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Congress of the United States

U.S. House of Representatives
Committee on Small Business

2361 Rayburn House Office Building
Washington, DC 20515-6315

Memorandum

To:	Members, Committee on Small Business
From:	Committee Staff
Date:	February 8, 2013
Re:	Hearing: "State of the Small Business Economy"

On February 13, 2013 at 1:00 p.m., the Committee on Small Business will meet in Room 2360 of the Rayburn House Office Building for the purpose of receiving testimony on the state of the small business economy. The hearing will review current economic indicators that measure the health of the economy, with a specific focus on access to capital. The hearing also will examine the general economic concerns facing small business owners during 2013.

I. Overall Economic Conditions

In 2012, economic activity, as measured by gross domestic product (GDP),[1] grew by 2.2 percent, up from 1.8 percent in 2011.[2] The modest increase for the year was highlighted by a decrease in the fourth quarter of 2012 when GDP contracted by 0.1 percent.[3] Factors leading to an increase in GDP include: a slowdown of imports; a rebound in residential housing; an upturn in inventory investment; and a smaller than expected decrease in state and local government spending.[4] The contributors to economic growth were countered by slowdowns in both consumer spending and exports.[5] According to the Board of Governors of the Federal Reserve System (colloquially referred to as the Federal Reserve System or simply Federal Reserve),[6] economic activity slowed at the end of 2012 because of weather-related concerns.[7] While GDP for the year grew, the United States has suffered from the weakest economic recovery since World War II.[8]

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[1] GDP is the market value goods and services produced by labor and property located in the United States *See* OFFICE OF THE CHIEF COUNSEL FOR ADVOCACY, SMALL BUSINESS GDP: UPDATE 2002-2010 at 1 (Jan. 2012), *available at* http://www.sba.gov/sites/default/files/rs390_1.pdf.
[2] http://www.bea.gov/newsreleases/national/gdp/gdphighlights.pdf.
[3] *Id.*
[4] *Id.*
[5] *Id.*
[6] This memorandum will use the formal and colloquial interchangeably.
[7] http://www.federalreserve.gov/newsevents/press/monetary/20130130a.htm.
[8] Michael Sivy, *What the Current Economic Outlook Means for American Families*, TIME (Jan. 16, 2013), *available at* http://business.time.com/2013/01/16/what-the-current-economic-outlook-means-for-american-families/.

The anemic economic growth is reflected in the labor market. In January 2013, the economy gained 157,000 new jobs and the unemployment rate increased to 7.9 percent[9] from 7.8 percent in December 2012.[10] Despite the new jobs being created, there continue to be 12.3 million workers who have dropped out of the labor force and are no longer actively looking for work.[11] According to J.P. Morgan Chase Bank, the sluggish pace of job growth will continue in 2013 with the economy adding approximately 175,000 jobs per month.[12] This projection is far short of the 300,000 jobs per month that many economists believe is necessary for a more robust recovery.[13]

In contrast to the lagging labor market, housing prices are currently growing at their fastest level since 2006,[14] signaling an end to the steep declines that were a leading cause of the 2008 financial crisis.[15] Despite the rebound, housing's contribution to the economy is not as significant as it was prior to the financial crisis; housing now represents only 2.2 percent of GDP down from 6 percent.[16]

The struggles in the labor market and housing affect consumer spending.[17] Consumer spending which accounts for 70 percent of overall economic activity rose 0.2 percent in December 2012.[18] According to the National Retail Federation, retail sales are expected to grow by 3.4 percent in 2013, lower than the 4.2 percent growth seen in 2012.[19]

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[9] BUREAU OF LABOR STATISTICS, THE EMPLOYMENT SITUATION – JANUARY 2013 at 1, *available at* http://www.bls.gov/news.release/pdf/empsit.pdf. [hereinafter BLS Employment Situation].

[10] BUREAU OF LABOR STATISTICS, THE EMPLOYMENT SITUATION – DECEMBER 2012, at 1, *available at* http://www.bls.gov/news.release/archives/empsit_01042013.pdf.

[11] BLS Employment Situation at 2.

[12] J.P. MORGAN CHASE BANK NA, THE US ECONOMIC OUTLOOK FOR 2013 at 2, *available at* https://markets.jpmorgan.com/research/EmailPubServlet?action_open&hashcode=990nmr0i&doc=GPS-1020810-0.pdf.

[13] Catherine Rampell, *Job Creation is Still Steady Despite Worry*, NEW YORK TIMES, Jan. 4, 2013, *available at* http://www.nytimes.com/2013/01/05/business/economy/us-economy-adds-155000-jobs-jobless-rate-is-7-8.html.

