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COMPETITION AND THE SMALL BUSINESS LANDSCAPE: FAIR COMPETITION AND A LEVEL PLAYING FIELD

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES
HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTEENTH CONGRESS

SECOND SESSION

HEARING HELD
MARCH 1, 2022

Small Business Committee Document Number 117–046
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U.S. GOVERNMENT PUBLISHING OFFICE
46–930 WASHINGTON : 2022

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COMPETITION AND THE SMALL BUSINESS LANDSCAPE: FAIR COMPETITION AND A LEVEL PLAYING FIELD

TUESDAY, MARCH 1, 2022

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The committee met, pursuant to call, at 10:00 a.m., in room 2360, Rayburn House Office Building and via Zoom, Hon. Nydia Velázquez [Chairwoman of the Committee] presiding.

Present: Representatives Velázquez, Golden, Davids, Phillips, Newman, Bourdeaux, Carter, Delgado, Houlahan, Kim of New Jersey, Craig, Luetkemeyer, Williams, Stauber, Meuser, Tenney, Garbarino, Young Kim of California, Van Duyne, Donalds, and Fitzgerald.

Chairwoman VELÁZQUEZ. Good morning. I call this hearing to order.

Without objection, the Chair is authorized to declare a recess at any time.

Before we get started, I would like to take a moment to recognize the passing of our colleague, Congressman Jim Hagedorn, the Ranking Member of the Subcommittee on Underserved, Agricultural, and Rural Business Development. He served on this Committee beginning in 2019 when he was first elected to Congress and over the years established himself as a productive Committee Member and a staunch supporter of small businesses. Even during his courageous battle with cancer, Mr. Hagedorn remained active on the Committee and never stopped advocating for the people and entrepreneurs of southern Minnesota. I respected his commitment to serving America's small employers and I was proud to work with him on several bipartisan initiatives. At this time, my thoughts are with his wife, family, friends, staff, and everyone else that knew him. I would like to take a brief moment of silence in his honor.

I know that many on the Committee had the opportunity to work with and get to know Congressman Hagedorn, so I would like to recognize them to say a few words. First, I would like to recognize the Ranking Member, Mr. Luetkemeyer.

Mr. LUETKEMEYER. Thank you, Madam Chair, for your kind words about our friend and colleague, James Hagedorn.

Jim dedicated his life to public service. He was a strong Christian and worked tirelessly on behalf of his constituents. As a representative from Minnesota's First District and our Ranking Member of the Subcommittee on Underserved, Agricultural, and Rural

Business Development, he was a champion for both the small business and agricultural community. In this Committee, Jim led legislation to improve resources for small businesses, advocated for rural entrepreneurs, and always upheld constitutional values. We know that his work to uplift small businesses in rural communities will be remembered for years to come.

Dealing with a long battle with cancer, he never lost his optimism, sense of humor, and diligent work ethic. We will greatly miss his presence on this Committee and in Congress. His genuine kindness and uplifting spirit are rare.

In reading the kind words shared about Jim after he passed, it was said, and I quote, "It is hard to imagine someone more passionate about serving the people of southern Minnesota than Jim." He was a great man and patriot, and our thoughts and prayers are with his family, friends and staff.

Thank you, Madam Chair. I would like to yield now to the gentleman from Minnesota, Mr. Stauber, to share a few words for his colleague from his home state.

Mr. STAUBER. Well, thank you very much, Ranking Member Luetkemeyer, and Madam Chair, for those kind words. I think that Jim gave it all he had and he loved nothing more than serving the First District of Minnesota. He loved his small farmers and he loved his small business. And he came to Congress with passion. He and I came in together, and he came with passion. He came with integrity. And I think for those of you who do not know, I think that we had a GOP Small Business Conference led by Ranking Member Luetkemeyer. It was about 2-1/2, maybe 3 months ago. Jim Hagedorn brought his father there to that morning breakfast. And do you remember how proud he was to introduce his father, Tom Hagedorn, a former Member of Congress? And you could just see father and son, they were just beaming with pride. And Jim was fighting the cancer for the second time. And having been close to Jim, I can say he never once complained about what he was going through. He battled it with courage. He had faith. Unshakeable faith. And do you all remember just, it was 3 weeks ago that he passed a bipartisan piece of legislature out of this Committee. And it was on Zoom. Unfortunately, we could not be here but this is who he was. And very proud of his home state of Minnesota. And I am just proud to have been a colleague of his. I learned a lot from Jim. His passion. And today, Roger Williams and I, we made the command decision to put his nameplate up here. He is with us in spirit today. And I wrote on the paper in front of his name tag, Madam Chair, "fiscal responsibility," because Jim Hagedorn loved his fiscal responsibility and I see my good friend Mr. Phillips down there. I know he will have some good things to say, too. But, you know, it is unfortunate that it takes something like this to bring us together but we can do better in Congress. And Jim wanted it better. His family, his father, and he gave it all he had for this country and we are going to miss him deeply. Rest in peace, Jim Hagedorn.

And I yield back.

Chairwoman VELÁZQUEZ. Thank you, Mr. Stauber. The gentleman yields back.

Now I recognize the gentleman from Minnesota, Mr. Phillips, for a brief statement.

Mr. PHILLIPS. Thank you, Madam Chair. And thank you to my friend, Pete Stauber, for the wonderful words about Jim.

Just a quick story because it is not one I have told much, but in 2019, Jim wanted to bring his nephew to the White House Christmas party. And wanted also to go with his wife, Jennifer Carnahan. And they needed an extra ticket. So, I volunteered mine. Little did I know that meant I also had to go with them to the White House Christmas party that year. So, Jennifer, his wife, Jim, and I, and Jim's nephew went to the White House Christmas party. And it was one of the more memorable evenings of my tenure in Congress to see Jim beaming with pride about bringing his nephew, his nephew's extraordinary experience, and just the simple humanity that my friend Pete just referred to. We are not Democrats and Republicans; we are Americans. Jim was a gentleman. We did not always agree, of course. He had a wry sense of humor. He did care about southern Minnesota, this country. He persevered. You would never know he was fighting for his life his entire term in Congress. In fact, I think just about a week before he passed away, he declared his run for 2022.

He will be missed. And I just hope we use his memory as a blessing and as an inspiration to all of us to look beyond our party labels and get good work done and in the spirit of fiscal responsibility, humanity, and decency. May his memory be for a blessing. Thank you.

Chairwoman VELÁZQUEZ. Thank you, Mr. Phillips. And thank you for all the kind words. He will be missed.

Now, turning to our hearing, I would like to begin by noting some important requirements. Standing House and Committee rules will continue to apply during hybrid proceedings. All Members are reminded that they are expected to adhere to these rules, including decorum.

House regulations require Members to be visible through a video connection throughout the proceeding, so please keep your cameras on. Also, please remember to remain muted until you are recognized to minimize background noise.

In the event a Member encounters technical issues that prevent them from being recognized for their questioning, I will move to the next available Member of the same party and I will recognize that Member at the next appropriate time slot provided they have returned to the proceeding.

For those Members physically present in the Committee room today, in accordance with the attending physicians most recent guidance, masks are optional and no longer required.

Now let's get into the hearing.

For generations, achieving the American dream and starting a business have gone hand in hand. Millions of Americans have utilized entrepreneurship to support their communities and create better lives for their families.

Business owners may start small, but the goal is almost always to grow the enterprise, reach more customers, and hire more employees. As these firms evolve, they build up the American economy and produce numerous benefits for our society. These entre-

preneurs are the bedrock of our economy, accounting for nearly 90 percent of all private-sector employers and generating roughly two-thirds of all new jobs. However, too often, we take our entrepreneurial ecosystem for granted.

The ability of entrepreneurs to start and grow a business is predicated on the existence of a level playing field between large corporations and their small peers. Competition is the precondition that allows small businesses to thrive.

