

December 2009

NFIB RECOMMENDATIONS FOR JOB GROWTH

Small business has created about two-thirds of the net new jobs in the United States over the last 35 years. Unfortunately, this recession has severely limited small business's job generation ability as poor sales depress balance sheets, real estate drags on borrowing capacity, banks appear reticent to lend, and confidence remains negative due not only to the lack of visible economic progress, but also to a series of policy threats that darken the horizon.

These issues must be addressed for small business to rebound. Previous opportunities have been missed, other priorities having drawn the attention instead. It is late, but not too late to tackle the jobs issue by providing means for small business to regain its traditional jobs generating role.

Small business clearly has been struggling to hold onto the jobs it has today, let alone create net new ones. NFIB's *Small Business Economic Trends*, the most current data available shows monthly employment declines in the small business sector reaching their nadir in the spring, corresponding with the peak in overall job losses. While now less severe than earlier in the year, small businesses continue to hemorrhage jobs. There is another side to the story, however. Those starting and growing businesses during the recession, and there are many, are projecting to hire or are hiring fewer people on average than in the past. The United States edition of the GEM project shows expected employment among entering firms down. The Bureau of Labor Statistics' (BLS) shows smaller job gains among new or expanding firms than in the past contrasted to job losses which, though large, are not proportionally so. Hence, the small business jobs problem is not just a story of losses, but of stunted employment among those that are growing.

The small business jobs picture remains dark. The frequency of job openings (a combination of both turnover and intended changes in employment levels) has not changed since August, and for all intents and purposes, since April. Hiring plans remain negative; more small employers still plan to reduce employment than to increase it. While hiring plans are less negative now than in the spring, the NFIB survey has not shown positive employment plans since September, 2008. It is insufficient to only stop losing jobs. Small business must expand hiring not only to restore the jobs lost in the current recession, but to compensate for the natural population increase.

Small business owners and managers do not hire because a national goal is to increase employment. They hire, when in their judgments, the person hired will generate enough additional revenues to cover the cost of the hire. No business, other than a state-owned enterprise surviving on taxpayer subsidies, can afford to pay people more than they contribute to the firm, not just at the moment, but into the future. Owners have considerable flexibility in this regard. Rather than committing to the added fixed-cost of a new employee, owners can work longer hours themselves or ask others to do so; they can hire part-time employees; they can substitute a machine for labor; or, they can

out-source work to firms with slack resources. Small business owners will hire, but only if they are convinced that the new position will be a long-term profitable investment.

To encourage and assist small business to resume its job generating role, NFIB recommends the following steps:

1. Recognize the problem.

The major economic problem confronting small business is spending weakness necessitated by an adjustment from a period of overspending and the creation of now unneeded capacity. In other words, we built too much housing, too often carelessly financed. As a result, a plurality of small business owners today considers the lack of demand (poor sales) as their single most important problem. Over eight times as many cite poor sales as finance and interest rates. (The second most frequently cited single most important problem is taxes.) Consumer spending power which constitutes 70 percent of GDP, must therefore be restored to create wealth and output. In addition, it would be foolish to encourage the reckless behavior that got us into this predicament in the first place.

Confidence and expectations are key ingredients to growth. Despite a potential call by the Dating Committee of the National Bureau of Economic Research (NBER) that the recession officially ended in the third quarter of the year, small business confidence remains historically low. Confidence has risen since the spring and summer. Yet, it compares unfavorably to similar periods in the past five recessions, the only ones for which there are small business records. The closest comparison to the present condition is the relatively deep 1974-75 recession. At a similar point in that downturn, NFIB's *Small Business Optimism Index* stood at 86.7, virtually identical to 2009's 86.5. However, three months later, the former rose to 95.2 while the latter only rose in three months to 89.1. The Index continued to rise over the succeeding three month period in 1975 reaching 99.4. It is a virtual certainty the same will not occur this time. In addition, over the last two months, a double digit percentage of small business owners reported that the climate for small business expansion was not good *and* the primary reason for that attitude was the political climate. Thus, confidence needs to be restored. No single policy action is likely to do that. Confidence will be restored only by a generally positive climate that includes both economic and policy factors.

