Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–0315

Memorandum

To:	Members, Subcommittee on Economic Growth, Tax and Capital Access
From:	Committee Staff
Date:	April 24, 2017
Re:	Hearing: "Small Business: The Key to Economic Growth"

On Thursday, April 27, 2017 at 10:00 A.M., the Committee on Small Business Subcommittee on Economic Growth, Tax, and Capital Access will meet in Room 2360 of the Rayburn House Office Building for the purpose of examining economic growth in the United States. The hearing will provide the Subcommittee with an opportunity to further understand the causes of economic growth, the benefits associated with economic growth, and current limits on economic growth in the United States. This hearing will also examine how small businesses are a vital catalyst for economic growth.

I. Overall Economic Conditions

In 2016, economic activity, as measured by gross domestic product (GDP),[1] grew by 1.6 percent.[2] This level is 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]

Absent changes in policy direction, the Congressional Budget Office (CBO) estimated in January 2017 that GDP growth is projected to be 1.7 percent from 2017-2020 and 1.9 percent from 2021-2027.[6] Although CBO expects a rise in productivity in the labor force during the second half of the ten year period, both the five year and the ten year projections are about half of the historical GDP growth rate from 1950 to 2000.[7] CBO also expects slower growth in the

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[1] GDP is the value of the goods and services produced by labor and property situated in the United States. *See* SMALL BUSINESS ADMINISTRATION, 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] The "Percent change from the preceding period" table from the National Economic Accounts page was used to examine the GDP growth rate over time. UNITED STATES DEPARTMENT OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS, NATIONAL ECONOMIC ACCOUNTS [hereinafter GDP Figures], *available at* https://www.bea.gov/national/index.htm#gdp.
[3] *Id.*
[4] *Id.*
[5] *Id.*
[6] CBO, THE BUDGET AND ECONOMIC OUTLOOK 2017 TO 2027, at 117 (2017), *available at* https://www.cbo.gov/sites/default/files/52370-Outlook_OneColumn_0.pdf.
[7] *Id.*

labor market, due to retiring baby boomers and a stable labor force participation rate among working age women.[8] With the expected decline in the labor supply in the coming decade, it is important to examine the other main drivers of economic growth to see if policy changes can help improve the future economic outlook.

II. Sources of Economic Growth and the Small Businesses Impact

Several models have been created by economists to measure long run economic growth. However, the Cobb-Douglas production function, which calculates economic growth through the equation, $Y = AK^{\alpha}L^{1-\alpha}$, is one of the most widely used equations to describe long run economic growth.[9] Although capital accumulation and the amount of labor in the economy are important factors in creating economic growth, the variable "A", or total factor productivity, is the most significant component to sustained long-term growth.[10] Total factor productivity encapsulates a variety of factors including human capital, technology, institutions, and innovation.[11]

Within total factor productivity, innovation, or the process of discovering new ideas, is the most central component to economic growth.[12] Innovation and the improvement of technology allows workers to produce more per hour, which increases their productivity, income, and the country's economic growth.[13] By understanding where innovation comes from, one can not only understand how to maximize innovation and new technology, but also maximize economic growth in the long run.

Small businesses are much more efficient at producing innovation than larger businesses. Therefore, small businesses are one of the most vital ingredients to economic growth. According to a report issued by the Small Business Administration's Office of the Chief Counsel for Advocacy, small businesses invented and managed an average of 10.01 products, and large businesses invented and managed an average of 21.44 products in 2002.[14] Although larger businesses invented about 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.[15] This means that larger and older businesses have to spend more on R&D to produce the same amount of innovation as smaller and younger businesses.

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[8] *Id.*
[9] In the Cobb-Douglas production function, Y = gross domestic product, K = capital, L = labor, and α is a parameter greater than zero and less than one to measure the share of rents paid to capital and labor in the economy. CHARLES I. JONES, MACROECONOMICS (2014).
[10] *Id.* at 86-87.
[11] *Id.* at 88-89.
[12] MICHAEL GREENSTONE & ADAM LOONEY, A DOZEN FACTS ABOUT INNOVATION, THE HAMILTON PROJECT 2 (2011), *available at* https://www.brookings.edu/wp-content/uploads/2016/06/08_innovation_greenstone_looney.pdf.
[13] *Id.* at 2.
[14] JOSE PLEHN-DUJOWICH, PRODUCT INNOVATIONS BY YOUNG AND SMALL FIRMS FOR SMALL BUSINESS ADMINISTRATION, OFFICE OF THE CHIEF COUNSEL FOR ADVOCACY (2013), *available at* https://www.sba.gov/sites/default/files/files/rs408tot.pdf.
[15] *Id.*

Even though productivity, innovation, and small businesses are key drivers of economic growth, all three have lagged in recent years. According to the Bureau of Labor Statistics, the average annual change in productivity steadily increased from 1973 until 2007. However, while the average annual percent change in productivity was 2.6 percent from 2000 until 2007, the average rate from 2007 until 2016 was only 1.1 percent.[16] The drop off in productivity coincided with the average GDP growth rate falling by 1.1 percent between the two time intervals.[17] Because of the connection between productivity, innovation, and small businesses, the recent decline in productivity and economic growth occurred during a period where business formation also suffered.

