Report by the House Small Business Committee
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Small Business Index

-- 2005, Third Quarter --

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Introduction

In 2005, the overall economic environment has been marked by sectors that have seen slight improvements but tempered by more pervasive negative economic news. As we enter the end of the year, the small business sector has failed to gain traction and anticipated high growth and job creation figures have failed to materialize. The term that may be appropriate to assess the current business conditions for small firms is "muddled" as firms are also faced with an uncertainty about the lasting effects of recent natural disasters and the volatility of energy prices.

The Small Business Index (SBI) for the third quarter of 2005 reveals that the economy continues to trudge along and appears to be a continuation of recent quarters that were characterized by high energy costs and less than expected job creation. The overall index is at an eight year low and is weighed down by rising energy, health care costs and an increasing cost of capital as interest rates continue to rise. For the last eight quarters, the SBI has hovered around 70 and in the latest quarter dropped below that for the first time.

The latest SBI report outlines the factors affecting small businesses in the United States economy. It examines the cost factors, industry metrics, credit conditions and access to capital to assess the business environment for small firms. It is catered to examine those statistics that are particularly important to small businesses. This report shows that while GDP may have risen in recent months, the small business sector continues to struggle and the prospect for future growth appears unlikely.

The most notable and perhaps alarming aspect of this quarter's SBI is the fact that the SBI continues to be so low. Recent economic downturns at the beginning and end of the 1980's and 1990's were generally followed by times of pronounced business growth and job creation. The SBI and other economic indicators show that the economy has failed to approach the levels of optimism and business growth seen in the mid-1990s or during the 1980's.

The third quarter report also includes some of the preliminary data on the effects of recent hurricanes. The data shows that even without the impact of these disasters, the economy was struggling in terms of rising energy costs and job creation. These figures will be exacerbated by the situation in the Gulf. The areas affected by Hurricane Katrina make up a major portion of the U.S. economy and the revitalization of the Gulf Coast must be a major part of any economic policy.

The devastation that was evident in the Gulf area has also started to create economic consequences for those areas outside the region due to the impact on trade and energy supply. The region hit hardest by the storm employs 1.6 million people who produce goods and services valued at about $130 billion a year.[1] There are also estimated to be over 900,000 small businesses in the area. Additionally, the region's ports are used to ship about $150 billion a year in goods or 20 percent of U.S. import-exports.[2]

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[1] Forbes.com. "Katrina's Impact is Spreading." Scott Reeves. August 31, 2005. Citing an Economy.com report.
[2] Id.

The impact on the trade deficit in this country could be significant. Until Hurricane Katrina hit, the Port of New Orleans moved more than 11 million tons of cargo per year, which included vital resources of rubber, concrete, gypsum, steel and poultry.[3] The region's ports showed an $11.9 billion deficit in September, compared with an $8.3 billion shortfall in September 2004.[4] The SBI shows that the trade deficit was at record levels even prior to the disasters.

The areas around the recent hurricanes not only produce many agricultural products, but the ports in the area are also responsible for shipments. Nearly 70 percent of the nation's grain exports (wheat, corn, soybeans) go through Louisiana.[5] The Port of New Orleans also handles a large amount of imports such as bananas, coffee, forest products, and other goods. As New Orleans begins to rebuild, this will have a damaging long-term effect on the price of U.S. exports. The other factor that will hinder growth in the agriculture industry is the expected 50 percent increase in natural gas prices this winter, a significant cost element in running a business.

The economy did not appear to be on stable ground before these disasters hit the area. The latest job figures in October show that while the recent hurricanes may not have had the same impact as 9/11, the economy continues to struggle to produce consistent job creation. Hiring was up only 56,000 in October, well short of the 100,000 predicted by most economists. The Commissioner of Labor Statistics reported that job growth in the areas outside of the hurricanes impacted regions appeared to be below trend.[6] This is alarming to many business owners who were hoping that the economy would finally begin to turn the corner and experience both a growth in GDP and job creation.

The lack of sustained growth may also be contributing to an overall decline in business and consumer confidence. Despite predictions otherwise, the September report of the Conference Board assessing consumer confidence dipped from 87.5 to 85. Additionally, the overall National Federation of Independent Business (NFIB) optimism index for small businesses slipped in the most recent monthly report. These seem to paint a picture for an economy that will continue on the path of moderate to non-existent growth.

The economic conditions suggest that any prospects for improvement among the small business sector will require a number of these obstacles to be overcome. Energy prices are expected to rise in coming months. Another deflating factor is the outlook of inflation that is on the mind of investors and small business owners. For businesses to start expanding, and for the economy to see the job creation numbers seen in the mid-1990's, businesses are going to need confidence in knowing the current economy is on stable ground.

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[3] Id.

[4] Bloomberg.com, "U.S. September Trade Deficit Widens to Record $66.1 Billion," Torres, Carlos. November 10, 2005.

