

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

To: Chairman Walsh, Ranking Member Schrader and Members of the House Small Business Subcommittee on Economic Growth, Tax and Capital Access

From: Small Business Committee Staff

RE: Field Hearing: “Is Uncertainty Contributing to the Jobs Crisis? The Views of Local Illinois Small Businesses”

On Monday, December 12, 2011 at 10:00 a.m. CST the House Small Business Subcommittee on Economic Growth, Tax and Capital Access is scheduled to hold a field hearing titled: *Is Uncertainty Contributing to the Jobs Crisis? The Views of Local Illinois Small Businesses*. The hearing will take place at the Woodstock City Hall, 121 West Calhoun Street, Woodstock, IL. The witnesses will include representatives from the restaurant, manufacturing and financial services industries.

The hearing will focus on how concerns regarding unresolved government policies are affecting small business decisions to invest in their businesses and to hire more workers. Small businesses are the historic source of job creation in the domestic economy, accounting for nearly 7 of 10 new jobs. However, while many economists believe the recession officially ended more than 2 ½ years ago, job creation has been anemic most months and negative in others.

One explanation for the lackluster recovery is that Washington, through its actions and inactions, has exacerbated business uncertainty thereby encouraging stagnation versus investment. The purpose of this hearing is to listen to small businesses regarding these concerns and hear their views on the effects of policy uncertainty. The small businesses will explain what they believe the federal government can do to create a business climate more conducive to job creation.

Introduction

This memorandum will briefly review the roots of the most recent recession, and the policies enacted by the federal government to spur an economic recovery. Next, the memorandum will explain the concept of “economic uncertainty” and why economic uncertainty alone does not

explain current economic conditions. Further, the memorandum will introduce the concept of “policy uncertainty” and discuss its impacts on the economy in general and small businesses in particular. Finally, four primary sources of uncertainty identified by small businesses and academic researchers will be discussed.

The State of the Small Business Economy

According to the National Bureau of Economic Research’s Business Cycle Dating Committee, the 2007-2009 economic recession officially ended in June 2009.¹ Unfortunately, unlike the 11 other previous post-World War II recessions,² the end of the most recent recession has not led to a significant increase in economic activity and the concomitant growth in private sector employment.

Small businesses are especially vulnerable during an economic recession. According to the Small Business Administration’s Office of Advocacy, the number of small business bankruptcies increased nearly 115% between 2007 and 2009.³ In addition, job losses at small firms exceeded those at larger firms in all but one quarter during the most recent recession, which is the inverse of their historical role as job creators.⁴

The benefits of the current economic recovery are also accruing to larger businesses compared to small business. Corporate earnings for companies listed on the Standard and Poor 500 index exceeded the prior record pre-recession record set in 2007.⁵ In contrast, earnings for small businesses remained below pre-recession levels and small businesses expressed less optimism in future sales volumes compared to larger businesses.⁶

¹ NATIONAL BUREAU OF ECONOMIC RESEARCH, BUSINESS CYCLE EXPANSIONS AND CONTRACTIONS, *available at* <http://www.nber.org/cycles.html>.

² *Id.*

³ U.S. SMALL BUSINESS ADMINISTRATION, OFFICE OF ADVOCACY, SMALL BUSINESS QUARTERLY BULLETIN, FOURTH QUARTER 2010, *available at* http://www.sba.gov/sites/default/files/files/SBQB_2010q4.pdf.

⁴ US SMALL BUSINESS ADMINISTRATION, OFFICE OF ADVOCACY, STATE OF THE SMALL BUSINESS ECONOMY 2010, *available at* http://www.sba.gov/sites/default/files/sb_econ2010.pdf.

⁵ STANDARD AND POORS, LOOKOUT REPORT: S&P 500 CORPORATIONS ARE REPORTING SOLID SECOND QUARTER EARNINGS GROWTH; EARNINGS PER SHARE REACH RECORD OF \$26, (July 29, 2011), *available at* <http://www.standardandpoors.com/products-services/articles/en/eu/?assetID=1245316176683#ID810>.

⁶ Bill Conerly, *Stark Difference Between Big and Small Business in the Recession*, OREGON BUSINESS REPORT (July 18, 2011), *available at* <http://oregonbusinessreport.com/2011/07/stark-difference-between-big-and-small-business-in-the-recession/>.

