All 20 counties that experienced significant new business growth were also located in major metropolitan areas, creating an even larger economic divide between urban and rural counties.[33] The weak and unbalanced recovery has resulted in two-thirds of the United States metropolitan areas experiencing a net loss in businesses during the recovery period.[34]

Newer and smaller businesses create more jobs, innovation, and economic growth. However, in the recent years, there has been a significant decline in the rate of new business formation, limiting the creation of new jobs. Although the previously cited unemployment rate has decreased since the height of the Great Recession, it is important to examine other measurements of employment to see if the decline in business formation has affected the job market.

III. Employment in the United States

The United States Bureau of Labor Statistics (BLS) defines the unemployment rate as the percentage of the labor force that is unemployed.[35] Even though this statistic can provide significant insight to the strength of the job market, the BLS definition of unemployment does not count workers that are marginally attached to the labor force. These individuals have not looked for a job in the last four weeks and are not looking for work due to the perceived lack of jobs in their field, failure to find work previously, a lack of necessary training or skills, or other reasons.[36]

One statistic that encapsulates both unemployed and individuals marginally attached to the labor force is the labor force participation rate. According to the United States Census Bureau, the labor force participation rate is the proportion of the population over the age of 16 that is in the labor force.[37] While the labor force participation rate was 66.5 percent in 1990, the rate fell to 62.8 at the end of 2016.[38] This is the lowest the labor force participation rate has been in 40 years.[39] If the United States labor force participation rate had remained 66.5 percent, there would be 9.3 million more Americans in the labor force.[40]

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[30] http://www.kauffman.org/multimedia/infographics/2015/infographic-millennial-entrepreneurs-and-the-state-of-entrepreneurship.

[31] ECONOMIC INNOVATION GROUP, THE NEW MAP OF ECONOMIC GROWTH AND RECOVERY (2016), *available at* http://eig.org/recoverymap#mapBusiness.

[32] This number was calculated using the June 1992 population of 256 million and the June 2010 population of 309 million. http://www.census.gov/data/datasets/2016/demo/popest/nation-total.html, http://www.census.gov/data/datasets/time-series/demo/popest/intercensal-1990-2000-national.html

[33] *Supra* note 31.

[34] ECONOMIC INNOVATION GROUP, DYNAMISM IN RETREAT 15 (2017) *available at* http://eig.org/wp-content/uploads/2017/02/Dynamism-in-Retreat.pdf.

[35] https://www.bls.gov/cps/cps_htgm.pdf.

[36] *Id.*

[37] http://www.census.gov/people/laborforce/about/acs_employ.html.

[38] https://data.bls.gov/timeseries/LNS11300000.

[39] *Id.*

[40] This number was calculated using the 1990 and 2016 civilian population over the age of 16 and the labor force participation rates for both years from the Bureau of Labor Statistics. *Supra* note 38. https://data.bls.gov/cgi-bin/surveymost?ln.

Breaking down the labor force participation by age, there has been a recent decline in participation by 16-54 year olds and an increase for Americans over the age of 65.[41] When comparing the labor force participation rates of December 2007 and September 2016, there are 1.5 million 'missing' 16-24 year old workers, 1.9 million 'missing' 25-54 year old workers, and 1.6 million more workers over the age of 65.[42] Senior citizens are also choosing to work full time. In 2000, 53.9 percent of Americans over 65 in the labor force worked full time. Today, that percentage has increased to 64 percent.[43]

Increasing the amount of Americans in the workforce would alleviate burdens on government assistance programs,[44] reduce the federal deficit,[45] and increase economic growth.[46] Also, by breaking down job creation by business size and age, smaller and newer businesses are the key contributors to innovation, job creation, and economic growth. However, accumulating barriers have made it more difficult than ever to start or keep a small business operating.

IV. Challenges for Small Business Growth and Job Creation

Although there are a myriad of issues confronting small businesses, three primary areas of concern for small businesses are the cost of health care, regulatory compliance, and the burdensome tax code. The 2016 NFIB "Problems and Priorities" report listed the cost of health care as the number one issue facing small businesses.[47] A recent National Small Business Association survey reported 95 percent of businesses experienced an increase in health insurance costs over the past 5 years, and 1 in 5 businesses surveyed reported premium increases of more than 20 percent.[48] Under the current law, businesses with less than 50 employees are not required to offer health benefits, however many small business owners provide health care to retain talent and because they feel it is the right thing to do.[49] Reforming the health care system to curb costs for small businesses and increase choices for their employees would not only provide more financial flexibility for small businesses, but it would also help small businesses retain qualified employees.

Regulatory burdens also have negative effects on both small businesses and economic growth. In a study that examined regulation's effect on economic growth, the GDP growth rate would have been on average two percentage points higher between 1949-2005 if regulation had

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[41] UNITED STATES CONGRESS-JOINT ECONOMIC COMMITTEE, THE 'NEW NORMAL'? PART 2: SUBDUED EMPLOYMENT (2016) *available at* http://www.jec.senate.gov/public/index.cfm/republicans/2016/10/the-new-normal-part-2-subdued-employment

[42] The Joint Economic Committee calculated 'missing' workers by examining the decrease in the labor force participation rate for select age demographics from December 2007 to September 2016 while also taking population changes into account. *Id.*

[43] DREW DESILVER, *More older Americans are working, and working more, than they used to,* PEW RESEARCH CENTER, (2016) *available at* http://www.pewresearch.org/fact-tank/2016/06/20/more-older-americans-are-working-and-working-more-than-they-used-to/.