[5] Aon.com release "Aon Agribusiness Expert Says Hurricane Katrina Bad News for U.S. Poultry Producers." September 6, 2005.

[6] Statement of Kathleen Utgoff, Commissioner, Bureau of Labor Statistics before Joint Economic Committee. November 4, 2005.

To get the economy back on track, policy priorities should be ensuring a drop in input prices such as health care and energy. The reconstruction of the ports and energy production in the Gulf Coast will alleviate some concerns about energy costs. As far as health care, there have been no major reforms to address this issue and a recent Kaiser report found that costs will continue to rise by double digits. The lack of a comprehensive health care policy has meant that small businesses can expect to bear the brunt of these price hikes. The one positive effect, in terms of economic data, of the rebuilding process will be an increased growth domestic product. The estimated $200 billion in rebuilding cost will translate to a higher GDP in coming months, but may not reflect the situation on the ground.

Implementing policies that cater to the needs of the small business sector have proven to be successful in generating jobs and improving the overall economy. Job training programs, reduced regulatory burdens, and reeling in skyrocketing health care costs are just a few of the ways to ensure U.S. small businesses remain competitive in the global marketplace. This report helps track these factors and reveals how the failure to address these important issues has hindered the economy. It also provides a focus on what issues should be addressed to improve business conditions.

Analysis

Overview

While the full effect of the Gulf hurricanes on the SBI will not be realized until 2006, the SBI displays the challenging conditions facing small businesses. For the 3Q 2005, the SBI is 69.99, continuing its downward trend and providing evidence that the economic environment is less than favorable for entrepreneurial activity. The current SBI is nearly 35 percent below its high point reached in 2000.

At this point, underlying economic trends that have been in place for the last several years will persist and continue to dominate the SBI. It is expected that the SBI will demonstrate modest reaction to the recent hurricanes, as the national economy absorbs and seeks to overcome these events.

Key Drivers

The 3Q 2005 SBI continues to be driven by factors affecting the economy more generally, including rising operating costs and increasing pessimism in the business community. Specifically, the decline in the 3Q 2005 SBI is due primarily to increases in oil and natural gas prices, a rise in interest rates, and challenging economic conditions in rural America. Rising health care costs, a downturn in business optimism, and an increase in business inflation also contribute to the fall in the index.

While many factors contained in the SBI have shown signs of continued weakness, several factors suggest that the economy is on firm footing – including an increase in manufacturing activity, a rise in the stock market, and an increase in commercial lending and venture capital investment. The factors have partially offset the decline in the SBI.

Findings

While recent economic data suggests economic progress – as demonstrated by recent GDP growth rates and consumer spending reports – many entrepreneurs throughout the country continue to face specific challenges. Many of these economic challenges have been exacerbated by the recent hurricanes.

In particular, rising energy prices, as tracked in the SBI by oil and natural gas prices, have diverted resources from businesses, making it less likely that firms will expand or hire new employees in the near future. Further clouding the economy is a growing pessimism within the business community, which is related to the near-term earnings outlook of many businesses, as well as the government's inability to quickly respond to the recent disasters.

To further analyze the SBI, the 17 economic indicators used are grouped below into four categories: costs factors, credit conditions, trade competitiveness, and industry metrics.

Cost Factors

Health Care, Oil, Natural Gas, Retirement and Savings, and Total Employee Compensation, Producer Price Index, Regulatory Costs

The day-to-day operations of small businesses are significantly affected by fluctuations in the prices of resources and labor. Resource costs – including raw materials, inventory purchases, and energy consumption – are among the most volatile. This volatility in resource costs is due to the global nature of the markets in which such goods are traded. As a result, the prices of key resources can be affected by a multitude of factors, including poor weather conditions, transportation network disruptions, and the rapid adoption of new manufacturing technologies. Labor costs – including wages and benefits – tend to be less volatile due to the stability of the domestic economy and the orderly structure of the U.S. labor market.

Small business owners, who tend to reinvest capital into their firms at a high rate, can do little to guard against volatility in key resources. As a result, severe price swings often have a substantial affect on entrepreneurs, impeding their growth, limiting their ability to hire new employees, and stifling innovation.

In the 3Q 2005, price increases in energy resources – namely petroleum and natural gas – have contributed significantly to the decline in the SBI. Hurricanes Katrina and Rita severely impaired oil and natural gas production in the Gulf of Mexico and led to supply disruptions in nearly half of the U.S. industry. As a result, U.S. oil production hit a 50-year low in September. Due to theses supply shortages, both natural gas and petroleum prices have risen. The impact of the hurricanes on both production and refining capacity will be exacerbated by the onset of winter and its increased demand for heating fuels.

The Energy Information Administration (EIA) reports that the benchmark crude oil prices (West Texas Intermediate) averaged about $66 per barrel in September. The EIA estimates that quarterly averages for crude oil prices are projected to remain above $63 per barrel for the rest of 2005 and 2006. It should be noted that continued high crude oil prices had been expected prior to Hurricanes Katrina and Rita, which have only further contributed to price pressures.