Recessions and Recoveries

The causes of recessions are numerous, but many attribute the most recent recession to an asset bubble in residential real estate that resulted in a broader financial markets panic when financial instruments linked to residential real estate collapsed in value.⁷ This occurrence had a cascading effect that economists call a contagion. Financial firms either stopped conducting business with client firms that had large holdings of residential real estate investments or required these client firms to take certain measures, such as posting additional capital or collateral, that the client firm's distressed position rendered impossible. The contagion occurred when financial firms and investors lost confidence in the creditworthiness of other business partners, regardless of the partner's involvement or investment in residential real estate or the partner's otherwise apparent ability to make good on its obligations. The normal flow of capital and liquidity in financial markets was interrupted and a panic ensued.

As the consequences of these panics were not limited to financial institutions, but affected non-financial businesses in the broader economy, the federal government intervened in financial markets and the economy as a whole.⁸ To restore confidence in the system, prevent the financial markets panic from impeding normal commerce and repair damage to financial firms, the federal government and took a number of active measures to support financial markets. These included the Federal Reserve's expansion of existing bank lending institutions, the creation of special lending facilities for non-bank financial firms, reductions in inter-bank lending rates,⁹ and the recapitalization of financial firms through the Troubled Asset Relief Program,¹⁰ among other efforts.

These actions were followed by efforts intended to stimulate demand and provide a stimulus to the broader economy including, but not limited to, the \$770 billion American Recovery and Reinvestment Act of 2009,¹¹ temporary extensions and enhancements to the 2001 and 2003 tax cuts,¹² and increases in the domestic money supply by the Federal Reserve through Quantitative Easing.

⁷ THE FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT, DISSENTING VIEWS 417-419, available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_hennessey_holtz-eakin_thomas_dissent.pdf, hereinafter "DISSENTING VIEWS."

⁸ DISSENTING VIEWS at 419.

⁹ A complete description of the various programs and efforts undertaken by the Federal Reserve in response to the crisis can be found on its website at http://www.federalreserve.gov/monetarypolicy/bst_crisisresponse.htm.

¹⁰ The Troubled Asset Relief Program was created in the Emergency Economic Stabilization Act.

¹¹ 123 STAT. Section 115 (2009).

¹² Tax Relief Unemployment Insurance Reauthorization and Job Creation Act of 2010, 124 STAT. §3296 (2010).

Despite these interventions, today the inflation adjusted growth of the U.S. economy barely exceeds its prerecession level¹³ and unemployment remains far above prerecession levels.¹⁴ Many economists believe that the American economy and job market should be further along in its pace of recovery and growth than is presently the case. Thus, the Subcommittee is interested in examining why businesses have been reluctant to invest in new hiring and job creation.

Economic Uncertainty

When firms lose confidence in their immediate and future prospects, they are reluctant to invest in new employees, business expansion or capital improvements.¹⁵

While all investment bears some risks, firms carefully weigh risk and benefits when deciding which investment strategies to pursue. Risk taking by firms regarding consumption and investment is necessary to promote greater economic growth. Since the consequences of an ill-timed or considered investment are large to the firm, the owners may decide to retain these resources or forgo new investment that contributes to job creation.

Oftentimes, these uncertainties are predicated on economic factors. If businesses fear a recession will result in less demand for their goods and services from customers, they may withhold making investment and hiring decisions until the future becomes clearer. While uncertainty over economic conditions remains a factor in small business decisions on making investments and hiring new workers,¹⁶ a growing body of evidence demonstrates it does not fully explain why the recovery from the recent recession is below the historic experience in previous recessions,¹⁷ nor does it fully explain small businesses current aversion to risk.

Policy Uncertainty and Its Effect on Small Business

¹³ U.S. DEPARTMENT OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS, NATIONAL INCOME AND PRODUCT ACCOUNT TABLES, REAL GROSS DOMESTIC PRODUCT AND CHAINED DOLLARS, *available at* <http://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1>.

¹⁴ U.S. DEPARTMENT OF LABOR, LABOR FORCE STATISTICS FROM THE CURRENT POPULATIONS SURVEY, *available at* <http://data.bls.gov/timeseries/LNS14000000>.

¹⁵ Ben Bernanke, *Irreversibility, Uncertainty, and Cyclical Investment*, 98 QUARTERLY J. OF ECONOMICS 85-106 (1983).