2. Retrench, at least temporarily, from the proposed threats to small business productivity and profitability.

The horizon is filled with cost unknowns, from health care to cap and trade to yawning deficits and the need to come to grips with them, from paid family and medical leave to card check, from expiration of the Bush tax cuts to state decisions about their finances. Nothing is settled; nothing creates a picture of a better future, one where small business owners are willing to invest more of their time and resources. The obvious exceptions are those receiving subsidies to do what they otherwise would not. Unfortunately, that free lunch cannot last indefinitely and without some other potential investor paying for it.

Washington cannot expect small business owners, facing difficult economic circumstances anyway, to commit themselves to investing in new employees or equipment and vehicles without acknowledging and revealing the policy-inspired costs that will be imposed on them. It is all about uncertainty and confidence. Retrenching is not the same as abandoning goals, so retrench. Establishing priorities is not the same as deserting beliefs, so establish priorities. The overriding priority and goal is fixing the economy.

3. Payroll tax cut, maybe. Full tax write-offs for new firms, probably. A general jobs tax credit, probably not.

Given the deficit and the increasing public concern over it, the wisdom of another stimulus, in the form of tax cuts or spending increases, either of which incur additional debt, is questionable. Not only does the calculus of further debt weigh against lost revenue from under-production, but so does the increasing debt's impact on the investment behavior of small business owners and the spending behavior of consumers. Is another stimulus likely to increase their willingness to invest and spend or not? The balance is not obvious, but NFIB thinks it is likely negative in a well-designed plan, almost certainly negative in a plan likely to emerge from the Congress.

New firm formation is a major factor in new employment growth. Moreover, much employment is generated in the first few years of a firm's life. In the first quarter (the latest BLS data available), the number of jobs not created by new and expanding firms exceeded historical norms, exceeding the number of jobs lost. Policy should encourage new firm formation. One important way to encourage larger formations is to liberalize the tax write-offs a new business can claim in its first year. Current tax policy requires substantial investments in a new business to be written-off in subsequent years, reducing liquidity and cash flow, and effectively demanding greater initial investment. Most new entrants could not use the proposed tax change; they are too small. But such a change would clearly assist larger small entries initially and in their early, typically job formative, years. Though this step should be taken in any event, it is more urgent now than it might otherwise be.

During consideration of the stimulus earlier in the year, NFIB proposed the payroll tax (FICA) be eliminated for a specified period. The rationale was as simple then as it is now: cutting the payroll tax puts more cash directly in consumers' hands, in relatively small amounts that are likely to be spent rather than saved. Given that the single greatest economic problem small business faces is the lack of customers, the additional spending would be an obvious way to improve sales and balance sheets. Second, cutting the payroll tax reduces the cost of employees to business. The effect is to save jobs as well as generate new ones. Both are highly desired. Third, a payroll tax cut can be turned on and turned off rather quickly with minimal administrative and informational issues. Administrative simplicity in a counter-cyclical initiative is particularly important. Finally, it is broadly based. All employed people and employing businesses will benefit, making a payroll tax holiday a desirable alternative

A General Jobs Credit was attempted (1977-78) and found wanting in its short lifetime. Major issues from the business perspective included excess complexity, largely the result

of political trade-offs, low awareness, and the difficulty determining the credit's value early in the tax year. The issues from the public's perspective, as interpreted by Robert Tannewald, first in a report for the Library of Congress (CRS) and subsequently in his doctoral dissertation at Harvard, was that the program was no more cost-effective than the Comprehensive Employment & Training Act (CETA), the major jobs training program at the time. Effectively, the credit went to employers who would have created jobs in any event. The relative significance of various aspects may change in a new iteration of the General Jobs Tax Credit. However, the overall impact will not. The Credit simply focuses too narrowly, offering a solution to a problem small business currently holds in a secondary position, while ignoring the important issues, a lack of customers and a shortage of sales.

4. Lending, not just small business, but real estate, particularly housing.

The business press contains considerable anecdotal information about a shortage of credit for small businesses needing to borrow. It also contains less, though still a considerable, amount of anecdotal information about small businesses' reduced demand for credit. While loans to small business are down, it is not clear what portion of the decline is a supply issue and what portion is a demand issue. Good data are unfortunately lacking, a problem NFIB expects to at least partially redress by January. But clearly the longest recession since the Great Depression has depressed credit demand and shrunk many balance sheets to the point that their owners cannot absorb more (any) debt.