In fact, this idea of competition underpins the entire American economy. More competition leads to lower prices, higher quality goods and services, greater variety, and innovation that moves our country forward.

Unfortunately, longstanding trends indicate that our economy is becoming less competitive. Today, in over 75 percent of industries, there is more corporate concentration, which has given large companies more market power than they had 20 years ago. From high-tech startups to family farms, small firms across nearly every industry are struggling under the weight of outsized corporate power.

As consolidation has increased, small business creation has suffered. Aside from the uptick in new business registrations from 2020 and 2021, the share of small firms entering the market had been declining since the early 1980s. In 1982, new firms constituted 38 percent of all businesses but that fell to only 29 percent in 2018.

The pandemic ignited a wave of small business creation, with new business applications reaching record highs in 2021. This is encouraging, but at the same time, we must ask if these businesses have a fair opportunity to develop without being crushed by their corporate competitors.

The federal government has a long tradition of creating rules and regulations that minimize anti-competitive behavior dating back to the 1800s. One of the primary means of protecting competition is enforcing antitrust laws. These laws help establish the free market rules, seeking to root out anti-competitive practices, like mergers and acquisitions. However, antitrust laws are just one tool at the government's disposal. Enforcement of intellectual property, labor, and consumer protection laws are also critical to rooting out anti-competitive practices.

So today, I want to survey the current competitive landscape and discuss what is needed to ensure a level playing field for small businesses and entrepreneurs. When small businesses have a chance to compete, they can achieve great things and provide tremendous benefits for our country. That is why it is important to assess the current environment to see how larger businesses are in some cases helping to facilitate market competition and in others tipping the scales against it.

The Biden administration understands this dynamic. Last July, the president issued an executive order directing government agencies to examine ways to increase competition to benefit consumers, workers, farmers, and small businesses. The order also established a White House Competition Council to monitor the rising power of large corporations in the economy.

I hope that this hearing allows us to build off these actions and discuss more ways we can ensure a handful of dominant players are not stifling the growth of small businesses.

I would now like to yield to the Ranking Member, Mr. Luetkemeyer, for his opening statement.

Mr. LUETKEMEYER. Thank you, Madam Chair. And also, thank you for the opportunity to honor the memory of Mr. Hagedorn this morning. I would also like to thank you for holding the hearing today.

As we all know, later this evening, President Biden will deliver his first State of the Union Address. It has been roughly 400 days since President Biden has taken office and I think we need to also take a look at the state of small business. In my view, when we do, we see it is in a crisis. Small businesses are being crushed by soaring prices as they face the highest inflation rates in 40 years.

I have heard from contractors that are unable to bid on jobs because the cost of construction materials continues to skyrocket into the unknown. Restaurant owners have limited their menus and shortened their serving hours as the high price of food and labor challenges their bottom line. And just last month, this Committee heard from an entrepreneur who was forced to narrow his scope of business due to the climbing prices at the gas pump.

Next, our job creators need workers. As we pass Help Wanted signs on the doors across main street, it is clear small businesses cannot compete with the government to get their employees back to work. Unprecedented government stimulus payments have led to 10.9 million job openings in this country, and despite historic numbers of small business owners raising compensation, nearly half of small businesses cannot find workers.

Another problem is that of the supply chain disruptions that are leading to lost revenue. Ninety percent of small businesses have been affected by supply chain disruptions according to NFIB. As consumer demand climbs, our nation is plagued by backlogs at the ports and truck driver shortages. The supply chain bottlenecks have resulted in the scarcity of key materials, project delays, and new challenges for business owners to serve their customers.

Also, crime is devasting small businesses. Smash and grab crime waves are damaging main street storefronts, leaving small business owners to pick up the pieces. Looting not only leads to broken windows and stolen goods, but small businesses have also been forced to halt operations and even face increases in insurance premiums.

Another problem is that of the regulations that are hamstringing recovery and progress. With all these headwinds, the last thing small businesses need is more regulations. According to the American Action Forum, the Biden administration capped off its first full year in office with more than $200 billion in regulatory costs and 131 million hours in new annual paperwork.

These challenges placed businesses at a competitive disadvantage as they lack the staff, ability to absorb costs, pricing flexibility, long-term contracts, and purchasing power. Although innovative and nimble, small businesses, entrepreneurs, and startups often operate on very thin margins.

Just as concerning, this administration continues to put small businesses on the back burner. As Members of the Committee, it is our job to advocate for small businesses and conduct oversight.

Secretary Yellen continues to ignore the law, this Committee, and small businesses. She is now over 310 days past the April 26th deadline and law for her to testify before this Committee. If a small business owner was late on his legal responsibility, I am confident the IRS would not exercise this level of leniency and allowances. This is another example of the administration's rules for thee but not for me.

This Committee has been fortunate enough to hear testimony from SBA Administrator Guzman. However, Members of this Committee deserve responses to questions submitted for the record 9 months ago and throughout this Congress regarding important programs that service our small business constituents.

The current economic climate for small businesses in response to the Biden administration are inexcusable. Main street creates approximately two-thirds of all new jobs and is key to our nation's recovery from the pandemic. However, the Job Creators Network Survey found only 7 percent of small businesses have fully recovered from the pandemic. It is clear, endless government spending in Washington and constantly changing mandates are not working for small businesses. We must champion pro-growth policies of lower taxes and deregulatory actions that allow small businesses to operate independently.

In short, the multitude of challenges facing the nation's job creators put them at a competitive disadvantage. The state of the small business economy must improve. I look forward to hearing from our witnesses today on how we can restore the small business economy and decrease barriers to competition for small businesses.

With that, Madam Chair, I yield back.

Chairwoman VELÁZQUEZ. Thank you, Mr. Luetkemeyer. The gentleman yields back.

I would like to take a moment to explain how this hearing will proceed. Each witness will have 5 minutes to provide a statement, and each Committee Member will have 5 minutes for questions. Please ensure that your microphone is on when you begin speaking and that you return to mute when finished.

With that, I would like to introduce our witnesses.

Our first witness is Dr. Diana Moss, President of the American Antitrust Institute. Dr. Moss has an in-depth understanding of antitrust issues with an expertise in digital technology, electricity, petroleum, food and agriculture, airlines, telecommunications, and healthcare. She is also adjunct faculty in the Department of Economics at the University of Colorado at Boulder. Thank you for joining us today, Dr. Moss.

Our next witness is Dr. Carl Shapiro, distinguished professor at the University of California-Berkeley. Dr. Shapiro has served on the President's Council of Economic Advisors and was the Deputy Assistant Attorney General for Economics at the Antitrust Division of the U.S. Department of Justice. He holds a Ph.D. in Economics from MIT and he has written extensively on competition policy and antitrust economics. We appreciate you joining us today, Dr. Shapiro.

Our third witness is Mr. Barry Lynn, Executive Director of the Open Market Institute. Over the past 2 decades, Mr. Lynn has made significant contributions to our understanding of how monopolies threaten democracy, individual liberties, security, and prosperity. He has authored three books and written extensively on antitrust and fair competition. He was previously the Executive Editor of Global Business Magazine and a correspondent for the Associated Press.

Thank you, Mr. Lynn, for being here today.

Now, I will yield to the Ranking Member to introduce our final witness.

Mr. LUETKEMEYER. Thank you, Madam Chair.

Our next witness is Dr. Douglas Holtz-Eakin. Dr. Holtz-Eakin is the president of the American Action Forum and one of the most important economic thinkers in our country. He has served on the Council of Economic Advisors multiple times, first serving as a senior staff economist from 1989 to 1990, and then again as a chief economist from 2000 to 2001. Dr. Holtz-Eakin also served as a sixth director of the Congressional Budget Office. He served in this nonpartisan capacity from 2003 to 2005. Additionally, Dr. Holtz-Eakin was appointed to serve as a commissioner of the Financial Crisis Inquiry Commission in 2009. Dr. Holtz-Eakin, welcome to the Committee. It is a pleasure to have you here in person this morning. Given the current economic conditions facing small businesses, the stakes could not be higher for our nation and we hope to discuss many of these topics with you today. I am looking forward to this morning's conversation and hearing from all our witnesses.

