

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2561 Rayburn House Office Building
Washington, DC 20515-6515

Memorandum

To: Members, Committee on Small Business
From: Committee Staff
Date: February 25, 2015
Re: Hearing: "Building an Opportunity Economy: The State of Small Business and Entrepreneurship"

Introduction

At 11:00 am on March 4, 2015, the Committee on Small Business will meet for the purpose of receiving testimony on the state of American small businesses and entrepreneurship. The hearing will examine the health and vibrancy of the American economy, particularly as it pertains to the creation, sustainability, and future growth of small businesses. The hearing aims to set the stage for future debates within the Committee in an effort to narrow our focus to the most pertinent obstacles hindering growth, and to tackle the most egregious impediments to business formation, job creation, and economic growth.

Economic Overview

According to the National Bureau of Economic Research, the United States economy was in a recession for 18 months from December 2007 to June 2009.¹ It was the longest and deepest recession of the post-World War II era. During the first half of 2008, the recession was not deep as measured by the decline in gross domestic product² (GDP) or the rise in unemployment. It then deepened from the third quarter of 2008 to the first quarter of 2009. The economy continued to contract slightly in the second quarter of 2009, before returning to expansion in the third quarter. When the fall of economic activity finally bottomed out in the second half of 2009, real GDP had contracted by nearly 4.0%, or about \$500 billion. This recession featured the largest decline in output, consumption, and investment, and the largest increase in unemployment since the Great Depression.

¹ NATIONAL BUREAU OF ECONOMIC RESEARCH, BUSINESS CYCLE DATING COMMITTEE REPORT 1 (2010), *available at* <http://www.nber.org/cycles/sept2010.pdf>. It is important to note this organization is not affiliated with the federal government.

² Real gross domestic product is defined as the output of goods and services produced by labor and property located in the United States.

While economic indicators point to the recession ending in June of 2009, economic activity has remained sluggish and erratic at best. In the years following the recession, real GDP growth has been spasmodic. For instance, over the first few years of recovery, the percentage change in real GDP growth or retraction ranged wildly from a negative 1.5 percent in the first quarter of 2011 to a positive 2.9 percent in the second quarter of that year.³ More recently, the data has shown the economic recovery to be just as uneven, with the quarterly GDP change ranging from negative 2.1 percent in the first quarter of 2014 to a positive 4.6 and 5.0 percent in the second and third quarters of last year. The most recent change released by the Bureau of Economic Analysis shows that real GDP grew by 2.6 percent in the fourth quarter of 2014.⁴ While GDP for last year has shown improvement, the United States has still suffered through the weakest economic recovery since World War II.⁵

The tepid economic growth has been reflected in the labor market. A corollary of a slow-paced economic recovery has been a slow reduction of the joblessness induced by the 2008-2009 recession. From a peak of 10.1 percent in 2009, the unemployment rate had decreased to 5.6 percent by December of 2014. However, other indicators, such as the falling labor force participation⁶ (62.9 percent in January 2015 versus a pre-recession one year average of 66.1 percent),⁷ higher rates of long-term unemployment⁸ (an average of 19.4 percent throughout 2008 to a steady 31.5 percent in January of 2015),⁹ and weakening worker wage growth indicates that the labor market shows plenty of slack and significant room for improvement.¹⁰ For example, wage growth was far most robust in 1999, increasing by nearly 4 percent versus 1.7 percent throughout 2014.¹¹ For a more recent example, average hourly earnings for all employees in December 2014 dropped from the prior month by 0.2 percent, the biggest drop since comparable records began in 2006.¹²

Other indicators, such as consumer confidence¹³ have improved recently. As gauged by the University of Michigan's Survey of Consumers, their Sentiment Index was 98.1 in the

³ <https://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1#reqid=9&step=3&isuri=1&904=2011&903=1&906=q&905=2014&910=x&911=0>.

⁴ <http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm>.

⁵ <http://fivethirtyeight.com/datalab/a-cheat-sheet-for-obamas-2015-state-of-the-union-speech/>.

⁶ Labor force participation rate is the percentage of working age population that is part of the labor force. It is a measure of what proportion of a country's population is employed or actively looking for employment. A higher labor force participation rate indicates more of the country's population is interested in working. The decline of this percentage indicates that a significant number of individuals who designated themselves as "unemployed" have given up on finding work and have dropped out of the labor force. <http://www.cbsnews.com/news/why-are-people-leaving-the-workforce/>

⁷ <http://data.bls.gov/timeseries/LNS11300000>.