Given that the supply of natural gas to the U.S. is achieved primarily through domestic production (only 15 percent of natural gas supplies are expected to be imported in 2005), it is unlikely that an increase in natural gas imports will be able to offset weather-related increases in demand. According to the EIA, natural gas prices are expected to average about $9.00 per million cubic feet (mcf) in 2005 and $8.70 per mcf in 2006. However, the EIA reports that in September, natural gas prices averaged $12.40 per mcf, due to warmer weather conditions in the East and Southwest that increased natural gas-fired electricity generation for cooling demand. According to the EIA, the natural gas market is likely to stay tight over the next couple of months, particularly in light of the supply impacts from Katrina and Rita.

While energy costs have risen sharply due to the recent hurricanes, rising health care costs continue to be a considerable challenge for business owners. In 2005, health care costs have again risen by nearly 10 percent – marking the fifth consecutive year of substantial increases. Even though small businesses are not required to offer health insurance, over half of them do. Scaling back health care insurance due to rising costs can lead to increased turnover and instability in their businesses.

Outside of energy and health costs, the cost factors showed moderate movement from previous values. The Produce Price Index was increased nearly 3 percent since 1Q 2005 – reflecting the pass-through of recent energy price increases to wholesale prices and creating another challenge for small business owners. Additionally, overall compensation and employee retirement costs have seen modest increases. Hurricane Katrina continues to displace workers and disrupt the labor markets, particularly in the Gulf Region – but new hurricane-related labor market dynamics are causing this rise. Finally, the increase in regulations by the federal government has moderated over the last year.

Taken together, sharply rising energy prices and continued high health care costs have further squeezed the already tight margins that small businesses operate on. The effect of the cost increases will be to dampen hiring and economic growth – particularly in the Gulf Region where the impact of the recent hurricanes will linger well into 2006 and 2007.

Credit Conditions and Access to Capital
Budget Deficit, Commercial and Industrial Loans, Interest Rates, Venture Capital

The barriers that entrepreneurs face in securing business financing are largely due to the very nature of small businesses. Small firms lack substantial financial resources, are more sensitive to local economic conditions, and often operate on very thin margins. As a result, smaller firms are highly susceptible to failure, which presents a major challenge to overcome when seeking capital. A key factor in small businesses' ability to secure financing is its affordability, which is largely determined by market interest rates.

Nearly all extensions of capital to small businesses, whether in the form of credit cards or commercial loans, are tied to the prime rate. The prime rate is adjusted as the Federal Reserve raises or lowers the target overnight federal funds rate. Since June 30, 2004, the Federal Reserve has raised the target federal funds rate twelve times, increasing this rate from 1 percent to 4 percent. During this time period, the prime rate has increased to 7 percent. For business owners, the impact of rising interest rates can be severe. Many extensions of credit and commercial loans are extended at a variable rate. As a result, interest rate increases can lead to unforeseen and unexpected costs.

Even though interest rates have risen, commercial lending activity has increased to over $1 trillion. This increase is largely due to more relaxed lender requirements. However, with interest rates continuing to rise further and business confidence showing signs of weakness, there is a strong likelihood that lending volumes may decline in the near future.

For business owners involved in high-growth industries, the venture capital industry is an increasingly important source of capital. Recently, venture capital funding has risen to $5.3 billion in the 3Q 2005. While this level of venture capital investment is a sign of continued resurgence for the industry, it is still well below the level of $27 billion a quarter in venture capital investment achieved in 2000.

The year-end FY 2005 budget deficit of $318.6 billion is nearly $100 billion less than the FY 2004 budget deficit. Such a reduction in budget deficits will reduce upward pressure on interest rates minimally, as the federal government continues to fund its operations through the issuance of debt. Doing so will continue to pressure interest rates higher, as private sources of capital compete with the public sector for investors.

Sharply higher interest rates are deterring many business owners from fully accessing the financing they need to hire new employees or expand their operations. While rising interest rates have not impeded growth to date, it is likely that such rate increases, coupled with the impact of higher energy prices, will ultimately lead to reduced economic activity in the near future.

Trade Competitiveness of Small Businesses
Trade Deficit, Manufacturers' New Orders

Hurricanes Katrina and Rita greatly affected the trade competitiveness of U.S. small businesses. Businesses throughout the country are reliant on the Port of New Orleans and the Mississippi River for their economic livelihood. This includes Midwest farmers that rely on the Mississippi River to bring their grain to market overseas, and retailers that sell durable goods brought in through the Gulf ports.

According to the U.S. Census Bureau, Hurricanes Katrina and Rita had a significant effect on U.S. trade activity. Total exports through the ports on the Gulf Coast located between Tampa and Houston declined by $1.2 billion, or 15.2 percent, based on a comparison of preliminary, non-seasonally adjusted data for September and August.