And with that, Ms. Madam Chair, I yield back.

Chairwoman VELÁZQUEZ. The gentleman yields back. Thank you all for joining today.

Dr. Moss, you are recognized for 5 minutes.

Ms. MOSS. Thank you, Chairwoman Velázquez, and Members of the Committee. It is an honor to be here today to lend the American Antitrust Institute's perspective to the issue of competition and——

Chairwoman VELÁZQUEZ. Dr. Moss, you are muted.

Ms. MOSS. Can you hear me? You can hear me? Okay, let me continue.

My testimony will focus on four important topics that are relevant to today's hearing. They relate specifically to how high concentration and the emergence of dominant firms——

Chairwoman VELÁZQUEZ. Okay, Dr. Moss, let's go to the next witness. We cannot hear you well.

Mr. LUETKEMEYER. Dr. Holtz-Eakin, you may be the only one we get to hear this morning.

Mr. HOLTZ-EAKIN. That is the advantage of being here.

Mr. LUETKEMEYER. That is okay; right?

Chairwoman VELÁZQUEZ. Okay, so we are going to start with Dr. Holtz-Eakin until we fix the technical difficulty.

You are welcome, sir.

STATEMENTS OF DOUGLAS HOLTZ-EAKIN, PRESIDENT, AMERICAN ACTION FORUM; DIANA L. MOSS, PRESIDENT, AMERICAN ANTITRUST INSTITUTE; CARL SHAPIRO, DISTINGUISHED PROFESSOR OF THE GRADUATE SCHOOL AT THE UNIVERSITY OF CALIFORNIA AT BERKELEY; BARRY LYNN, EXECUTIVE DIRECTOR, OPEN MARKETS INSTITUTE

STATEMENT OF DOUGLAS HOLTZ-EAKIN

Mr. HOLTZ-EAKIN. Thank you, Chairwoman Velázquez and Ranking Member Luetkemeyer, Members of the Committee. It is a privilege to be here today to discuss this important topic. And I will make a couple of points and then I look forward to answering your questions.

To begin, I do not need to remind this Committee of the importance of small businesses in the American economy. A lot of the discussion, the public discussion today is about big firms, and you hear a lot about them, but the reality is that small businesses are the heart of the American economy. There are over 32 million small businesses. Well over 95 percent of all businesses are small businesses. They have 60 million employees, which is nearly half of all employees in the United States. And in 2019, part of the pandemic, small businesses created 1.6 million new jobs, which is over 80 percent of the new job creation in that year. They are central to growth in the U.S. economy. They will be central to the recovery from the pandemic recession. And they are spread throughout the economy. I have tabled my written testimony which shows every sector is populated by small businesses. They are a pervasive phenomenon.

The other important aspect of small businesses is the dynamics. As the Chairwoman mentioned in her remarks, we have lots of new startups every year. And indeed, coming out of the pandemic in 2021, we have 5.4 million applications for new businesses. That is up 53 percent over prior applications before the pandemic. But if history is any guide, roughly 50 percent of them will fail in the first 5 years. And that process of entry, growth, sometimes failure, leads to the fact that in every sector of the economy, small and large businesses exist side by side. And that is the norm, not the exception. In the economy as a whole, 62 percent of firms are under 5 employees, 89 are under 20, 99.6 are under 500 employees. So, there is a lot of small businesses out there. And only a very tiny fraction, less than 1 percent, are large employers of over 5,000 employees. And so, the discussion that is dominated by these larger firms I think is misplaced if we want to understand the best for the future of the economy.

Now, to my eye, the best single thing this Committee and Congress as a whole can do to promote fair competition is to support the continued entry of new businesses. To apply the competitive pressures that you mentioned in your opening statement, Chairwoman. That is the thing that will discipline large firms the best, has the least potential for unintended consequences. Good competitive pressures have few of those. Will provide American households with value for their money, variety and innovation, and is exactly what the economy needs.

Now, if one looks at the National Federation of Independent Business Surveys of Small Businesses, one of the things that becomes real clear is that on a regular basis they complain about the cost of regulation and it is one of the biggest barriers for small businesses. And so, one thing to keep an eye on is the increasing cost of the regulatory state as a great barrier to entry, and thus, a great protector of large incumbents. And anything that can be done to keep that regulatory barrier to a minimum would be important.

During the 8 years of the Obama administration, that administration finalized a major regulation, something that cost more than $100 million to comply with, at an average rate of 1.1 per day every day for 8 years. A total self reported—these are their numbers—regulatory burden of $890 billion. That is a $100 billion stealth tax increase every year and I think one of the reasons we saw diminished entry rates over that period. That growth and regulatory state stopped for several years. But as the Ranking Member mentioned, in the first year of the Biden administration, we saw over $200 billion of regulatory costs. That is the largest first year number of any administration we have tracked. I would be concerned about that.

The second thing is, at this moment, what small businesses are most concerned about, the number one thing in the surgery is inflation. And the inflation that the United States has has a component which is due to supply chain difficulties and which many nations share. We hear this a lot. Europe saw inflation rise about a percentage point a quarter during 2021. It went from basically 0 to 4 percent. But the U.S. has a unique inflation problem, a jump that is the third largest in the post-war history, and it contains not just those supply chain components but also excessive demand from, in particular, the American Rescue Plan, a $1.9 trillion stimulus at a time when the economy is growing at 6.5 percent. History shows that if you overstimulate an economy that is growing rapidly, you will create inflation. And we have created a very big inflation problem in the United States. I expect that it will be difficult to tame.

Current circumstances, the tragic invasion of Ukraine, will exacerbate commodity and energy prices that will add to the persistence. Workers are demanding higher wages, and inflation expectations have gone from 3 to nearly 6 percent in one year. That is the recipe for more durable inflation that will be much harder to fight. So, this is an environment that is very tough for small businesses. Fighting inflation and keeping regulatory burdens low are two important steps to help in their future. Thank you.

Chairwoman VELÁZQUEZ. Thank you.

Now let's try this again. Dr. Moss, you are recognized for 5 minutes.

STATEMENT OF DIANA L. MOSS

Ms. MOSS. Thank you, Chairwoman Velázquez and Members of the Committee. It is an honor to be here today to lend the American Antitrust Institute's perspective to the issue of competition and small business.

My testimony will focus on four important topics that are relevant to today's hearing. They relate specifically to how high con-

centration and the emergence of dominant firms and oligopolies affect small business and entrepreneurship.

First, small business is an integral part of the U.S. economy. It accounts for a significant portion of all new jobs and economic activity, driving innovative and competitiveness, but there are indicators that small business may be in decline. From 1998 to 2014, the small business share of GDP fell and the portion of real GDP accounted for why small business slowed relative to large business.

This translates to hundreds of billions of dollars that would otherwise deliver benefits from small business in terms of innovation, economic development in smaller communities, and injecting competitive discipline and resiliency into our markets.

Second, there is evidence that decades of weak antitrust enforcement has adversely affected the competitive process where small business is particularly exposed. Economic research identifies the role of increasing concentration and potentially driving up prices, slowing rates of firm entry, increasing gaps in wage and wealth inequality, and higher returns for only the largest firms. This era was born of conservative ideology that gave too much weight to the risk that antitrust enforcement would chill competition and less weight to the risk that consolidation and anticompetitive conduct would harm it. This has put competition, our markets, and the democratic principles that support them at risk. The exercise of market power harms virtually all market participants. It hurts consumers through higher prices, lower equality, and less innovation. Producers are squeezed through lower prices paid for their products and services, and smaller businesses are harmed through higher costs, barriers to market entry, and the threat of retaliation.