¹⁶ Mark Schweitzer and Scott Shane, *Economic Policy Uncertainty and Small Business Expansion*, November 29, 2011, Federal Reserve Bank of Cleveland, Available at <http://clevelandfed.org/research/commentary/2011/2011-24.cfm>.

¹⁷ N. Gregory Mankiw, *How to Make Business Want to Invest Again*, Editorial, N.Y. TIMES, September 10, 2011, *available at* <http://www.nytimes.com/2011/09/11/business/business-investment-as-a-key-to-recovery.html>.

If economic uncertainty does not explain the lack for growth, other factors must be affecting small business investment decisions. In a recent paper, economists from Stanford University and the University of Chicago hypothesized that political, or economic policy, uncertainty may also influence economic business cycles.¹⁸ To test their hypothesis, the researchers created a “policy uncertainty index” to measure policy uncertainty’s potential impacts on economic output and employment.

The researchers define economic policy uncertainty broadly, deeming it to include unresolved or potential policy changes that may have a significant impact on expectations of future economic well being.¹⁹ In the present case, these policy uncertainties can be attributable to future tax and spending policies, proposed or potential regulatory changes, implementation of the healthcare law, and expectations about future interest rates.²⁰

In applying econometric models to publically available data going back to 1985, the researchers found a positive correlation between periods of policy uncertainty and reduced economic growth and job creation. According to their findings, “greater policy uncertainty in 2011, relative to 2006, lowered GDP by 1.4 percent and employment by about 2.5 million”²¹

This study was followed by another study at the Reserve Bank of Cleveland²² that examined whether policy uncertainty affected small business owner investment and expansion plans.

This research concluded that policy uncertainty is real and that it has “significant negative effects on small business owners’ plans to hire and make capital expenditures.”²³ The researchers conclude that, in “the Summer of 2011, hiring by small business firms would be 6 percentage points higher if it were not for policy uncertainty.”²⁴

Identified Sources of Uncertainty

The memorandum will now examine four specific sources of uncertainty identified by academic researchers, small businesses and their representative associations. While small businesses are not monolithic entities and many uncertainties regarding parochial interests that are not

¹⁸ Scott Baker, Nicholas Bloom and Steven Davis, *Measuring Economic Uncertainty*, October 2011, available at <http://faculty.chicagobooth.edu/steven.davis/pdf/PolicyUncertainty.pdf>.

¹⁹ Bloom, Baker and Davis, *supra* note 19 at 2.

²⁰ *Id* at 2.

²¹ *Id* at 15.

²² Schweitzer and Shane, *supra* note 7 at 1.

²³ *Id*.

²⁴ *Id* at 3.

applicable to small businesses in other industries exist, the following issues have been identified as sources of concern among small businesses regardless of industry.

Taxes

Most small business pay their taxes at the individual level,²⁵ where income subject to taxation is assessed at progressively higher marginal rates. In 2001, the Congress passed and President Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)²⁶. Among its many provisions, this law incorporated a number of features long advocated by the small business community, including a reduction in marginal income tax rates,²⁷ a phase down of estate and gift taxes,²⁸ a temporary increase the Alternative Minimum Tax (AMT) exemption,²⁹ and marriage-tax penalty relief.³⁰ To comply with congressional budget rules, the law included a sunset provision that reverts all these provisions to their pre-EGTRAA levels on December 31, 2010. However, subsequent legislation temporarily extended this tax relief until December 31, 2012.

The 2001 tax relief bill was followed by the 2003 Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA)³¹. This law accelerated the phase-in of certain provisions in the 2001 EGTRRA, including marginal income tax relief³² and marriage penalty tax relief.³³ The law also included reduced taxes on long-term capital gains³⁴ and qualified dividend income.³⁵ The law also temporarily enhanced expensing provisions for small businesses,³⁶ and temporarily extended

²⁵ Integrated Business Data, INTERNAL REVENUE SERVICE, STATISTICS OF INCOME, *available at* <http://www.irs.gov/taxstats/bustaxstats/article/0,,id=152029,00.html>.

²⁶ 115 STAT § 38 (2001)

²⁷ *Id.* at §41.

²⁸ *Id.* at §§ 69-86.

²⁹ *Id.* at § 148.

³⁰ *Id.* at §§ 53-57.

³¹ 117 STAT §752 (2003).

³² *Id.* at § 755.

³³ *Id.* at §§ 753-754.