⁸ Long-Term unemployment is defined as the number of persons unemployed 27 weeks or longer. The long-term unemployment rate is defined as the share of a particular group's labor force total that has been unemployed for 27 weeks or more. <http://www.bls.gov/opub/btn/volume-2/long-term-unemployment-over-mens-careers.htm>.

⁹ <http://data.bls.gov/timeseries/LNS13025703>.

¹⁰ <https://www.aei.org/publication/december-jobs-report-workers-partying-like-1999-really/>.

¹¹ *Id.*

¹² <http://www.bloomberg.com/news/articles/2015-01-09/december-employment-gain-caps-best-year-for-u-s-since-1999>.

¹³ Consumer confidence is an economic indicator which measures the degree of optimism that consumers feel about the overall state of the economy and their personal financial situation. How confident people feel about stability of their incomes affect their economic decisions, such as spending activity, and therefore serves as one of the key

January, 2015, up from 93.6 in December and 81.2 last January.¹⁴ This was the highest level the Sentiment Index has reached since a score of 103.8 was recorded in January 2004.¹⁵

Other encouraging economic signs come from home values, which have seen an uptick of 6 percent from November 2013 to November 2014.¹⁶ However, dampening that positivity is the fact that as of the end of the third quarter of 2014, 16.9 percent of American homeowners still maintain a negative-equity mortgage,¹⁷ which is down from a peak of 31.4 percent in the first quarter of 2012.¹⁸ In short, following the recession, the American economy has grown at a tepid pace with signs for both optimism and apprehension throughout the past few years.

The State of Small Businesses

Small businesses, those with fewer than 500 employees,¹⁹ are generally the creators of the most new jobs, as well as the employers of about half of the nation's private sector work force. Small firms accounted for 63 percent of the net new jobs created between 1993 and mid-2013 (or 14.3 million of the 22.9 million net new jobs).²⁰ Small businesses also account for about 46 percent of the nonfarm, private real gross domestic product.²¹ Starting in late 2009 and early 2010, small firms appear to have suffered more from deteriorating business conditions than large businesses. Corporate profits recovered more quickly than non-corporate profits in 2010. Since a larger share of corporations are large businesses, that likely resulted in a further weakening of the small business share of GDP.²²

The Bureau of Labor and Statistics releases data on quarterly net job changes by firm size in its Business Employment Dynamics series. The figure on the next page shows net changes in employment for firms with 1 to 19, 20 to 499, and 500 or more employees from the first quarter of 2005 through the third quarter of 2011. It clearly illustrates that small firms shed a significant number of jobs during the recession. In fact, larger small businesses with 20 to 499 employees saw dramatic declines in their net employment at the end of 2008 through the first quarter of 2009. Small businesses as a whole lost more jobs than their larger counterparts in all but one quarter during the recession.²³ This makes the most recent recession different from the 2001

indicators for the overall shape of the economy. <http://libertystreeteconomics.newyorkfed.org/2013/09/consumer-confidence-a-useful-indicator-of-the-labor-market.html#.VOdGsE03PAU>.

¹⁴ UNIVERSITY OF MICHIGAN, SURVEYS OF CONSUMERS 1 (Jan. 30, 2015), available at http://press.sca.isr.umich.edu/press/press_release.

¹⁵ *Id.*

¹⁶ ZILLOW REAL ESTATE MARKET REPORT 1 (NOV. 2014), available at http://cdn1.blog-media.zillowstatic.com/3/2014_NovemberReport_Zillow_a_03-99d547.pdf.

¹⁷ Negative equity is a situation that arises when the market value of a property falls below the outstanding amount of its mortgage.

¹⁸ <http://www.zillow.com/research/negative-equity-2014-q3-8532/>

¹⁹ There are multiple definitions of small business and this memorandum adopts one such categorization, less than 500 employees.