The Port of New Orleans – the fifth largest U.S. port by tonnage – was affected, but has begun to show initial signs of recovery. However, Port operations, which could cost up to $1.7 billion to repair, are not at typical operating levels. Goods exported through the New Orleans region fell $590 million in September, led by sharp declines in chemicals, petroleum, coal products and farm and food products.

According to Port of New Orleans officials, six weeks out from Katrina, the Port was averaging 14 to 15 ship calls per week, about 35 to 40 percent as compared to pre-hurricane levels and truck capacity was 35 to 40 percent below normal operating levels as well. In addition, it has been reported that outbound trade through the Houston area ports dropped $579 million in September due to a decrease in chemical and machinery exports.

In addition, the hurricanes affected the agricultural industry, including small farms and rural small businesses. The United States ships much of its corn, wheat and soybeans through Louisiana ports on the Mississippi River. When Hurricane Katrina hit New Orleans, it crippled the Midwest's grain-moving system. Mississippi River barges were grounded, export elevators shutdown, and grain exports ceased. Agricultural commodities are now moving again down the river, but at a slower pace due to the hurricanes' impact.

Overall, the trade deficit rose 11.4 percent to $66.1 billion in September – its highest monthly sum – as the United States spent a record $23.8 billion on oil. U.S. exports fell by 2.6 percent to $105.2 billion in September, the biggest monthly decline in four years. The trade imbalance, already on pace to set a new record in 2005, will likely grow more rapidly due to the recent hurricanes. The American Farm Bureau Federation estimates that there could be a $500 million export loss for U.S. producers who normally export through the Gulf ports. That loss could be exacerbated if foreign purchasers seek out other suppliers, such as China for corn, or South America for soybeans.

Sustained large deficits are indicative of the challenges small businesses incur in the global marketplace. With rising foreign imports, domestic small businesses face challenges from lower-cost manufacturers located in far-flung countries. Unfortunately, such competition at home comes without commensurate opportunities for competition abroad.

Manufacturing activity continues to increase gradually – likely reflecting the adoption of new technologies and increases in productivity. While this increase in activity is a positive development for small manufacturers, it is unclear if this trend will be sustained.

The recent hurricanes have had a significant impact on trade and are affecting small businesses' ability to compete globally. Disruptions in the Mississippi River shipping lanes and at the Port of New Orleans have adversely affected businesses ability to bring their products to markets and receive the raw materials they need to operate. As a result, many small firms are facing short-term financial challenges due to a decline in revenue.

Industry Metrics
NFIB Small Business Optimism Index, Net Farm Income, Russell 2000 Index, Total Unemployed

Industry metrics provide insight into various factors critical to the business environment. This includes an assessment of the agricultural industry, the performance of small cap stocks, business confidence, and the state of the labor market.

From 2003 through 2005, the U.S. farm sector experienced record level growth due to higher prices for cattle, hogs, poultry, and milk. In 2005, the United States Department of Agriculture (USDA) projects that net farm income will be $71.5 billion, down $11.1 billion from the record $82.5 billion estimated for 2004. The decline in net farm income is due to a decline in market prices and an increase in production costs from 2004, when both crop and livestock commodities experienced exceptionally favorable market and/or production conditions. Nevertheless, net farm income in 2005 is the second highest ever, exceeding 2003 by $12 billion.

The NFIB Optimism Index is near a two-and-a-half year low, reflecting the uncertainty small business owners have about the economy. Contributing to this are the recent hurricanes that have affected the business climate nationally. According to the NFIB, business owners' outlook for general business conditions have worsened substantially, as have their sales, earnings, and sales expectations. Higher energy prices and the impact of the recent hurricanes appear to be weighing heavily on the business community. Buttressing the drop in business confidence is an unexpected drop in consumer confidence to a two-year low. According to the Conference Board, its consumer confidence index fell to 85 from 87.5 in the previous month. It had been expected to rise to above 88 by market observers.

The number of unemployed, which is intended to show hiring patterns, has decreased – likely reflecting the drop in labor market participation rather than job creation. There are 5 million additional workers who want a job but are not counted among the unemployed (including about 1.4 million who have searched for work enough to be considered marginally attached to the labor force). An additional 4.3 million people work part-time because of the weak economy. The unemployment rate would be 8.7 percent if the figure included those who are marginally attached to the labor force and those who are forced to work part-time because of the weak economy. Hurricane Katrina has had a major impact on the Gulf Region as unemployment in Louisiana hit 11.5 percent at the end of 3Q 2005, up from 5.4 percent in the 2Q 2005. Mississippi's unemployment rate increased to 9.6 percent from 7.1 percent during the same period.

Additionally, the Russell 2000, a small company stock index, has seen gains in the last six months of nearly 10 percent – partially reflecting investors' appetite for higher returns in a market flush with capital. This rise indicates an increased appetite among investors to fund to smaller companies – one of the few bright spots in the SBI.