³⁴ *Id.* at § 758.

³⁵ *Id.* at § 760.

³⁶ *Id.* at § 7575.

the bonus depreciation allowance originally created in the Job Creation and Worker Assistance Act of 2002.³⁷

However, many of the 2001 and 2003 tax cuts are scheduled to expire and it remains unclear whether or not they will be extended and for how long. Firms carefully weigh the potential costs and benefits of investment, and uncertainty renders them incapable of making those assessments. Therefore, temporary policies, that are accompanied by uncertain future outcomes, such as the level of expected taxation, are less conducive to new investment than policies that promote longer-term certainty.³⁸

Small businesses have also expressed concern over the President's proposal to tax incomes above \$200,000 for an individual and \$250,000 a couples filing jointly at their pre-EGTRAA level of 39.6 percent. As most small businesses pay taxes at the individual level, an analysis of the President's proposal by the Heritage Foundation found that small businesses subjected to this increased level of taxation generate 72% of all small business income and pay 82% of all small business taxes.³⁹

Spending/Budget

Concerns regarding the fiscal policy of the United States have been identified as a source of policy uncertainty. Persistently high annual budget deficits, combined with demographic shifts and other federal policies that will increase demand for government-funded entitlement services, are leading some to question how the federal government will be able to make good on these promises. To balance its obligations against resources, the federal government may have make major reforms to entitlement programs, pay for the programs with large tax increases, finance the programs with additional government borrowing and debt, or a combination of the three.

The United States recently experienced a ratings downgrade as a result of its fiscal policy.⁴⁰ There is growing concern that investors may lose confidence in the sovereign debt of the United

³⁷ 116 STAT. § 74 (2002).

³⁸ John B. Taylor, Editorial, *Why Permanent Tax Cuts Are the Best Stimulus*, Wall St. J., available at <http://online.wsj.com/article/SB122757149157954723.html>.

³⁹ Curtis Dubay, *Backgrounder: Obama Tax Hikes, Bad for All Americans*, The Heritage Foundation 4, available at http://thf_media.s3.amazonaws.com/2010/pdf/bg2473.pdf.

⁴⁰ Press Release, Standard and Poors, *United States of America Long-Term Rating Lowered to 'AA+' On Political Risks and Rising Debt Burden; Outlook Negative* (August 5, 2011), Standard and Poors, available at <http://www.standardandpoors.com/servlet/BlobServer?blobheadername3=MDT-Type&blobcol=urldata&blobtable=MungoBlobs&blobheadervalue2=inline%3B+filename%3DUnitedStatesofAmericaLongTermRatingLoweredToAA.pdf&blobheadername2=Content-Disposition&blobheadervalue1=application%2Fpdf&blobkey=id&blobheadername1=content-type&blobwhere=1243942987733&blobheadervalue3=UTF-8>.

States. If this occurs, the cost of borrowing funds would not only increase for the federal government, but would increase for private individuals and businesses as well.

Regulatory Burdens and Small Businesses

According to a report by the SBA's Office of Advocacy, government regulations impose approximately \$1.75 trillion in costs on small businesses.⁴¹ The report also demonstrated that the burdens imposed by these regulations disproportionately impact small businesses. On average, the cost of regulations for firms with 20 or fewer employees is 36 percent higher than larger firms. The severity of the disparity is related to the types of activities that are being regulated. The SBA Office of Advocacy report estimated that compliance with environmental regulations can be 364% higher for smaller firms and the cost of tax compliance can be 206 percent higher than for larger firms.

Unfortunately, the cost and scope of these burdens show no sign of abating. Since the beginning of FY 2011, 15 major new regulations have been issued with estimated annual costs exceeding \$5.8 billion and one-time implementation costs approaching \$6.5 billion.⁴² These regulations are among more than 75 new major regulations proposed or implemented since January 2009.

While a complete review of all these regulations is beyond the scope of this hearing, a few of the proposed regulations that would have substantial direct and indirect impacts on small businesses include the Environmental Protection Agency's (EPA) proposed rule to regulate greenhouse gases (GHG)⁴³; 2) the EPA's proposed Utility Maximum Achievable Control Technology Rule,⁴⁴ and the potential regulation of Coal Ash.⁴⁵

⁴¹ U.S. SMALL BUSINESS ADMINISTRATION, OFFICE OF ADVOCACY, THE IMPACT OF REGULATORY COSTS ON SMALL FIRMS, available at <http://www.sba.gov/sites/default/files/rs371.pdf>.