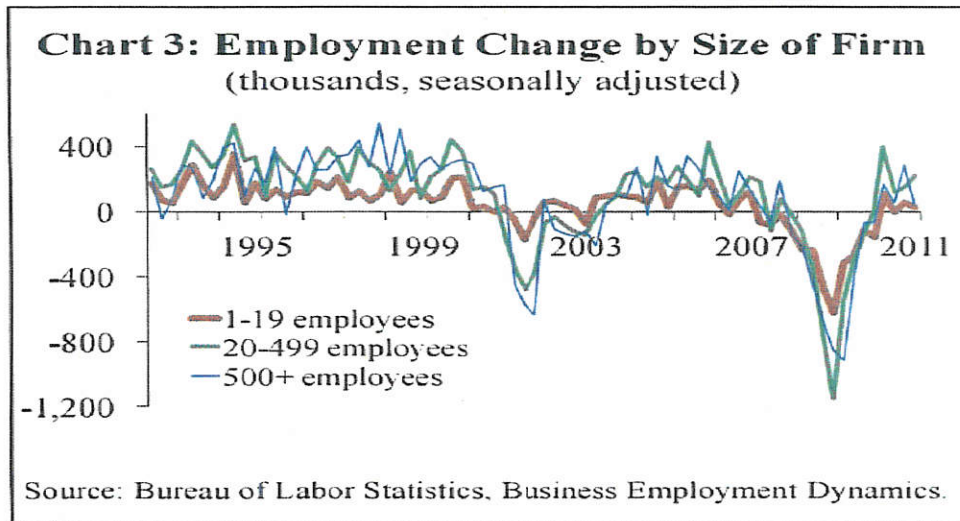
²⁰ UNITED STATES SMALL BUSINESS ADMINISTRATION, OFFICE OF ADVOCACY, FREQUENTLY ASKED QUESTIONS 1 (2014), available at https://www.sba.gov/sites/default/files/FAQ_March_2014_0.pdf.

²¹ KATHRYN KOBE, SMALL BUSINESS GDP: UPDATE 2001-2012, OFFICE OF ADVOCACY, UNITED STATES SMALL BUSINESS ADMINISTRATION 1(2012), available at https://www.sba.gov/sites/default/files/rs390tot_1.pdf.

²² *Id.*

²³ A. SAHIN, ET. AL., WHY SMALL BUSINESSES WERE HIT HARDER BY THE RECESSION 3 (2011) available at http://www.newyorkfed.org/research/current_issues/ci17-4.pdf.

downturn, in which larger businesses experienced greater net job declines and very small businesses were quicker to recover and have net job increases.²⁴



Small businesses have been at the forefront of the aforementioned recent lowering of unemployment rates. A little more than half of the net number of jobs created since employment began growing in 2010 has been generated by firms with fewer than 250 employees, and most of that amount was accounted for by firms with fewer than 50 employees.²⁵

Continued evidence of an improving small business climate is the National Federation of Independent Businesses (NFIB) Optimism Index. Each month the NFIB surveys its members and compiles this index by asking its member specific questions about hiring practices, capital outlays, inventories and other growth oriented questions. That index is compiled to help determine the general sentiment of small business owners across the country. The optimism index hit a new post-recession high of 100.4 in December, 2014.²⁶ It dipped slightly to 97.9 in January, 2015, however the optimism index has (including the occasional ebb and flow) steadily gone upwards since the end of the recession. When optimism is high, small businesses tend to look to add more inventory, accelerate hiring, and expand their business. This, in turn, creates more jobs in firms supplying those expanding small businesses.

Additionally, Intuit, Inc. releases a monthly index examining employment and compensation changes among businesses with less than 20 employees. This index shows that American small businesses added 20,000 new jobs in January, 2015, an increase from December, 2014 of 0.09 percent, making for more than 880,000 jobs added since March 2010.²⁷

Small businesses play a significant part of our economy. Undeniably, while the recovery has been painfully slow for several industry segments, the economy at large and the small

²⁴ *Id.*

²⁵ <http://www.federalreserve.gov/newsevents/speech/yellen20140515a.htm>.

²⁶ WILLIAM C. DUNKELBERG, HOLLY WADE, NFIB SMALL BUSINESS ECONOMIC TRENDS 4 (Jan. 2015), available at <http://www.nfib.com/Portals/0/PDF/sbet/sbet201502.pdf>.