The Administration and the Congress have made half-hearted forays into the area without success. The initiative the Administration announced a month ago holds promise, though the source of funds (TARP) makes it dead-on-arrival should it ever officially arrive. Yet, it should be obvious by now that no one wants to replicate the credit debacle that created the current condition. Simply put, a small business government loan program, no matter how well intended, resulting in a 60 percent default rate, or a rate remotely close, is unacceptable to small business owners as a population, let alone to the broader population of taxpayers. The need is to identify those creditworthy firms that want debt and cannot find it, and then match them with healthy lenders. That can only be achieved by initiatives using the entire financial system. Channeling all activity through the Small Business Administration (SBA) is merely cosmetic; the agency simply does not have the reach or resources to dent any shortfall.

Perhaps more important, the country must look to the future, to the day when the immediate consequences of this recession abate, small firm balance sheets rebound, and small business credit demand rises. Normal market forces will increase credit supply at that time. The size of the increase is another question. Weak banks, real estate hangovers, crowd-out from massive federal deficits, and lender reaction to recent experience pose serious threats to adequate credit supply for bankable deals. Getting the fundamentals right is the principal answer to the longer-term small business credit problem. But even that may prove inadequate and additional steps necessary. At a minimum, this condition should be carefully monitored over time.

The nation's current finance problems began with real estate, particularly housing. Housing remains an issue that requires resolution, though only time can fully resolve the housing oversupply. The same may also be true for commercial real estate problems.

Small business has a huge interest in and reliance on the real estate industry. As of last December, one in eight small employers owned at least one upside-down property. Moreover, a similar number collateralized real estate to support borrowing for business purposes. Those two facts imply a significant number of small business owners are hamstrung in job creation efforts by real estate issues. Until the real estate situation improves, therefore, many small businesses will simply be unable to borrow, depressing their presence in the job generation game.

5. Get everyone in the loop.

Officials of government programs who disburse funds for the purpose of stimulating employment should have some idea of an employer's requirements, or at least easier and harder ways for small business owners to reach an objective. Too often, they simply do not. Take the case of the \$5 billion from the stimulus bill designated to increase residential weatherization as reported by AP:

The weatherization program has been in operation for about 30 years. During that period, the prevailing wage requirements of Davis-Bacon have generally not been applied. The Administration has/wants to change that and bring most, if not all, employed with program funds under the Act's coverage. Department of Labor (DOL) officials notified the agencies that oversee the work of their intent, but failed to make the necessary wage determinations to carry out the rules. In response, agencies typically refrained from spending weatherization money pending DOL action. But Departments of Energy (DOE) and Labor officials advised the agencies to move ahead, hire people, and spend the money. As one put it, "I'm satisfied we have communicated as clearly as we can to the states and the agencies that we want them to move forward spending recovery funds even before (the U.S. Department of Labor) issues new wage determinations." The agencies were told not to worry. If they underpay their employees, they can always give them back-pay.

Granted, this is one data point, and one data point does not make data. And, granted that the employers who used discretion were state and local government employees. But the point remains – responsible DOE and DOL officials did not understand the impact of potential back-pay on an employer's budget. Even assuming that these officials had/have enough "juice" to make any civil penalties or potential liability disappear, where is the money for back-pay (with interest) coming from? Apparently, that question never occurred to the DOE and DOL officials.

Handling such foolishness on a case-by-case basis is almost impossible. The federal government is too large and there are too many points of contact. However, the Regulatory Flexibility Act is the one method available that systematically requires federal personnel to address such potential issues before they become institutionalized. The Act thereby often reduces or eliminates much needless expense and other unproductive

impediments to small business growth, impacts documented over the prior two Administrations. Though perhaps not a large jobs generator, a positive employment effect can only result from the lesser cost and fewer hassles vigorous enforcement of the Act engenders.

Small business wants back in the job creation business. It cannot under present circumstances. The NFIB recommendations just presented are important steps to let small business resume its traditional job generating role.