[14] J.P. MORGAN CHASE BANK NA, THE US ECONOMIC OUTLOOK FOR 2013 at 4, *available at* https://markets.jpmorgan.com/research/EmailPubServlet?action_open&hashcode=990nmr0i&doc=GPS-1020810-0.pdf.

[15] FINANCIAL CRISIS INQUIRY COMMISSION, FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 213 (2011), *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

[16] Agustino Fontevecchia, *Housing Recovery Firm, But Don't Expect a Return to Pre-Crisis Growth*, FORBES, Jan. 29, 2013, *available at* http://www.forbes.com/sites/afontevecchia/2013/01/29/housing-recovery-firming-but-dont-expect-it-to-spark-pre-crisis-growth-this-time/.

[17] *See* C. JONES, MACROECONOMICS: ECONOMIC CRISIS UPDATE 249-51, 346 (2010) (discussing consumer spending patterns and effect on growth rates).

[18] Shobhana Chandra, *Consumer Spending in U.S. Rose in December as Incomes Surged*, BLOOMBERG, Jan. 31, 2013, *available at* http://www.bloomberg.com/news/2013-01-31/consumer-spending-in-u-s-climbed-in-december-as-incomes-surged.html.

[19] Joan E. Solsman, *U.S. Retail Sales Growth Expected to Pull Back in 2013* WALL STREET JOURNAL, January 28, 2013, *available at* http://blogs.wsj.com/economics/2013/01/28/u-s-retail-sales-growth-expected-to-pull-back-in-2013/?KEYWORDS=consumer+spending+forecast.

Given the importance of consumer spending in the United States economy, reductions in consumption are likely to act as a brake on economic growth. This, in turn, will affect the predominate number of firms in the United States – small businesses.

II. Small Business in the Economy

According to the Office of the Chief Counsel for Advocacy of the United States Small Business Administration, small businesses represent 99.7 percent of all businesses having employees (commonly referred to as "employer firms") in the United States.[20] Small businesses employ 49 percent of the workers in the private sector[21] and account for 42 percent of the private sector payroll in the United States.[22] Between 1993 and 2011, small businesses generated 64 percent of net new jobs.[23]

Uncertain economic indicators have led to a lack of small business confidence in the economy. According to a December 2012 survey by National Federation of Independent Business, small business optimism was at its second lowest level since March 2010.[24] Small and medium-size businesses expect lower growth rates in 2013.[25]

The constraints facing small businesses, such as reduced consumer expenditures and their own outlook for growth, are exacerbated by their cost of doing business relative to their larger competitors. Small businesses face regulatory compliance costs 36 percent higher than larger businesses.[26] Thus, it is not surprising that a recent National Small Business Association survey found that 38 percent of small businesses cite regulatory burdens as one of their three most significant challenges to future growth and survival.[27]

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[20] OFFICE OF THE CHIEF COUNSEL FOR ADVOCACY, FREQUENTLY ASKED QUESTIONS (Sept. 2012), *available at* http://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf.

[21] *Id.*

[22] *Id.*

[23] *Id.*

[24] WILLIAM DUNKELBERG & HOLLY WADE, NFIB SMALL BUSINESS ECONOMIC TRENDS 1 (Jan. 2013), *available at* http://www.nfib.com/Portals/0/PDF/sbet/sbet201301.pdf.

[25] PEPPERDINE PRIVATE CAPITAL ACCESS INDEX, QUARTERLY SURVEY REPORT, THIRD QUARTER 2012 at 1, *available at* http://bschool.pepperdine.edu/appliedresearch/research/pcmsurvey/content/Pepp_Q3.pdf [hereinafter Pepperdine Private Capital].

[26] NICOLE V. CRAIN & W. MARK CRAIN, THE IMPACT OF REGULATORY COSTS ON SMALL FIRMS 8 (2010), *available at* http://www.sba.gov/sites/default/files/The%20Impact%20of%20Regulatory%20Costs%20on%20Small%20Firms%20(Full).pdf.

[27] NATIONAL SMALL BUSINESS ASSOCIATION, 2012 YEAR END ECONOMIC REPORT 5, (Feb. 2013), *available at* http://www.nsba.biz/wp-content/uploads/2013/02/2012-Year-End-Economic-Report.pdf.

III. Small Business Access to Capital

Despite these aforementioned constraints on the overall economy and the small business sector, there will be small businesses seeking to expand.[28] For entrepreneurs looking to expand a business, financing is critical.[29] Financing for a business can come in many different forms: the business can be self-funded; funded by friends or family; an equity share in the business can be sold; or the business owner can obtain debt capital from a lending institution - generally a commercial bank.