Third, horizontal and vertical integration can create and reinforce high concentration that disrupts the role of small business. Mergers can increase a dominant firm's ability and incentive to cut off smaller rivals' access to critical inputs or distribution or to engage in predatory behavior. This was a concern for small craft brewers in the merger of AB InBev and SAB Miller. It is also a concern in beef processing where Members of the domestic packer cartel, which is vertically integrated now into cattle supply have incentives to force out smaller, independent ranchers. The court also noted that in the merger of AT&T and Time Warner consolidation would frustrate innovation from smaller firms with innovative, over-the-top models for delivering content. And in the FTC's pending monopolization case against Facebook, the effect of exclusionary conduct on smaller rivals plays a central role.

Finally, legislators and policymakers should consider the importance of a public policy approach to competition to promote the role of small business in the economy. This would tap into multiple tools in the competition policy toolkit, including stronger antitrust enforcement and pursuing mergers, cartels, and strategic conduct that neutralizes smaller rivals, but it also includes antitrust role in policing the abuse of intellectual property and deceptive practices that are designed to squeeze out smaller rivals.

However, it is important to recognize that antitrust enforcement may not focus on certain things that are priorities for small business. For example, antitrust is concerned with harm to competition and the competitive process, not independent competitors. Enforc-

ers may challenge acquisitions of smaller rivals who seek to be acquired and maximize their acquisition prices under the venture-capital backed startup model.

The same is true of noncompete clauses, which may be disfavored by antitrust enforcement but used by small business to protect trade secrets.

Finally, some antitrust remedies put small business in a very difficult position. For example, conduct remedies are enforceable only if smaller firms that are the target of anticompetitive behavior complain to enforcers. These firms often fear retaliation from dominant firms and are therefore reluctant to step forward.

These complementarities and tensions highlight the importance of promoting strong antitrust enforcement to do what it was designed to do, not to task it with solving all problems. Antitrust should work together with other policies to support and promote small businesses. These include labor law, intellectual property law, consumer protection law, procurement practices, and others.

Thank you very much, and I look forward to your questions.

Chairwoman VELÁZQUEZ. Thank you, Dr. Moss.

Now we recognize Dr. Shapiro for 5 minutes.

STATEMENT OF CARL SHAPIRO

Mr. SHAPIRO. Good morning. Thank you for inviting me to testify in front of you today. I hope to provide you with a unique and valuable perspective based on my experience as a professor who has been studying competition policy for over 40 years, as someone who served twice as a chief economist in the Antitrust Division at the Department of Justice, and as an economic expert witness who has testified numerous times in federal court on behalf of the government in important antitrust cases.

I would like to emphasize three main points. First, I encourage this Committee to reaffirm that the goal of the antitrust laws is to promote and protect competition throughout the American economy. This will benefit small businesses but applies throughout the entire economy.

Second, I offer specific recommendations for how Congress can reinvigorate antitrust enforcement, correcting errors made by the courts in recent decades.

Third, if this Committee would like to further assist small businesses that are facing powerful competition from larger firms, many policies other than antitrust are available and should be used.

There is an active debate today about what the goals of antitrust should be. My answer to that is simple. Antitrust should be about promoting and protecting competition. Full stop. We have learned over many years that competition delivers enormous benefits to our society, fueling economic growth, innovation, and rising standards of living.

However, competition is messy. Competition can be rough and tumble, and competition can feel deeply unfair when one loses. We all say we like competition, but who really welcomes a formidable rival in any domain, be it love, sports, or business?

Nonetheless, promoting competition does not mean shielding any businesses from the buffing winds of legitimate rivalry. Not large

firms with outsized political influence, nor small firms struggling to compete against larger ones with lower costs.

My written testimony describes a positive program for strengthening our antitrust laws to better promote and protect competition in the 21st century economy. The basic idea is to shift the law by establishing a number of rebuttable presumptions in favor of antitrust plaintiffs. My written testimony has a number of examples, and my attached paper has more, but here are two. If a dominant firm requires its customers to deal with it exclusively, that presumptively violates the Sherman Act. Or, if a dominant firm acquires a significant actual or potential rival, that presumptive violates the Clayton Act.

The changes I recommend would help protect small businesses from predatory and exclusionary conduct by dominant firms. The changes I recommend also would help protect small businesses from anticompetitive mergers. I have been in favor of strengthening merger enforcement for at least 25 years. As an example, I testified a few years ago on behalf of Steves Doors, a 150-year-old family firm based in San Antonio, Texas, that manufactures doors used in homes. Steves Doors successfully challenged a merger between two of the leading suppliers of door skins, a critical input into the manufacturer of doors. That merger threatened to drive Steves Doors and other small door manufacturers out of business.

Antitrust law also could be modernized to give small businesses more latitude to cooperate in order to compete more effectively against larger firms. In particular, Congress could establish a presumption that when a group of small businesses cooperate to better serve their customers by replicating what their larger rivals can do internally, that cooperation does not violate the Sherman Act.

Finally, let me address those whose calls for stronger antitrust enforcement are motivated by concerns about the political power of large corporations. I very much share those concerns. Very much. We urgently need campaign finance reform, including greater transparency regarding money in politics to control the excessive political power of large corporations, not to mention billionaires.

But asking antitrust to solve these political problems is very likely to be counterproductive. The antitrust enforcement agencies are ill-suited to tackle issues beyond competition. Indeed, the core mission of antitrust, to promote competition, could easily be undermined if we ask antitrust to solve problems unrelated to competition. For example, asking the Department of Justice to block mergers that enhance political power as distinct from economic power would necessarily politicize antitrust enforcement, which strikes me as extremely dangerous and unwise.

Fortunately, antitrust is just one arrow in the quiver of available policies to assist small businesses. For example, in the meat packing industry, the Biden administration is pursuing a number of policies to expand independent processing capacity and to combat abuses by large meat packers and processors, in part by updating rules under the 1921 Packers and Stockyard Act. As another example, financial service regulators could adjust their rules in favor of community banks if preserving more community banks is judged to be in the public interest.

Thank you very much. I look forward to taking your questions.

Chairwoman VELÁZQUEZ. Thank you, Dr. Shapiro.
Now we recognize Mr. Lynn for 5 minutes.

STATEMENT OF BARRY LYNN

Mr. LYNN. Chairwoman Velázquez, Ranking Member Luetkemeyer, thank you for inviting me to speak. I am Barry Lynn and I direct the Open Markets Institute.

Today, I am going to make three simple points. First, independence is essential to American democracy. The declaration is not simply about independence of nation from nation. It was also about the independence of person from person. And from the first, Americans understood such independence required the liberty to work one's own land, ideas, labor, and business free from interference by people with more power.

This vision was based on the idea that only someone fully independent can be trusted in political debate and that, to be fully in control of one's own mind and one's own voice requires being in control of one's own means.

Second, antimonopoly is the foundation of independent business. From the first, the American people fought to make laws and rules to protect the property of the individual, including independent businesses, from all predation. This meant engineering open markets where every individual is free to succeed based on their own efforts. This meant regulating corporations to ensure they are used to serve people, not to exploit them. We see this in the Constitution with its system of checks and balances. We see it in the Northwest Ordinance, America's first law, that blueprint for the society Americans wanted to build. That careful plan to outlaw slavery. To divide land into family-sized plots. To ban predatory corporations. To provide free education to all. The result was the American system of liberty.

After the Civil War, the network technologies of railroad and telegraph upset traditional balances and forced Americans to make new laws to regulate private power—the Interstate Congress Act, the Sherman Antitrust Act. Just as was true of the Declaration and Constitution, these laws aim to protect the independence of small business. As Senator Sherman put it, defending the bill that bears his name, "It is the right of every man to work, labor, and produce in any lawful vocation. This is industrial liberty and lies at the foundation of the equality of all rights and privileges."