⁴² James Gattuso and Diane Katz, *Backgrounder: Red Tape Rising: A 2011 Mid-Year Report on Regulation*, July 25, 2011, The Heritage Foundation, available at <http://www.heritage.org/research/reports/2011/07/red-tape-rising-a-2011-mid-year-report>.

⁴³ Prevention of Significant Deterioration and Title V Greenhouse Gas Tailoring Rule, 75 Fed. Reg. 31,514 (June 3, 2010) (to be codified at 40 C.F.R. 51, 52, 70 and 71, available at <http://www.gpo.gov/fdsys/pkg/FR-2010-06-03/pdf/2012-11974.pdf#page=1>).

⁴⁴ Proposed National Emission Standards for Hazardous Air Pollutants from Coal and Oil-Fired Electric Utility Steam Generating Units and Standards of Performance for Fossil Fuel-Fired Electric Utility, Industrial-Commercial-Institutional, and Small Industrial-Commercial-Institutional Steam Generating Units, 76, Fed Reg. 24,975 (May 3, 2011) (to be codified at 40 C.F.R. §§ 60 & 63).

⁴⁵ Hazardous and Solid Waste Management System, Identification and Listing of Special Wastes, Disposal of Coal Combustion Residues from Electric Utilities, 75 Fed. Reg. 35,128 (June 21, 2010) (to be codified at 40 C.F.R. §§ 257, 261, 264, 268, 271, 302).

Each of these rules, on their own and in combination, could directly and indirectly led to substantially high energy costs and reductions in employment. On average, small businesses face a 30 percent price differential for electricity and a 20 percent price difference for natural gas compared to larger businesses.⁴⁶ Some estimate the EPA GHG regulation alone could increase the cost of gasoline by 50 percent, electricity by 50 percent and natural gas by 75% over the next twenty years.⁴⁷ In addition, the rules could result in a number of small businesses becoming subject to emissions regulations,⁴⁸ which may subject them to significant costs associated with permitting and compliance.

Small Businesses and the Patient Protection and Affordable Care Act

Small businesses have expressed concerns over the scope and possible consequences of the Patient Protection and Affordable Care Act (PPACA)⁴⁹ to their businesses. The law requires businesses with 50 or more full-time equivalent employees to provide government-approved health insurance or pay a tax assessment of \$3,000 for every employee that receives taxpayer subsidized coverage through a health insurance exchange.⁵⁰

Small businesses have also expressed concern regarding the potential for higher health insurance premiums as a result of the health care law. According to a study by former Congressional Budget Office Director Douglas Holtz-Eakin, the PPACA tax on health insurance companies alone will increase small businesses health care costs by up to 3 percent, or nearly \$5,000 per family over the next decade.⁵¹

Conclusion

A growing body of evidence demonstrates that policy uncertainty is not just a political talking point, but a real and measurable phenomenon that has profound implications for small businesses and the broader economy. When faced with uncertainty, individuals and businesses may forgo

⁴⁶ U.S. SMALL BUSINESS ADMINISTRATION OFFICE OF ADVOCACY, CHARACTERIZATION AND ANALYSIS OF SMALL BUSINESS ENERGY COSTS (April 2008), *available at* <http://archive.sba.gov/advo/research/rs322tot.pdf>.

⁴⁷ AFFORDABLE POWER ALLIANCE, POTENTIAL IMPACT OF THE EPA ENDANGERMENT FINDING ON LOW INCOME GROUPS AND MINORITIES (March 2010), *available at* <http://www.affordablepoweralliance.org/LinkClick.aspx?fileticket=GBqH57mHH5w%3D&tabid=40>.

⁴⁸ 74 Fed. Reg. 55,292 (October 27, 2009) (to be codified at 40 C.F.R. §§ 51, 52, 70, et al).

⁴⁹ 124 Stat. § 199 (2010).

⁵⁰ *Id.* at §253.

⁵¹ Douglas Holtz-Eakin, *Higher Costs and the Affordable Care Act: the Case of the Premium Tax*, American Action Forum, March 9, 2011, *available at* <http://americanactionforum.org/sites/default/files/Case%20of%20the%20Premium%20Tax.pdf>.

activities important to economic growth and job creation. This in turn influences the recovery of the broader economy from recession.