Business confidence has been impacted and pockets of high unemployment persist – especially in the Gulf region – and have the potential to dampen investment and growth throughout the country. Reluctance by small businesses to move forward and expand could ultimately lead to a significant economic downturn.

Conclusion

The current economic conditions have caused many potential business owners to be risk averse when it comes to investment and expansion. The lack of risk-taking is attributable to a business environment characterized by the high cost of borrowing, rising input costs, a high trade deficit, and a federal budget deficit that threatens to have a drag on the economy. This has created a situation where consumer confidence, something that is a strong indicator of the future direction of the economy, remains at low levels. The SBI, which tends to track along side of consumer confidence, now stands at an eight year low due to these factors.

The SBI shows that while recent natural disasters had an impact on the economy, but the economy was already experiencing a number of downward trends. The SBI statistics tracking back to July and August 2005 reveal that the cost of energy and the trade deficit were at high levels even before Hurricane Katrina hit. It may be the case that these hurricanes exacerbated these problems in September and in future months, but statistics show the economy was not on solid grounding prior to that time, especially when taking the job creation numbers into account.

The combination of these factors has many small business owners reluctant to invest in new ventures – the primary reason why business confidence has dropped in recent months. It appears that for the economy to begin experiencing the growth seen after the recent economic downturns of the 1980s and 1990s, there is a need for new and innovative policies that are radically different from the current ones. The recipe for economic success in the mid and late 1990s was characterized by policies that kept the budget deficit in check, while promoting investment in new industries and opening markets.

During that time firms had confidence that the business environment was conducive to growth, but that does not seem to exist today. The Conference Board Consumer Confidence Index during the mid-to-late 1990s was well over 100 and reached peaks of 140. It now stands at only 85.0, and has been consistently below 100 since 2001. As a result, the current outlook for business investment remains low unless there are significant changes to the factors that affect small businesses.

Over the past five years, one of the cruxes of the economic policy has been reducing marginal tax rates as the primary means to benefit small businesses. The theory was that these reductions would provide an influx of cash to these firms who would then turn around and invest such monies to expand and grow their businesses. In reality, these cuts have provided marginal benefit and as an example, the cut in the top marginal tax rate provided a benefit to only 1.3 percent of small business owners according to the Tax Policy Center. In terms of job creation and small business investment, the SBI shows that these policies have failed to do so.

These tax cuts, while providing little benefit to small businesses, have contributed to expanding budget deficits, which also weighed on the economy. The federal deficit has been at record levels since 2001. Despite warnings to Congress from the Federal Reserve Chairman to rein in this deficit, it has not been addressed. These persistent deficits are part of the reason that long-term interest rates have started to rise, which has only increased the cost of running a business.

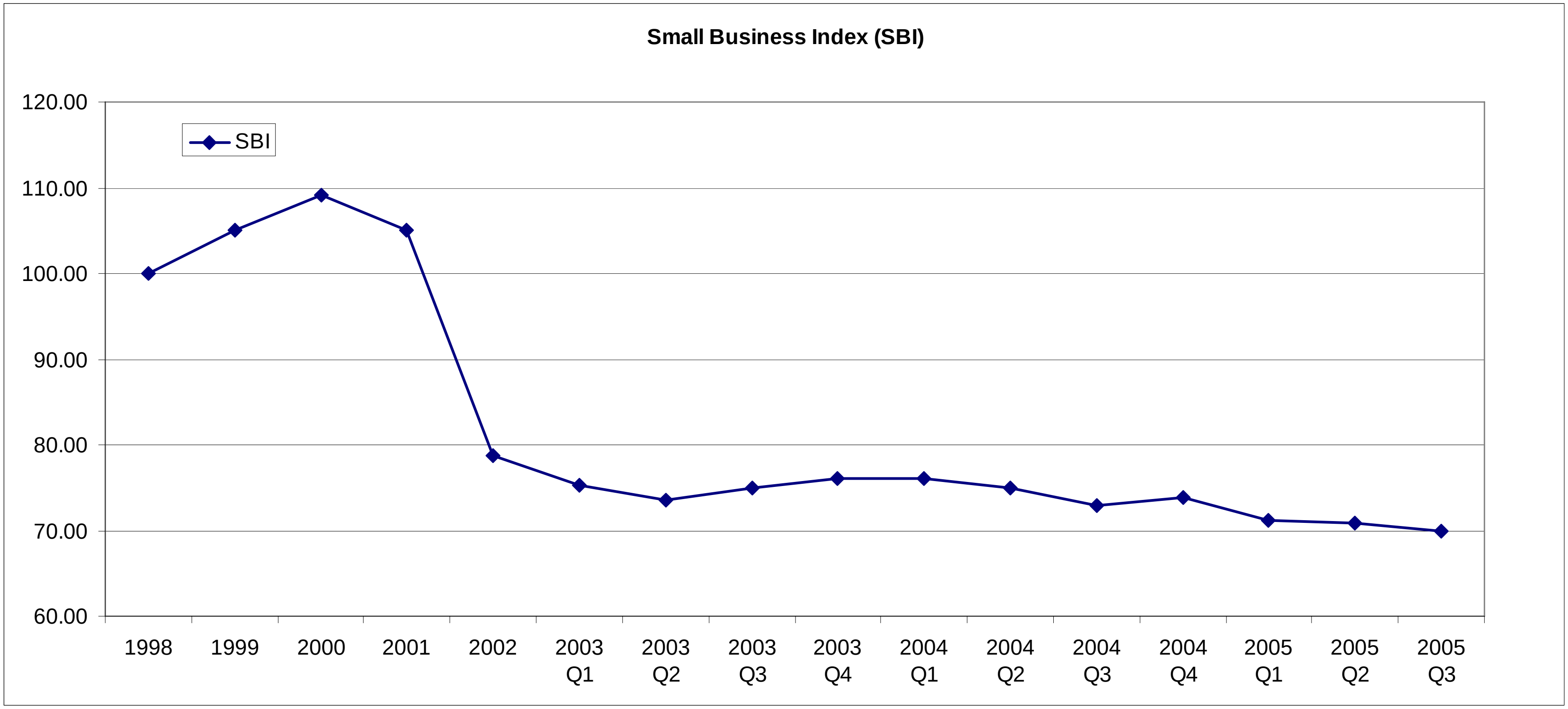
In terms of other legislative approaches to improving the economy over the past five years, there has been little done to reduce the input costs of running a business. The federal government has failed at improving or affecting the business environment on a number of fronts, most noticeably on health care and energy costs. Health care costs have risen by over 70 percent in the last five years, and energy prices have seen spikes of up to 20 percent annually. The business outlook is based on the prospects that these costs will decline and the market appears to lack confidence that the current policies will do so.