Buttressed in the 20th century by the Clayton Act, FTC Act, Glass-Steagall, Robinson-Patman, and other acts of Congress, this updated system of liberty worked.

In 1980, the United States was home to many giant industrial corporations—IBM, Boeing, General Electric, General Motors—that made America the most powerful nation on earth. Yet, 2 centuries after the founding, most retail, farming, services, light manufacturing and publishing remained family enterprises. And this liberty to be one's own boss was now claimed by every Member of our society no matter the color of their skin, gender, religion, or sexual orientation.

Third, the consumer welfare ideology has been a catastrophe for American democracy. In 1981, President Reagan introduced a new political economic goal. No longer was the need to protect liberty

and democracy. The aim now was to deliver more stuff. To this end, his administration reinterpreted the laws Americans had put in place to protect independent business. They twisted the laws to promote efficiency instead. Until President Biden, every administration since Reagan has followed this lead.

The result was social and political revolution. The expropriation of the businesses of millions of families, the erection of futile control over the family businesses that remain. Today, under the rule of Amazon, Google, Facebook, Uber, millions of Americans most energetic and creative citizens are forced day after day to borrow from the company bank, to buy from the company store, to pay tax to the company treasury, to heed the company's command. In America today, there is no fair competition. There is no level playing field.

In 1913, President Wilson defined tyranny as, "the conduct of our affairs and the shaping of our legislation in the interest of special bodies of capital and those who organize their use." By that definition, the American people today live under a tyranny of corporate monopoly, and America's entrepreneurs are among the first to feel the boot.

This hearing demonstrates that Congress has awakened to the crisis. We look forward to working with you all to rebuild American entrepreneurship and American democracy.

Chairwoman VELAZQUEZ. Thank you, Mr. Lynn.

I will begin by recognizing myself for 5 minutes.

Dr. Moss, how do we ensure that small firms can compete in today's economy given the massive consumer demand for quick and simple delivery of products and services from large, dominant firms?

Ms. MOSS. Thank you for the question, Chairwoman.

It is really a central question to public policy surrounding the promotion of small business and the U.S. economy. And I would assert, as I do in my testimony and in my remarks, that a strong system of antitrust enforcement is very, very important to that.

We have a lot of small business. I talk to small businesses every day in their calls to the American Antitrust Institute, their struggles, the restraints that they face, the intimidation and the harassment they face by larger firms, including and protecting small business is part of our economy, not only increases diversity and our supply chains; it increases their stability and their resiliency.

The COVID-19 pandemic very much is evidence of the failure of that to have occurred. So strong antitrust enforcement, but also other policy tools that can support and assist small business are extremely important.

Chairwoman VELAZQUEZ. Thank you.

Ms. MOSS. To think about and to work in complementary ways.

Chairwoman VELAZQUEZ. Thank you. Amazon holds about 50 percent or more of the U.S. online retail market. Due to Amazon's market power, are there other firms out there that can compete with Amazon? How can we create a level playing field for these other firms?

Ms. MOSS. So I think the question of Amazon and their ecommerce platform is really central to the debates that we are having over digital technology. I would take a slightly different

view of Amazon and my hope was that this view would have been injected far earlier into the public debate about Amazon. It is not so much about dominance of the online market, which does contain myriad actors. It is really about dominance in a very important part of the supply chain which is the logistics part of the supply chain. So, a monopoly over picking, packing, sorting, and tracking, if you will, has given Amazon an ability and an incentive to use its dominance there to engage in conduct that forecloses small rivals. My hope would be that private enforcement would step forward to think about framing cases and that public enforcers would do as well.

Chairwoman VELÁZQUEZ. Dr. Moss, can you explain to us how Amazon's self-preferencing practices have hurt small businesses?

Ms. MOSS. Sure. So going to the logistics part of the supply chain, again, the use of the Amazon Prime system absolutely creates incentives to preference Amazon's affiliated businesses, their preferred businesses in terms of whether they show up in the consumers' buy box at the end of a transaction. Absolutely. Amazon's incentives to replicate successful products and services on its website are another way for Amazon to see enhanced incentives to disadvantaged smaller businesses. This part of the supply chain is a very specific market and really deserves to be looked at very, very carefully so that Amazon cannot leverage its monopoly to the disadvantage of small businesses. Again, that hinges on strong antitrust enforcement.

Chairwoman VELÁZQUEZ. Thank you, Dr. Moss.

We have seen increased levels of concentration across markets with small and medium-sized businesses sometimes being subject to discriminatory terms and conditions.

Mr. Lynn, is the Robinson-Patman Act equipped to deal with the reality of today's economy? Or does Congress need to take steps to strengthen the law to protect small employers?

Mr. LYNN. Chairwoman Velázquez, that is a very important question and the answer is no. Right now, the Robinson-Patman Act is not prepared, is not fit for purpose, for protecting America's independent businesses as it was originally created. The problem is that it has been severely eroded by court decisions over the years. It has also been severely eroded by sort of a lack of use by the recent administrations.

It is important to understand that there are many other ways to achieve the same ends, and we need to be using these other approaches to achieving these same ends, you know, a much more aggressive use of antidiscrimination law in every aspect, in every way. But we can, and we should be working to sort of restore the original purpose of the Robinson-Patman and the original power of the Robinson-Patman Act.

Chairwoman VELÁZQUEZ. Thank you, Mr. Lynn.

My time has expired.

Now I recognize the gentleman, Mr. Luetkemeyer, Ranking Member, for 5 minutes.

Mr. LUETKEMEYER. Thank you, Madam Chair.

Dr. Holtz-Eakin, in your written testimony you have a statement that says, "To diagnose the roots of inflation is to identify the appropriate policy response." That is a pretty salient comment. If we

could identify the roots of the problem, we can fix the problem because we should be able to find solutions for that.

So along that line, you know, we had the discussion before with regards to what makes up the problem of inflation within this country right now. We have talked about energy before. Regulations, I would argue. The money supply problem as you mentioned in your testimony, and also the supply chain/workforce problem. I think that is the four biggest ones. I would assume you agree with that, or is there another one with that or are those the four biggies?

Mr. HOLTZ-EAKIN. The excessive stimulus early in 2021 as well.

Mr. LUETKEMEYER. Okay. Well, I thought that was money supply. That is where I would throw that underneath there. Too much money in the system. Okay.

I would like for you to quantify that if you would. We have talked about this before and you thought energy could make up as much as 40 to 50 percent of the inflation that is being caused today. Could you break down the percentage you think of inflation is caused by energy, regulations, access to money supply and supply chain workforce problems? I realize it is a ballpark but it would give us an idea of the immensity of the problem in each one of these categories.

Mr. HOLTZ-EAKIN. So there is a crude way to do it which is in my testimony, is to imagine that the globe suffers from common energy problems, common pandemic-induced workforce problems, common supply chain interruptions. And so, take European consumer price inflation. It goes up at a percentage point a quarter through 2021. That is about 0 to 4 percent. The U.S., the moment the American Rescue Plan is passed in the face of also very, very accommodative monetary policy, gets not a percentage point increase but three. Almost three. Three times bigger. So that is the excessive money supply stimulus part of it compared to the rest.

And then I would say you have roughly equal amounts in the workforce and energy components. So that is going to give you something that looks like 2 percentage points or so of inflation. And there is the baseline regulatory inflexibility which comes with the accumulation of regulatory costs. So, I think you really can do some crude breakdowns. But the real issue is to go in the other direction. Stop creating inflationary pressures. So do not do any more stimulus. Do not do any more monetary accommodation. Be careful with the regulatory burden. And allow greater supply of energy. That is the best that Congress can think about.

Mr. LUETKEMEYER. Okay. Thank you.