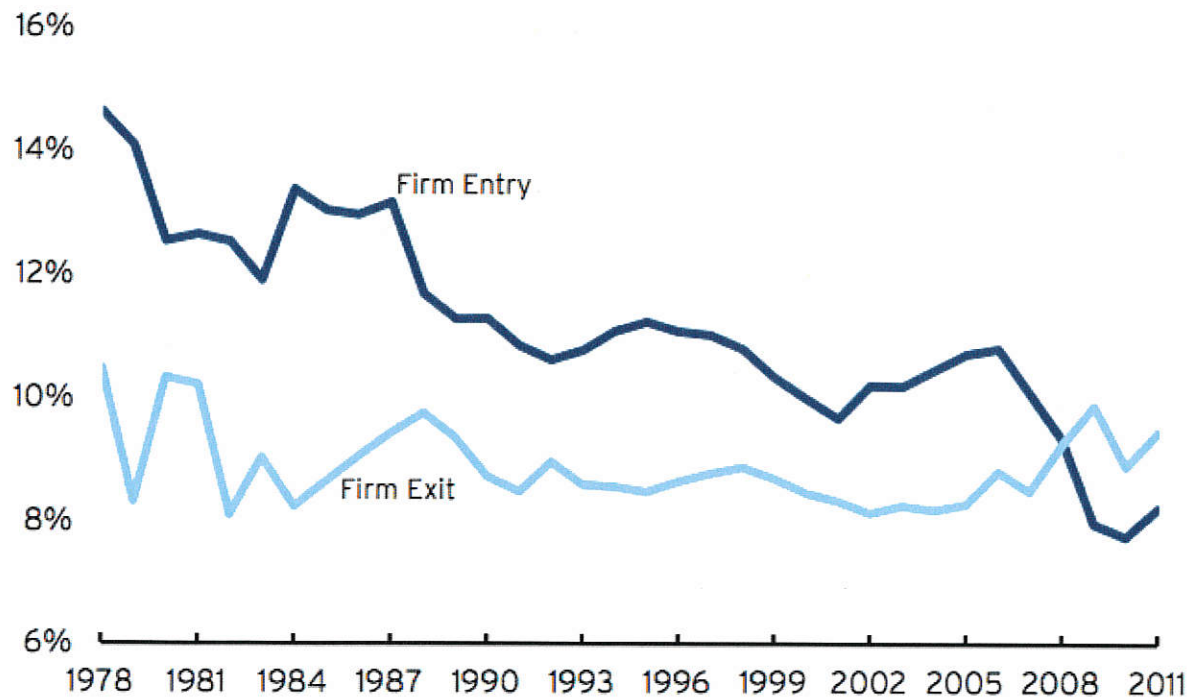
²⁷ <http://index.intuit.com/>.

business economy is in a much better situation than as little as two years ago. However, equally undeniable is the problem the economy faces going forward: the decline of entrepreneurship in the United States.

Entrepreneurship in the United States

Entrepreneurship is in decline in the United States. As the figure below shows, beginning in 2008 the number of business startups fell below the number of business deaths for the first time since such data has been recorded. The rate of firm failures held relatively steady—aside from the uptick during the recession.²⁸ In other words, the level of business deaths kept growing along with the overall level of businesses in the economy, but the level of business births did not—it held relatively steady before dropping significantly in the recent downturn.²⁹

Firm Entry and Exit Rates in the United States, 1978-2011



Source: United States Census Bureau, Business Dynamics Series, Hathaway & Litan, Brookings Institution

²⁸ IAN HATHAWAY, ROBERT E. LITAN, BROOKINGS INSTITUTION, DECLINING BUSINESS DYNAMISM IN THE UNITED STATES: A LOOK AT STATES AND METROS, 1 (2014), available at http://www.brookings.edu/~media/research/files/papers/2014/05/declining%20business%20dynamism%20litan/declining_business_dynamism_hathaway_litan.pdf. [hereinafter Hathaway and Litan].

²⁹ *Id.*

The United States now ranks not first, not second, not third, but 12th among developed nations in terms of business startup activity.³⁰ Countries such as Hungary, Denmark, Finland, New Zealand, Sweden, Israel and Italy all have higher startup rates than America does.³¹

Business dynamism³² also is on the decline. Existing research and a cursory review of broad data aggregates show that the decline in dynamism has not been isolated to particular industrial sectors and firm sizes, rather the decline in entrepreneurship and business dynamism has been nearly universal geographically the last three decades - reaching all fifty states and all but a few metropolitan areas.³³

This data shows that whatever the reason, older and larger businesses are doing better relative to younger and small ones.³⁴ Academia has yet to pinpoint the reasoning behind this decline, but it could be surmised that firms and individuals appear to be more risk averse too - businesses are hanging on to cash, fewer people are launching firms, and workers are less likely to switch jobs or move to new areas.³⁵ Clearly, there are roadblocks to entrepreneurship, and several of those potential barriers have the potential to be addressed or eradicated by the federal government.

Conclusion

In recent years, small businesses have consistently identified a preponderance of regulatory burdens, limited access to capital, excessive taxation, and a state of general confusion understanding the myriad of policies and mandates coming from the federal (and often compounded by their states') government. This hearing represents an opportunity to hear from small businesses and economic policy experts about the obstacles that hinder the success of both current and future small business owners.

³⁰ http://www.gallup.com/businessjournal/180431/american-entrepreneurship-dead-alive.aspx?utm_source=WWWV7HP&utm_medium=topic&utm_campaign=tiles.

³¹ *Id.*

³² Business dynamism is the process by which firms continually are born, fail, expand, and contract, as some jobs are created, others are destroyed, and others still are turned over.

³³ Hathaway and Litan, *supra* note 27 at 6.

³⁴ *Id.*

³⁵ *Id.*