The rate of business formation in the United States has dropped by almost 50 percent since 1978.[18] 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.[19] 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.[20] The precipitous decline in business formation resulted in two-thirds of the United States metropolitan areas experiencing a net loss in businesses during the recovery period.[21] The recent decline in business formation has had a significant effect on productivity, innovation, and economic growth. While economic growth has been muted in recent years, understanding the benefits of economic growth and its current limitations can help form policy that can lead to sustained long term economic growth.

III. Poverty and Economic Growth

Economic growth is more than just a statistic, or something that only affects one segment of the population. Rather, economic growth benefits everyone. In fact, higher economic growth rates are strongly correlated with a reduction in poverty. According to Stephen Moore of The Heritage Foundation, it was not a government policy that reduced poverty, but rather economic growth. The poverty rate in the United States was roughly 50 percent in 1900, 30 percent in 1950, and less than 12 percent in 2000.[22] More recently, the economic expansion of the 1990s

[16] https://www.bls.gov/lpc/prodybar.htm.
[17] GDP Figures, *supra* note 2.
[18] 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.
[19] ECONOMIC INNOVATION GROUP, THE NEW MAP OF ECONOMIC GROWTH AND RECOVERY (2016) [hereinafter EIG Map], *available at* http://eig.org/recoverymap#mapBusiness.
[20] 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.
[21] ECONOMIC INNOVATION GROUP, DYNAMISM IN RETREAT 15 (2017), *available at* http://eig.org/wp-content/uploads/2017/02/Dynamism-in-Retreat.pdf.
[22] STEPHEN MOORE, IT'S GETTING BETTER ALL THE TIME: 100 GREATEST TRENDS OF THE LAST 100 YEARS, CATO INSTITUTE 74 (2000).

reduced the poverty rate in 205 of the 206 metropolitan areas in the United States.[23] The decline in poverty rates during the 1990s was also greatest in areas that had the highest poverty rates before the period of high economic growth.[24]

Conversely, times of economic contraction result in an increase in the poverty rate. The Great Recession caused the official poverty rate to increase from 12.5 percent in 2007 to 15 percent in 2011.[25] Combined with the fact that the poverty rate declined during the 1990s, it is not policy that causes the largest swings in poverty reduction, but rather economic growth. Therefore, when the United States experiences high economic growth, benefits are felt by individuals across the income distribution spectrum.

IV. Challenges for Economic Growth and Small Businesses

As previously mentioned, the United States economy grew by just 1.6 percent in 2016 and is expected to grow at less than 2 percent over each of the next 10 years. With innovation propelling that economic growth, and small businesses being a key contributor of innovation, small businesses are a vital catalyst for long run economic growth. Therefore by understanding which government policies have adversely affected small businesses in recent years, the United States can improve innovation, productivity, and economic growth.

Regulatory burdens have a negative effect 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 remained at the 1949 level.[26] The burden of these regulations disproportionally falls on small businesses. According to a study conducted for the National Association of Manufacturers, businesses with less than 50 employees annually incur regulatory costs of almost $12,000 per employee.[27] Therefore, regulatory relief would allow small businesses to use more of their limited resources to hire and expand and increase economic growth overall.

Tax reform would also greatly benefit small businesses and economic growth. When President Reagan lowered the marginal income-tax rates by two percentage points each in 1987 and 1988,[28] GDP growth improved to an impressive 4.5 percent and 3.9 percent, respectively.[29] Similarly, estimates show that if marginal individual income tax rates today were lowered by 2 percentage points, the GDP growth rate would increase by 0.5 percent a year for the next two

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[23] Ross Gittell & Edinaldo Tebaldi, *Did a Strong Economy in the 1990s Affect Poverty in U.S. Metro Areas? Exploring Changes in Poverty in Metropolitan Areas Over the Last U.S. Business Cycle, 1992-2003*, 357 ECON. DEV. Q. 4 (2007).
[24] *Id.* at 365.
[25] SHELDON DANZIGER, KOJI CHAVEZ, & ERIN CUMBERWORTH, THE RUSSEL SAGE FOUNDATION AND THE STANFORD CENTER ON POVERTY AND INEQUALITY, POVERTY AND THE GREAT RECESSION 1 (2012), *available at* https://web.stanford.edu/group/recessiontrends/cgi-bin/web/sites/all/themes/barron/pdf/Poverty_fact_sheet.pdf.
[26] John Dawson & John Seater, *Federal Regulation and Aggregate Economic Growth*, J. ECON. GROWTH 18: 137 (2013).
[27] NATIONAL ASSOCIATION OF MANUFACTURERS, THE COST OF FEDERAL REGULATION TO THE U.S. ECONOMY, MANUFACTURING AND SMALL BUSINESS 3 (2014), *available at* http://www.nam.org/Data-and-Reports/Cost-of-Federal-Regulations/Federal-Regulation-Full-Study.pdf.
[28] Robert Barro, *How to Engineer a Trump Boom*, WALL ST. J. (Mar. 27, 2017) [hereinafter Trump Boom], *available at* https://www.wsj.com/articles/how-to-engineer-a-trump-boom-1490655757.
[29] GDP Figures, *supra* note 2.

years.[30] Because 83 percent of all small businesses are taxed at the individual income level, small businesses would also benefit from lower individual rates.[31] As it stands now, the smallest businesses also have higher proportional tax burdens than their larger counterparts. Businesses with more than 50 employees have a tax burden of about $182 to $191 per employee, but businesses with 5 employees or less face burdens about $4,308 to $4,736 per employee.[32] Therefore, through tax reform, both small businesses and economic growth would benefit.