[44] EILEEN NORCROSS & EMILY HAMILTON, THE COSTS AND CONSEQUENCES OF UNEMPLOYMENT BENEFITS ON THE STATES, MERCATUS CENTER (2010), *available at* https://www.mercatus.org/publication/costs-and-consequences-unemployment-benefits-states.

[45] FEDERAL RESERVE BANK OF ST. LOUIS, THE GREAT RECESSION'S EFFECT ON THE FEDERAL BUDGET (2016), *available at* https://www.stlouisfed.org/on-the-economy/2016/may/great-recession-effect-federal-budget

[46] *Supra* note 35 at 1.

[47] HOLLY WADE, NFIB SMALL BUSINESS PROBLEMS AND PRIORITIES 12 (2016), *available at* http://www.nfib.com/assets/NFIB-Problems-and-Priorities-2016.pdf.

[48] NATIONAL SMALL BUSINESS ASSOCIATION, SMALL BUSINESS HEALTH CARE SURVEY 8 (2015), *available at* http://www.nsba.biz/wp-content/uploads/2015/11/Health-Care-Survey-2015.pdf.

[49] Ruth Simon, *Some Small Businesses Restore Group Health Coverage,* WALL STREET JOURNAL, August 21, 2016, *available at* http://www.wsj.com/amp/articles/some-small-businesses-restore-group-health-coverage-1471771802.

remained at the 1949 level.[50] The burden of these regulations disproportionally falls on small businesses.[51] A recent survey found that on average, small business owners spend 200 hours-or 25 full work days learning, navigating, and managing regulations.[52] Committee on Small Business Chairman Steve Chabot introduced H.R. 33, the "Small Business Regulatory Flexibility Improvements Act of 2017," to ensure the economic impacts of regulations on small businesses are fully considered and alternatives are considered to reduce unnecessary burdens. H.R. 33 was included as Title III of H.R. 5, "Regulatory Accountability Act of 2017," which passed the House on January 11, 2017. Through passage of this legislation, Congress has acknowledged that regulation is a growing concern, and is dedicated to reducing the regulatory burden on small businesses.

Tax complexities and high tax rates also detract from a small business's ability to grow. Currently, the tax code has more than 70,000 pages of laws and regulations that small businesses must navigate with only limited resources.[53] Businesses with more than 50 employees have a tax burden of around $182 to $191 per employee, but businesses with 5 employees or less face burdens around $4,308 to $4,736 per employee.[54] In the previously cited NFIB "Problems and Priorities" report, 5 of the top 10 issues are tax related.[55] Comparing tax rates and business growth, a National Bureau of Economic Research study found that, reducing a sole proprietor's marginal tax rate from 50 percent to 33 percent led to an increase in the size of the business of 28 percent.[56] Tax reform would be yet another measure to give small business owners more time and financial flexibility to grow their business.

V. Conclusion

The United States has experienced slower than normal growth of business formation and GDP over the past several years. At the same time, higher health care costs, accumulating regulatory compliance costs, and an increasingly complex tax code has made it more difficult to start, operate, and grow a small business. Job growth has slowed, causing millions of Americans to leave the workforce entirely. This hearing represents an opportunity to hear from economic experts about how addressing these concerns so the United States GDP growth rate and the business formation rate can be returned back to their historical averages.

[50] JOHN DAWSON & JOHN SEATER, FEDERAL REGULATION AND AGGREGATE ECONOMIC GROWTH, NORTH CAROLINA STATE UNIVERSITY (2013), *available at* http://www4.ncsu.edu/~jjseater/regulationandgrowth.pdf.
[51] RAY KEATING, REGULATION: COSTS, INCENTIVES, AND THE NEED FOR REFORM, SBE COUNCIL (2016) *available at* http://sbecouncil.org/wp-content/uploads/2016/10/SBECouncilRegReportOct2016.pdf.
[52] BABSON COLLEGE, STATE OF SMALL BUSINESS IN AMERICA 2016 2, *available at* http://rethinkredtape.com/assets/content/State_of_Small_Business_in_America_2016_Full.pdf.
[53] NATIONAL SMALL BUSINESS ASSOCIATION, REFORM THE CURRENT TAX REGIME, *available at* http://www.nsba.biz/wp-content/uploads/2016/02/Reform-the-Current-Tax-Regime.pdf.
[54] *Small Businesses, IRS Considers Compliance Burden in Tax Administration, but Needs a Plan to Evaluate Its Payment Card Information Pilot: Hearing Before the H. Comm. on Small Business*, 114th Congress, First Session (2015) (testimony of J. Christopher Mihm), *available at* http://www.gao.gov/products/GAO-15-754T.
[55] *Supra* note 47.
[56] MATT NESVISKY, HIGH INCOME TAXES INHIBIT THE GROWTH OF SMALL FIRMS, NATIONAL BUREAU OF ECONOMIC RESEARCH, *available at* http://www.nber.org/digest/apr01/w7980.html.