A restoration of confidence through improved business conditions is necessary to stir economic activity in the small business sector. Reining in the budget and trade deficits, and addressing rising health and energy costs will enable business owners to re-evaluate their risks and encourage investment and expansion. For this reason, it is critical to implement policies that improve the economic conditions impeding small business growth.

By addressing these problems, it will also help small businesses overcome the unseen hurdles that lie ahead. With recent data suggesting the housing market is cooling off, it increases the urgency for economic policies to be put in place to offset these changes. Significant economic activity was fueled by an influx of cashing out the equity in American homes, and the fall of home values could have a dramatic reverse affect. To combat such negative market forces, it is important to put the economy on stable grounding.

Over the last five years the economy has been marked by inconsistent growth and weak job creation. For small business owners, the decision to start a venture involves a risk and reward analysis. Budding entrepreneurs must assess a number of factors including: the required investment to start, the likelihood of making a profit which includes a consideration of the cost of running a business, as well as the market for the goods and services. In order for the U.S. economy to adequately adjust to the ever-expanding global marketplace, policies must be implemented that put our nation’s small businesses at the top when it comes to receiving the tools for success.

Data



Period		98-99	99-00	00-01	01-02	02-031Q	031Q-032Q	032Q-033Q
% Change		5.0%	3.9%	-3.7%	-25.0%	-4.4%	-2.3%	2.1%
	1998	1999	2000	2001	2002	2003 Q1	2003 Q2	2003 Q3
SBI	100.00	105.00	109.11	105.05	78.75	75.26	73.49	75.02

Period	033Q-034Q	034Q-041Q	041Q-042Q	042Q-043Q	043Q-044Q	044Q-051Q	051Q-052Q	052Q-053Q
% Change	1.5%	0.0%	-1.5%	-2.7%	1.2%	-3.6%	-0.6%	-1.2%
	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2005 Q1	2005 Q2	2005 Q3
SBI	76.12	76.10	74.99	72.96	73.86	71.23	70.84	69.99

Methodology

The SBI is comprised of a basket of economic indicators. These indicators provide a broad measure of the degree of small business creation and viability by representing the characteristics necessary for a healthy domestic small business sector. An increasing SBI is indicative of an improving small business sector. The data is gathered and compiled quarterly from various sources, including government agencies, congressional sources, and private institutions. The report is generally released semi-annually.

The SBI is what is generally known as a coincident index in that it reflects the current economic conditions facing small businesses. In order to expand the scope of the economic environment measured by the SBI, both leading and lagging indicators are included. Leading indicators are commonly used to predict changes in economic activity, whereas lagging indicators typically confirm previous changes in the economy. By using both types of data, the SBI demonstrates not only the current state of small businesses, but also how strong the environment is for starting new ventures.

The SBI is calculated using both broad economic measures as well as more specific indicators showing the health of the small business sector. Broad economic measures incorporate the effect of changes in aggregate economic conditions, such as inflation, employment, and trade balances. The sector, specific indicators track changes in the costs associated with operating a small business, such as health care and energy costs. Together, this combination of indicators provides an expansive measure of the small business economic environment.