In your testimony and written testimony, you also talk about some different, like the Administrative Procedures Act, the Regulatory Flexibility Act, things that Congress should be looking at to minimize the impact on small businesses, as well as being able to help small businesses as we watchdog some of the stuff that we are doing. So as a leader on the Republican side here of the Small Business Committee, this got my attention because this is something we at Congress should be looking at and doing, and I really appreciate you highlighting that. So, I want to kind of go through

that a little bit but I am running out of time. Hopefully, my colleagues will follow up on this.

The one I want to start out with is Regulatory Flexibility Act, because that technically is what, you know, the agency is supposed to look at the rules and regulations and their impact on small business and it does not seem like they are doing that or we are not doing it. Or is it too weak a law? Do we need to enforce it? Do we need to do something different? What would you suggest we do to make that particular act actually work?

Mr. HOLTZ-EAKIN. So first, let me just stipulate, because it is often misunderstood. I am not opposed to all regulation. There is much necessary regulation. But it should be done as well as possible. It should be done best practice, least cost. And the Regulatory Flexibility Act is an attempt to keep the costs from being too onerous, particularly on small businesses. It is not working. So, you can try other methods.

The Trump administration essentially stopped the growth of regulatory costs by imposing regulatory budgets on the agencies. They gave them a number. Said you cannot do any more than that. The numbers were all zero and negative and had a very big impact. So, Congress could statutorily impose constraints on the regulatory state and say, okay, we need these regulations. Let's find savings elsewhere to offset those costs, keep the burden low. That way you are constantly cleaning out the regulatory overhead. That is virtuous. You have an attempt to do regs at least cost. There is no particular incentive to do regs at least cost now. And you will have less interference in the economy and still get the regulatory outcomes that you want. Congress can have a strong statutory requirement that they do that.

Mr. LUETKEMEYER. My time is just about up here. I would just like to have a general comment here with regards to some of the other folks testifying this morning were talking about basically having a level playing field for small businesses to be able to compete on. That the big guys have got an advantage. So, I guess the question becomes, and I hope we have some follow-up with regards to my colleagues here this morning, are the rules and regulations skewed for the big guys? Do we need to change that? Have they got too much? Not enough? Are the rules and regulations the cost of compliance as Dr. Holtz-Eakin has talked about here in his testimony of $200 billion in 1 year, is that so oppressive that it is taking away the ability of small businesses to compete? I think those are things we need to continue to discuss.

And with that, Madam Chair, I yield back.

Chairwoman VELAZQUEZ. The gentleman yields back.

Now we recognize the gentlelady from Kansas, Chairwoman of the Subcommittee on Economic Growth, Tax, and Capital Access, Ms. Davids, for 5 minutes.

Ms. DAVIDS. Good morning. Well, first of all, thank you, Chairwoman Velázquez and Ranking Member Luetkemeyer for holding the hearing that we are having today.

I represent the Kansas Third District and entrepreneurship is based into the DNA of our community. And we are definitely proud of our small business community. I think what we are hearing now demonstrates that it is undeniable that the economic environment

for small businesses has gotten more difficult. And that was exacerbated by the pandemic.

Small business's share of the GDP has been falling steadily since the 1980s and we have certainly seen increased rates of consolidation and concentration across various industries. And with small businesses being an essential piece of our economy, I am glad that we are getting the time to discuss how our current antitrust laws need to be operating to ensure the competitiveness of our economy.

I was hoping to ask my first question here to Dr. Moss. We have seen this concentration in something like three-quarters of the U.S. industries over the past 20 years, so I was hoping you could take a moment to explain what that means both for consumers and then for the small businesses that are trying to get into these various industries.

Ms. MOSS. Thank you for the question, Congresswoman. I am very happy to answer that.

There have been many studies of rising concentration at the sectoral level, at the industry level. The challenge for antitrust enforcement is to do the research, the empirical research that shows that increases in concentration have resulted in what we call antitrust markets, which are much smaller and narrower for the purposes of evaluating antitrust claims. More generally speaking, we have seen increases in concentration across the board. In airlines, we now have a merger on deck that will increase concentration even more. We have seen it in healthcare, pharmacy benefit managers. We have seen it in hospital systems. We see it in food and agriculture. We have essentially cartels of packers and chicken growers and processors. I am sorry, not chicken growers but chicken processors. That is a real problem. These are all very consumer-facing products and services. So, consumers see it through higher prices, lower quality.

But in these bottleneck supply chains where we see the midstream portion really dominated by just a few firms, market power is exercised going up the supply chain. So, they depress prices to producers and a lot of these producers are small businesses. So, they are squeezed on the top end by getting lower prices for their products. And consumers are squeezed on the back end by paying higher prices. These supply chains are very unstable and they lack diversity that small business is really important historically has served a very important function in promoting. That must be restored through some combination of policy tools to protect this really vital element of our economy.

Ms. DAVIDS. Thank you, Dr. Moss.

Can you, and maybe this is not a good way to ask this, but can you give us like a sense of the industries? You kind of did this a little bit with airlines and then a couple of other things, but can you give us a sense of the maybe most impactful concentrations that we have seen?

Ms. MOSS. Yeah. So, I mean, there is a number of examples we could cite to. Let's go to medical supplies and medical devices, for example. Very famous antitrust case, Becton Dickinson—I am sorry, Retractable Technologies, Inc. v. Becton Dickinson. Small market player. Came to market with a really superior technology, a retractable syringe, up against a dominant player. And really, in

litigation for years. Forced out of the market. Forced to assume a much smaller market share through an innovative product than they would have if there had been more competition in that market. That has a direct effect on small business, and erecting barriers to entry and incentives for other small businesses to form. We are also seeing it, as I said, in other parts of the healthcare supply chain. Take agricultural biotechnology. There are a lot of digital farming startups that are out there. Digital farming is the wave of the future in agriculture. Again, very consumer facing. Unfortunately, a lot of this stuff flies below the antitrust radar, and part of it is a result of this fear factor that smaller firms really are afraid to step forward to complain to enforcers and so the problem goes unnoticed.

Ms. DAVIDS. Thank you for that.

I do have a bill, The Supplies Act that might help us with some of that and I would love to talk to you more about that offline.

Thank you, Madam Chair, and I yield back.

Chairwoman VELÁZQUEZ. The gentlelady yields back.

Now we recognize the vice Ranking Member of the Committee, Mr. Williams from Texas for 5 minutes.

Mr. WILLIAMS. Thank you, Madam Chairwoman and Ranking Member Luetkemeyer.

Main street businesses are the backbone of our communities, and I am proud to be a main street small business owner for 51 years. And I can tell you this, after hearing some of this testimony, profits are good. The government does not create competition; the private sector does. That is just a basic thing that we have. And from rural to urban America, small businesses provide critical competition are an essential source of jobs as we have already heard. Unfortunately, small business owners continue to be burdened by excessive federal regulations and that is really your competition is the federal government, and often lack the resources to comply with the latest rules. And big government is not the answer; big government is the problem.

So, Dr. Holtz-Eakin, the American Action Forum recently reported that the last year alone, the Biden administration addressed the small business owners nearly $201 billion in new regulatory costs and I have also seen numbers of, what, it is 130 some odd million manhours to comply with that. And so, while that figure is astonishing, it further draws attention to how main street American could not possibly be equipped or staffed to closely track these changes to regulatory compliance.

So, my question is, can you compare these high regulatory costs for any other recent time period in our history? And how are small business owners, like me, of convenience stores or gas stations, supposed to be able to handle compliance costs that come with these more heavy burdened regulations?

Mr. HOLTZ-EAKIN. So thank you for the question. First, I want to just say that these are not our numbers. We keep track of all the rulemaking in the federal government and the agencies report their estimate of the costs it will take the private sector to comply with the rulemaking and that is the burden cost and the hours of paperwork that are generated by that rulemaking. We simply keep track of them by agency in total, by legislation. And the $200 bil-

lion in burden costs is the largest single number for the first year of any administration going back to 2005, which is where our data begin. As I mentioned in my opening remarks, the Obama administration was an extraordinary explosion of regulatory costs, over $100 billion a year for 8 straight years. This would exceed that. And I have deep concerns that a big part of the sluggish recovery from the Great Recession and the reduced entry of new firms in that period was due to the regulatory burdens that we were seeing coming out of Washington.