Access to capital for small businesses is yet another impediment that not only limits the growth of small businesses, but also hinders innovation and economic growth. According to a survey by the United States Chamber of Commerce, although 40 percent of small business executives would like to increase capital investments in 2017, 53 percent of small business executives report that access to affordable credit has not improved in the past year.[33] Asked if decreasing lending regulations would benefit small businesses, 51 percent of respondents said it would help small businesses in the United States.[34] Although entrepreneurship capital methods such as venture capital have grown in popularity in recent years, venture capital has been disproportionally concentrated in only a few metropolitan areas. In 2015, 78 percent of the country's venture capital investment was centered in California, Massachusetts, and New York.[35] Additionally, 8 of the top 20 counties for business formation from 2010 to 2014 were in either California or New York.[36] Initiatives such as the Kauffman Foundation's scholarship program to accelerate venture capital in the Midwest,[37] and Revolution Growth's initiative to fund high growth companies outside Silicon Valley seek to address the geographic imbalance of venture capital.[38] By increasing access to capital, especially venture capital, small businesses would have the financial backing to establish and expand their businesses, innovate, and grow the economy.

Improving American infrastructure could help small businesses as well. Contracts for small businesses to improve the nation's infrastructure would benefit small businesses in a variety of industries. The productivity potential from better highways with less traffic would benefit small businesses and economic growth for decades to come.[39] In an International

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[30] Trump Boom, *supra* note 28.

[31] *Start-ups Stalled? The Tax Code as a Barrier to Entrepreneurship: Hearing Before the H. Comm. On Small Business*, 115th Cong. (2017) (testimony of Tim Reynolds), *available at* http://smallbusiness.house.gov/calendar/eventsingle.aspx?EventID=399602.

[32] *How Tax Compliance Obligations Hinder Small Business Growth: Hearing Before the H. Comm. on Small Business*, 114th Cong. 3 (2015) (testimony of J. Christopher Mihm), *available at* https://www.gpo.gov/fdsys/pkg/CHRG-114hhrg95580/pdf/CHRG.

[33] *Key Points from Financial Services Survey*, U.S. CHAMBER OF COMMERCE FOUNDATION, CENTER FOR CAPITAL MARKERS AND COMPETITIVENESS, *available at* http://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/Financial-Services-Survey-For-Small-Businesses-Growth-and-Credit-Go-Hand-in-Hand.pdf?x48633.

[34] *Id.*

[35] National Venture Capital Association, "Yearbook 2016" (2016).

[36] EIG Map, *supra* note 19.

[37] *New Kauffman Foundation Scholarships to Accelerate the Midwestern Venture Capital Ecosystem*, KAUFFMAN FOUNDATION (Oct. 24, 2016), *available at* http://www.kauffman.org/newsroom/2016/10/scholarships-to-accelerate-the-midwestern-venture-capital-ecosystem.

[38] *Revolution Growth Announces $525 Million Fund to Invest in Next Wave of High-Growth Companies*, Revolution LLC (June 24, 2016), *available at* http://revolution.com/press-release/revolution-growth-announces-525-million-fund/.

[39] Trump Boom, *supra* note 28.

Monetary Fund study that surveyed advanced economies, an increase of one percentage point of GDP in infrastructure investment spending increased economic output by 0.4 percent that same year.[40] Four years later, the increase in economic output from the initial investment would be 1.5 percent higher.[41] However, the same study warns that if investment is concentrated in inefficient projects, the public debt to GDP ratio will rise, and the investment would not be worthwhile.[42] Thus, it is critical that infrastructure investments are focused on efficient projects to ensure that they will benefit small businesses and the American economy over the next several decades.

V. Conclusion

Increasing economic growth in the United States is not simple. However, reducing regulatory burdens, improving access to credit, and tax reform, could help the growth of small businesses. Both prominent economic models and real economic data show that small businesses and the innovation they create are a catalyst that propels long term economic growth. Making it easier for small businesses to innovate will help them and the United States economy flourish for decades to come.

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[40] Abdul Abaid, David Furceri, & Petia Topalova, *IMF Survey: The Time Is Right for an Infrastructure Push*, INTERNATIONAL MONETARY FUND (Sept. 30, 2014) *available at* https://www.imf.org/en/News/Articles/2015/09/28/04/53/sores093014a.

[41] *Id*.

[42] *Id.*