Since the initial SBI was released in 2003, the index's indicators have been reviewed and updated to ensure that the SBI remains the most accurate measure of the small business economy. Revisions to data series maintained by federal agencies used in the SBI are commonplace; as a result of these changes, the current SBI's comparability to previously released SBIs is limited.

Business starts and failures, which were originally used as a broad measure of small businesses' confidence in the economy, were removed in 2004 from the index due to the substantial lag in the issuance of the data series. In place of these variables, NFIB's benchmark Index of Small Business Optimism was incorporated into the SBI to measure small business owners' views of and confidence in the economy. Also in 2004, the SBI's energy indicators were refined to more accurately capture the costs of the energy resources most relied on by small businesses – oil and natural gas.

For each economic indicator, data is used to calculate a percent change. This change is calculated quarterly beginning in 2003. For the five-year period between 1998 and 2002, the SBI was calculated annually. The change in each indicator is used as the basis for computing the SBI.

Understanding that not every indicator positively affects the economic conditions facing small businesses, each indicator is assigned a positive or negative correlation. Positive indicators contribute to more favorable economic conditions for small businesses, whereas negative indicators weaken their economic environment. The correlation determines whether the SBI will increase or decrease given a change in the value of each economic indicator.

The average percent change of the basket of economic indicators is then calculated. For this calculation, each economic indicator has an equal statistical weight. This average percent change is used to increase or decrease the SBI.

Indicators

Balance of Trade represents the net amount of domestic international trade, as the combination of the number of imports and exports. A trade deficit occurs when foreign imports exceed domestic exports. Conversely, a trade surplus occurs when domestic exports exceed foreign imports.

While trade deficits have helped contain inflation during periods of economic growth, they produce many challenges to domestic manufacturers and exporters, the majority of which are small businesses. For these domestic small businesses, trade deficits often signal a lack of global competitiveness and a loss of market share. Larger corporations are better able to move their operations abroad, reducing their exposure to the factors that cause trade imbalances. Small businesses, however, are unable to easily relocate overseas and must reduce their operating costs or change their business model.

Commercial and Industrial Loans and Leases reflect the amount of business lending by commercial banks. Small businesses, including small manufacturers, rely on commercial and industrial loans to expand their operations and to modernize their facilities. These loans are used to purchase real estate and equipment, as well as for working capital purposes.

The measure of commercial and industrial lending and leasing activity provides a good gauge of the credit conditions facing small businesses. An increase in lending and leasing indicates that banks are willing to extend more credit, while a decrease represents a tightening, or rationing, of credit. Because bank lending patterns also reflect the financial conditions of their borrowers, a change in this measure is often correlated with the underlying economic fundamentals of the business sector.

Federal Budget Surplus or Deficit represents the net amount of federal government outlays and receipts. A budget deficit may negatively affect small businesses for two reasons. First, it may be indicative of a decrease in federal government domestic discretionary spending, including reductions in programs targeted to assisting small businesses and entrepreneurs. For instance, budget deficits are likely representative of reductions in many of the Small Business Administration’s (SBA) programs, as well as programs that provide vocational training to adults, energy and technological support to companies, assistance to small manufacturers, and mentoring opportunities to minority-owned businesses.

Second, budget deficits contribute to higher credit costs. As the supply of government debt is increased, the price (interest rate) on the debt must also be increased in order to attract investors. To remain competitive, private sector debt issuers often raise the interest rates on their instruments as well. The result is higher interest rates for all borrowers. Borrowers who rely on commercial loans, such as small business owners, are most likely to be hurt by these interest rate increases.

Health Care accounts for the cost of health care insurance premiums. The indicator represents the price companies pay for providing health care to their employees. It is a combination of the cost of health care supplied by all providers (HMO, PPO, and point of service). While small businesses are not required to provide health care to their employees, most do so in order to retain qualified workers. As with any workforce benefit, changes in the price of health care have a direct impact on the company's bottom line. For small businesses, increases in these costs can lead to either a reduction in coverage offered or other forms of compensation, and can have a detrimental affect on the stability of the company.

Manufacturers' New Orders represent the amount of orders for durable and non-durable goods placed with domestic manufacturers, the majority of which are small businesses. Manufacturers' new orders are a benchmark for economic activity, often signaling a near-term economic recovery or downturn.

A rise in manufacturers' new orders reflects an upturn in economic activity and is a likely indicator of a rise in near term profitability. A decrease in manufacturers' new orders is indicative of a decline in business, which will result in lower profits for manufacturing businesses.

Natural Gas Costs are the average monthly price of natural gas sold to consumers in the United States. These figures are taken from the U.S. Energy Information Association. The amounts are measured in dollar amounts per cubic foot.

For many small businesses, the costs of energy, including natural gas, make up a significant percent of their daily operating costs. Spikes in natural gas prices can be devastating to certain sectors of the economy. These price increases are particularly tough on gas-intensive businesses like small restaurants and dry cleaners. Federal Reserve Chairman Alan Greenspan and other economists have cited the rising costs of natural gas as an impediment to economic growth.