Mr. WILLIAMS. Well, and we know it costs jobs. Small businesses cannot take that so they cut jobs. And banks are a good example hiring more compliance officers and loan officers filters down to small business. So, when we talk to small business owners in Texas where I am from, they are most concerned about how they will have to alter their business operations to manage soaring prices and compensate for inflation that has reached record highs since the early 1980s. And the National Federation of Independent Business reported that more than 60 percent of small business owners across America were forced to raise prices to keep up with the Biden administration's policies that are driving inflation and supply chain. And there are a lot of businesses quite frankly as we all know cannot raise their prices. They are stuck even more. So, all while the Biden administration Democrats continue to dismiss this inflation is transitory, one of the famous statements of all time, turning their back on any real solutions to right the ship. So again, my question is, as an economist, you know the negative impacts inflation has on small businesses. What steps should the Biden administration and Congress be taking to get this growing inflation under control?

Mr. HOLTZ-EAKIN. Well, step number one is no more harm. And so no more stimulus-style legislation. In particular, the Build Back Better Act had all the structure of upfront spending and backloaded pay-fors that a stimulus bill would have so that would be a misstep at this point. So do not do that. Number two, do not complicate the mission of the Federal Reserve. It has mandates for full employment and price stability. That is a hard enough job in this environment. They do not need mandates for inequality or for climate change or other things that the administration might desire but that should not be their job. Number three, add no new costs. So, the regulatory burden is the thing most directly controllable. Keep those regulatory burdens to a minimum certainly, this year and next year when inflation will continue to persist. I think there is little doubt about that. And I do not know how much of a quick U-turn we can do on energy but global energy prices are going to be stressed for the foreseeable future due to the recovery around the globe but now the invasion of Ukraine by Russia. So those are all very important aspects of the inflation problem. Right now, commodity inflation is running at about 20 percent. It will be higher going forward. And that is a supply chain pressure that is going to go straight through to consumer prices. It will not diminish overnight.

Mr. WILLIAMS. And as a small business owner myself, one that deals in inventory is auto industry, it is not going to change in the

next several years. Bottom line is maybe we need to cut taxes again.

Thank you for being here today, and I yield my time back.

Chairwoman VELAZQUEZ. The gentleman yields back.

Now we recognize the gentlelady from Illinois, Ms. Newman, for 5 minutes.

Ms. NEWMAN. Thank you, Madam Chair, and thank you, Ranking Member for having this great meeting and hearing from our guests. Thank you to our guests this morning.

I, first, Madam Chair, I am going to, on behalf of the Authors Guild and Society of Composers and Lyricists, I would like to submit their following testimony for the record. One of the things that they are looking to find solutions for is leveling the playing field through independent artists and entertainment companies. So, these independent workers in the creative economy often go unseen as larger companies monetize their work. So please accept testimony on their behalf,

Chairwoman VELAZQUEZ. Without objection, so ordered.

Ms. NEWMAN. Thank you. And then I have a couple of questions. I will go to Dr. Holtz-Eakin first.

So, I am just curious, can you share the formula by which you use the 2 percent of the inflation attribution, how you cane to that regarding the American Rescue Plan?

Mr. HOLTZ-EAKIN. My estimate, based on looking at the difference between European consumer price inflation and U.S. consumer price inflation over the course of 2020-2021, sorry. From January of 2021 to this January, consumer price inflation went from 1.4 percent to 7.5 percent in the United States. It went from 0 to 4 in Europe. So, it is about half.

Ms. NEWMAN. Okay. I am not sure I agree with it but thank you for explaining.

So, my next question is for Dr. Moss. We heard from Dr. Holtz-Eakin that reduction in interest rate hikes are a good way to curb inflation. I am just curious to get another thought on that. As an economist, can you respond to the impact these strategies might have on small firms, small businesses, and consumers? Thank you.

Ms. MOSS. Thank you for the question. Certainly, inflationary pressures are topline news at this stage in the pandemic. I think treating inflation deserves very careful attention. There are numerous policy tools to deal with inflation. There is monetary policy. There is fiscal policy. Exchange rates, reserve requirements at the Fed. There is a big toolkit involved here.

As far as small business is concerned, certainly higher interest rates would be directly felt by small business as they seek to take loans, to expand, or to build out their businesses. Debt requirements if they are to be used as a tool would also affect small business. So, when you come up with sort of a macroeconomic policy approach to dealing with inflation, I think you have to get to the genuine sources of the problem. But given the importance of small business, I think it is really important to figure out how small businesses are going to be affected by various types of policy tools and what they need most at this stage in this contraction and coming out of the pandemic, which will have lasting effects for many years to come. It will not be over at the end of the pandemic itself.

Ms. NEWMAN. Thank you, Dr. Moss. I have one more question to follow up for you. So, the Biden administration has taken a lot of really strong steps to increase competition. Can you describe the benefits these steps will have in lowering prices and creating a level playing field for small business?

Ms. MOSS. Sure. So, the executive order that the Biden administration put out really takes a whole of government approach to looking at competition problems. It recognizes the very different tools and prongs of competition policy more generally and that includes sector regulation. It includes labor law, intellectual property issues, consumer protection issues. And it recognizes antitrust enforcement. Very much a toolkit kind of approach. And to increase coordination and cooperation across federal agencies as they attempt to really build a strong competition policy.

This is fundamentally the right approach, I believe. Implementing it, of course, the devil is in the details. We have seen several initiatives come out. USDA, for example, is doing quite a bit of work on that. Department of Transportation on airline alliances and the like. So, increasing coordination and cooperation to develop coherent competition policy, but most important, having these tools work together. Antitrust and sector regulation, for example, should work together in a complementary way to bootstrap each other, not to create conflicts where small business or the competitive process is sort of in the cross-hairs of tensions.

Ms. NEWMAN. Well, thank you for the answer. I certainly agree with the complementary and supplementary working together idea very much so. So, thank you, and I yield back.

Chairwoman VELAZQUEZ. The gentlelady yields back.

Now we recognize the gentleman from Minnesota, Mr. Stauber, for 5 minutes.

Mr. STAUBER. Thank you, Madam Chair, and Ranking Member Luetkemeyer, for holding this. And thank you to all the witnesses. I appreciate that.

Dr. Holtz-Eakin, you had just mentioned that the Obama administration brought in $100 billion of punishing regulatory burdens on small businesses for 8 straight years. Is that what I heard you say?

Mr. HOLTZ-EAKIN. That is correct.

Mr. STAUBER. And in your testimony, in the first year, in the very first year of this administration, in a pandemic, this administration brought $201 billion of punishing regulations on small business; is that what you said?

Mr. HOLTZ-EAKIN. That is correct.

Mr. STAUBER. You know, I think we need more people that have signed the front of the checks in small businesses.

Mr. Williams, I have only been a small business owner for 31 years, so you have got 20 years on me. This is unbelievable. You know, my colleagues on the other side of the isle, they said they want to break up big companies and advocate for small businesses. Two hundred billion dollars in year 1 of this administration.

We always talk about small businesses are the engine of our economy. They are the mom and pop shops that struggle every day. And to hear some of the witnesses talk about, well, these regulations are good. They do this or do that. I think government ought

to get out of the way and let small businesses flourish under those prudent regulations that you talked about, Doctor. Reasonable prudent, not redundant burdensome that punishes those small business owners that just want to live the American dream and employ people. This is really frustrating for me to hear this.

To that end, Dr. Holtz-Eakin, in the America Competes Act, how are those provisions? How are they furthering harming small businesses? Can you give us a couple of examples?