According to the Thompson-Reuters/Paynet survey, the number of loans made to small business was up slightly in 2012.[30] Despite the increase, small business owners report that their credit lines have been cut and obtaining loans from banks has become more difficult.[31] This difficulty is reflected in the fact that 72 percent of small businesses believe that raising new capital remains difficult in the current business environment.[32]

Bank loans are more difficult to obtain when there is uncertainty about the economy because banks tighten lending standards.[33] When banks tighten lending standards, they require more collateral or higher credit scores and are more cautious about other factors linked to repayment.[34] Stricter lending standards inexorably lead to fewer loans being made. This occurred in the aftermath of the 2008 financial crisis.[35]

The Federal Reserve Board's Senior Loan Officer Survey shows that commercial and industrial lending standards which began to tighten in 2008 started to relax in 2010.[36] The Office of the Chief Counsel for Advocacy found that "small business lending peaked in 2008, when depository institutions in the United States held small business loans valued at more than $711 billion. From 2008 to 2010, small business lending by depository institutions declined by 8.3 percent to $652 billion."[37]

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[28] Pepperdine Private Capital at 1.
[29] *Id.* at 5.
[30] Ann Saphir, *U.S. Small Business Borrowing Rises in December, But Barely*, Feb. 4, 2013, *available at* http://www.reuters.com/article/2013/02/04/us-usa-economy-paynet-idUSBRE9130BC20130204.
[31] Pepperdine Private Capital at 4.
[32] *Id.*
[33] PEDRO GETE & NATALIE TIERNAN, IMPERFECT INFORMATION, LENDING STANDARDS AND CAPITAL 3 (Dec. 2012), *available at* http://www9.georgetown.edu/faculty/pg252/Gete-Tiernan_imperfect-info.pdf.
[34] *Id.* at 2-3.
[35] R. LOWENSTEIN, THE END OF WALL STREET 221-22 (2010).
[36] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, SENIOR LOAN OFFICER OPINION SURVEY ON BANK LENDING PRACTICES CHART DATA, *available at* http://www.federalreserve.gov/boarddocs/snloansurvey/201302/chartdata.htm.
[37] OFFICE OF THE CHIEF COUNSEL FOR ADVOCACY, UNITED STATES SMALL BUSINESS ADMINISTRATION, SMALL BUSINESS RESEARCH SUMMARY: LENDING BY DEPOSITORY LENDERS TO SMALL BUSINESSES 2003 TO 2010 at 1-2 (2011), *available at* http://www.sba.gov/sites/default/files/rs380.pdf.

Overall demand for loans remains weak.[38] NFIB's annual survey of business owners confirms this, with only 6 percent of respondents stating that they had difficulty accessing capital and 52 percent stating that they did not want a loan.[39]

The changed lending environment is affected further by new legal and regulatory challenges.[40] For example, the Dodd-Frank Wall Street Reform and Consumer Protection Act,[41] which was passed in response to the financial crisis, requires federal agencies to conduct 388 new rulemaking actions.[42] One estimate, from a staunch opponent of federal regulations, estimates that the rulemakings could have a $90 billion annual cost on the economy.[43]

IV. Federal Reserve

Congress created the Federal Reserve System in 1913[44] to serve as the central bank of the United States. The Federal Reserve's statutory mandate is to foster maximum employment and price stability.[45] Since the onset of the financial crisis, the Board of Governors of the Federal Reserve System has used its oversight of monetary policy[46] to keep interest rates low with the expectation that this intervention in the marketplace would spur economic growth. The Federal Reserve System manages interest rates in the economy through a variety of processes, the scope of which requires an in-depth examination of macroeconomic theory that is beyond the scope of this memorandum. It is sufficient to assert that the Board of Governors can lower interest rates by continually purchasing United States Treasury securities.[47] The net effect of this action is to lower interest rates, especially, the federal funds rate – the rate at which banks lend to each other.[48] If that rate goes down, banks can lend money more profitably (the spread between their cost of borrowing and the interest rate they charge to borrowers) thereby putting more money

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38 BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, OCTOBER 2012 SENIOR LOAN OFFICERS OPINION SURVEY ON BANK LENDING PRACTICES 5 (Oct. 2012), *available at* http://www.federalreserve.gov/boarddocs/snloansurvey/201210/fullreport.pdf.

39 WILLIAM DUNKELBERG & HOLLY WADE, NFIB SMALL BUSINESS ECONOMIC TRENDS 2 (January 2013), *available at* http://www.nfib.com/Portals/0/PDF/sbet/sbet201301.pdf.