NFIB Small Business Optimism Index is a composite measure of ten qualitative small business survey indicators and generally reflects small businesses' views of the economy. The index is based on monthly surveys of NFIB members.

Net Farm Income is a measure of the financial condition of the farm industry. It reflects the farm income received from the sale of livestock and crops, as well as payments from the government less the production expenses. Farms often drive rural economies, providing jobs to local residents and generating wealth in these communities. As a result, the economic well-being of rural small businesses is frequently tied to local farms.

An increase in net farm income is indicative of an improving rural economy. Growth in net farm income often translates into higher profitability for rural small businesses. Alternatively, a decline in net farm income often signals tougher times for small firms, as farms purchase less goods and services from local rural small businesses.

Number of Unemployed represents the number of individuals without jobs, indicating the level of small business economic activity. A decline in the number of unemployed reflects an improving economy, in which more consumers have the means to purchase goods and services. An increase in the number of unemployed indicates a slowing economy, in which consumers are less able to spend freely on goods and services.

Oil Costs pertain to the sweet crude oil costs in U.S. dollars per barrel. Such figures are compiled by the New York Mercantile Exchange Index and are posted by the U.S. Department of Energy. As many small companies are dependent on transportation costs, changes in gasoline prices can severely affect the cost of doing business. In addition, price volatility of oil can make it difficult for small businesses to decide on future investments due to cash flow issues related to these rising costs.

Prime Rate is the interest rate charged by banks to their most creditworthy customers. Interest rates on small business loans are generally tied to the prime rate. The prime rate is included as a measure of the credit terms available to small businesses. While the prime rate is directly charged to the most creditworthy small businesses, the interest rates charged to less creditworthy small businesses are increased and decreased according to this rate. This demonstrates how the prime rate affects the lending conditions of nearly every company.

The prime rate fluctuates based on the federal funds rate and other factors. The prime rate provides the lender with sufficient revenue to cover the costs associated with loans to borrowers determined to have a low risk of default. The rate is adjusted in increments, called the margin, to compensate for greater credit risk or other factors that affect the cost of lending.

Producer Price Index (PPI) measures the average change over time in the selling prices received by domestic producers for their output. The PPI represents the prices that small manufacturers and producers will receive for their products. In addition, the PPI also measures the prices charged to small businesses for purchases of their retail inventory.

Rising resource and labor costs often cause the PPI to increase and may result in a reduction in the demand for small businesses products, dampening economic activity. A decrease in the PPI reflects declining costs of production and may cause small businesses to lower their prices or increase their profit margins.

Regulatory Costs represent the total number of final regulations issued each year. This measure is used as a general indicator for small business regulatory burden. Regulatory compliance and paperwork consistently rank as one of the top ten costs facing small businesses in America today. Costs to small firms for regulatory compliance are generally 60 percent higher than they are for large firms.

Retirement and Savings represent the costs for small businesses to provide employee pension benefits per working hour. These costs are associated with the amount spent in offering retirement coverage, a critical tool in attracting and retaining employees.

Russell 2000 Index represents the 2,000 smallest companies in the Russell 3000, a broad based index that represents approximately 98% of the value of what is invested within the U.S. equity market. The Russell 2000 makes up only about 8% of the total market capitalization of the Russell 3000. This is the most quoted index that focuses on the smaller company portion of the economy.

While most small businesses are not publicly traded, the Russell 2000 Index is a benchmark measure of the economic performance of smaller companies. An increase in the Russell 2000 reflects rising investor confidence in the smaller company sector and heightened expectations for future profitability. A decline in the Russell 2000 is generally driven by decreased investor confidence and lower profit expectations for the Index's companies.

Total Employee Compensation accounts for what small businesses spend on employees for each hour worked. This number represents the compensation for companies that have 99 employees or less, and is a combination of salary, benefits, and government paycheck requirements. This measure does not account for employee retirement costs.

Cost increases for small businesses can have a detrimental affect on them, since many operate on very thin profit margins. An increase in the cost of each employee hour worked can force small firms to make cuts or raise their product's price. When the cost of each hour worked decreases, small businesses have more flexibility in running their companies, as they are able to provide more benefits, hire additional workers, or save money for a later date.

Venture Capital reflects the amount of equity investment in private companies, the majority of which are small businesses. Equity capital is an important financing element for entrepreneurs seeking to improve their business model, expand their operations, and reach new customers.

Venture capital activity is beneficial to small enterprise because it provides a source of long-term capital investment. Any increase in venture capital investment is beneficial to small businesses, as it provides another source of financing. A rise in venture capital financing is also symbolic of increased innovation and entrepreneurship. On the other hand, a decline in venture capital financing increases the likelihood that small businesses will have to rely on more costly financing arrangements, such as high interest credit cards**.**