40 Deborah Solomon & Victoria McGrane, *Regulatory Delay Stokes Unease Over Dodd-Frank*, June 7, 2011, *available at* http://online.wsj.com/article/SB10001424052702304563104576363730800713042.html.

41 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

42 DAVIS POLK, DODD-FRANK PROGRESS REPORT 2, Jan. 2013, *available at* http://www.davispolk.com/files/Publication/7191edca-f4ed-4460-a514-01ca9d3cf8b9/Presentation/PublicationAttachment/63d52126-7e7f-477a-b47c-08e8acfe145e/Jan2013_Dodd.Frank.Progress.Report.pdf

43 John Berlau, *Dodd-Frank Law Threatens Small Banks*, NEWSMAX, July 20, 2012, *available at* http://www.newsmax.com/JohnBerlau/dodd-frank-banks-libor/2012/07/20/id/446019.

44 BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE FEDERAL RESERVE SYSTEM: PURPOSES & FUNCTIONS 2 (9th ed. 2005), *available at* http://www.federalreserve.gov/pf/pdf/pf_complete.pdf.

45 *Id.* at 15.

46 Monetary policy is defined as those policies which a central bank establishes to control the amount of money in the economy. *See* C. JONES, MACROECONOMICS: ECONOMIC CRISIS UPDATE 193-201 (2010). The Federal Reserve controls the money supply by, among other things, changing the federal funds rate. *Id.* at 266.

47 *See id.* at 286-90, 366-72.

48 *Id.* at 266.

into the economy.[49] Another mechanism for keeping interest rates low is called quantitative easing (which is a variation of the Federal Reserve System's capacity to set the federal funds rate). The goal of quantitative easing is to pump money into the economy through the purchase of long-term Treasury securities and mortgage-backed securities.[50]

The Federal Reserve has committed to keeping the federal funds rate trading in a range from zero to one-quarter percent.[51] This is accomplished through the Federal Reserve System's purchase of $267 billion in long-term Treasury securities, selling short-term Treasury securities,[52] and purchasing $40 billion mortgage-backed securities per month.[53] The Federal Reserve's Federal Open Market Committee has stated that intervention in the marketplace will continue until unemployment reaches 6.5 percent.[54]

Critics of the current Federal Reserve policy argue that this policy has little impact on the overall economy, since few people can access financing.[55] Moreover, questions have been raised about how long intervention in the economy can be sustained and the unintended consequences of continued action. Opponents of long term intervention by the Federal Reserve argue that the artificially low rates have the potential to change investor behavior[56] and can lead to economic bubbles. Further, ongoing policy by the Federal Reserve makes ending the intervention more difficult because the marketplace comes to expect continued action.[57]

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[49] There are other ways to put more money in the economy, such as changing government spending, reducing taxes, or increasing exports while decreasing imports. *See id.* at 386-405, 425-29.

[50] Brad Plumer, *QE3: What is Quantitative Easing? And Will It Help the Economy?,* WASHINGTON POST, Sept. 13, 2012, *available at* http://www.washingtonpost.com/blogs/wonkblog/wp/2012/09/13/qe3-what-is-quantitative-easing-and-will-it-help-the-economy/.

[51] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, MINUTES OF THE FEDERAL OPEN MARKETS COMMITTEE DECEMBER 11-12 (2012), *available at* http://www.federalreserve.gov/monetarypolicy/fomcminutes20121212.htm.

[52] *Id.*

[53] *Id.*

[54] http://www.federalreserve.gov/newsevents/press/monetary/20130130a.htm.

[55] Megan Woolhouse, *Economists: Fed Action Will Have Minor Impact*, BOSTON GLOBE (Aug. 8, 2012), *available at* http://www.bostonglobe.com/business/2012/08/07/economists-fed-action-will-have-minor-impact/MnNSmM7UsgrWzAOTjZYAOJ/story.html.

[56] Michael S. Derby, *A Policy Hawk Assails Easy Money*, WALL STREET JOURNAL, Jan. 11, 2013, *available at* http://online.wsj.com/article/SB10001424127887324442304578234103239795208.html.

[57] *Id.*

V. Conclusion

Most economists are predicting that slow growth will continue in 2013. While bank credit standards have eased since the financial crisis, small businesses continue to lack an appetite for taking on additional debt when they remain uncertain about consumer demand and the economy over the coming months. Coupled with uncertainty about the impacts and costs of federal regulatory and policy changes, small businesses are unlikely to take the risk that can be associated with expansion. Witnesses will examine the state of the economy, access to capital, and the barriers that currently exist to continued small business expansion.