Mr. HOLTZ-EAKIN. The America Competes is in many ways, well, it is, industrial policy. The stated intent is to improve the U.S. competitive position, especially versus China. And there are places where there are broad public goods and rules and basic research and innovation that makes sense. But there is some $50 billion in there to build semiconductor plants which the private sector can build semiconductor plants, and if they are not in China, they do not have to be in the U.S. They have to be somewhere so they have diversification of the supply chain. I have no idea why they would move money that was in the Senate bill targeted towards the National Science Foundation and give it to the Department of Commerce to fix supply chains. The Department of Commerce does not have a supply chain. Every American business has their own supply chain. They have every incentive to fix it. And so, I have no idea what that will be other than tilting the playing field to those who have access to the Department of Commerce to get a subsidy. And so, I am deeply concerned about those kinds of provisions.

Mr. STAUBER. Do those kinds of provisions help or harm small businesses?

Mr. HOLTZ-EAKIN. They are not helpful. Small businesses may not yet have started and they are going to now have to enter against someone who has got some help from the Department of Commerce. It is not leveling the playing field.

Mr. STAUBER. So that is getting involved in competing?

Mr. HOLTZ-EAKIN. Yeah.

Mr. STAUBER. You know, to my colleagues on both sides of the aisle on this Committee, we have a responsibility to make sure small businesses across America succeed. My guess is if this keeps up, we are not only going to have $200 billion of punishing burdensome regulations from this administration in year 1; the same thing is going to happen in year 2. How can we do this to our small businesses? They are the engine of our economy. It is the American dream.

When my brothers and I opened up our small sporting goods store in June 1990 and dished out what we had in the bank to open up a small business, and to have this type of regulation, we have an opportunity, Madam Chair, Ranking Member Luetkemeyer, on the Small Business Committee, to make sure that our small businesses flourish in this country. We need these regulations, the reduction in the regulations, not adding $200 billion a year. This is very frustrating.

And this is a challenge for this Committee. Madam Chair, Ranking Member Luetkemeyer, this is a challenge to stop those burdensome regulations.

Madam Chair, I yield back.

Chairwoman VELÁZQUEZ. The gentleman's time is expired. I invite the gentleman to support legislation when it comes to cutting taxes where small businesses are not an afterthought like it happened before.

Now we recognize the gentleman from Louisiana, Mr. Carter for 5 minutes.

Mr. CARTER. Madam Chair and Ranking Member, thank you very much for the opportunity.

My question is for Mr. Lynn. Mr. Lynn, we know that the president signed an executive order calling for a government-wide approach to increased competition for small businesses. Can you share with me what that really means? Because as you can hear the frustration from some of our Members, we continue to hear the pain of our small businesses that we know are the backbone of our economy. Yet, we continue to see small businesses die on the vine, if you will, because they do not have access to resources or because they oftentimes as subs have to wait so long to be paid by a majority firm. These are things that we have talked about for many years and it is frustrating that here we are in 2022 and we continue to hear the same kind of concerns from small businesses that we all acknowledge are critically important to our economy. In plain language, tell me, what are we doing and what can we do?

Mr. LYNN. That is a great question, Mr. Congressman. The Biden administration has taken a radically new approach to competition policy compared to any presidency over the last 40 years. This includes two things. It includes putting much stronger enforcers into the Federal Trade Commission and into the Department of Justice Antitrust Division. And it includes, as you mentioned, taking this whole government approach to competition policy. Together what we see is a radical change in how we are going to enforce the law through the agencies and it is also an approach in which we are going to use every part of the administration to achieve specific ends. Every business person across America right now, every small business, every independent business, including those who own car dealerships should appreciate what the Biden administration is doing to protect you from predatory actors such as Google, Facebook, and Amazon. And also, to create a level playing field in which your ability to sort of use your own tools, your own skills, your own minds to provide better services and goods will be rewarded.

Mr. CARTER. But with all due respect, a part of the problem is small businesses often do not have the requisite tools. They do not always have the requisite skills. Small businesses often need a little bit more help to level the playing field and create opportunity. What are we doing? What can we do to level that playing field? And with no disrespect to the car dealerships, I would like to dig a little bit deeper and talk about the truly small businesses. Those who do not have consultants, lawyers, and accountants to help them wade through regulations. What are we doing for the mom-pop, the small drug store, the small sandwich shop or restaurant or barber or beauty shop, people that are struggling but they employ people and they collect sales taxes for police and fire but they need help?

Mr. LYNN. Yeah, that is a great question as well. Traditionally, in the United States, we have provided, one, a fair field so that people can compete without predation. But we have also made sure that people have the capital they need. That they have the skills that they need. This is a role that government has fulfilled for 200 years in this country. This is not something new. It is not something that The New Deal created. It goes back to the founding of this country. And when people talk about the idea that people create competition, yeah, they do. But what they do, they create competition by using government to make it possible for them to succeed. And so, as we go forward, we should be looking at new ways to provide the kinds of funding that small businesses, truly small businesses, the kind of credit they need to succeed.

Mr. CARTER. I am sorry to cut you off. I have got about 45 seconds and I want you to, if you could, zero in on access to capital. Because many small businesses fail because they do not have enough capital to sustain themselves when they are starting a new business. Small businesses fail because they do not have that technical expertise and capital. Is there a program and how are you addressing those issues for small businesses?

Mr. LYNN. It has been a disaster over the last 40 years. This country used to be set up to provide capital to anyone who really needed it. We had community banks. We regulated our commercial banks. We ensured that if you needed capital, you could find it someplace and get it at a reasonable price. You did not have to pay predatory prices. So, we have a number of ways in which we can actually deal with this right now but we have got to get studying what we did for 200 years in this country and not what we did for the last 40 years because that has been choking off credit to our needy small businesses.

Chairwoman VELAZQUEZ. The gentleman's time has expired.

Now we recognize——

Mr. CARTER. Madam Chair, thank you. I yield.

Chairwoman VELAZQUEZ. We recognize the gentleman from Pennsylvania, Ranking Member of the Subcommittee on Economic Growth, Tax, and Capital Access, Mr. Meuser for 5 minutes.

Mr. MEUSER. Thank you, Madam Chair. Thank you, too, Ranking Member Luetkemeyer.

It is certainly a somber day here in the Small Business Committee on a number of fronts, but seeing our friend's nameplate and him not behind it is very, very sad. Jim told it like it was. Telling the truth was always the only option because our country's national security and economy is truly at stake. So, let's get into this.

In my district, you know, all this idea that the biggest problem small business has is big business, in my district, with the exception of big tech, and I was in business for 25 years and I served as revenue secretary for the Commonwealth for 4 years, so I saw all the taxable incomes and who was doing what and so forth. With the exception of big tech these days and online retailers, and definitely Amazon, big government is not the problem. Or excuse me, big business is not the problem for small business. It is big government.

So, let's unpack this a little bit. Let's talk about it. Dr. Holtz-Eakin, so in the BBB, our friends who passed it, thought it was a

wonderful idea to tack on a 3.8 percent surtax on investment income for pass-throughs. Was that good for small business?

Mr. HOLTZ-EAKIN. No. And before I expand on that I will just point out that if you look at the NFIB Monthly Survey of Small Businesses, that never is competing with large business mentioned as their biggest problem. That is mentioned by 1 percent of people.

Mr. MEUSER. Precisely. Precisely. And my me search reflects your research throughout all of my district and I visit my small businesses regularly.

Let's try to do a little bit of——

Mr. HOLTZ-EAKIN. So the surtax——

Mr. MEUSER. Go ahead.

Mr. HOLTZ-EAKIN.—just remember that more than half of all business income is taxed on individual income tax returns. It is not taxed on C corporations.

Mr. MEUSER. Precisely.

Mr. HOLTZ-EAKIN. So that is where you are going to hit small businesses.

Mr. MEUSER. Right. And under 400K in income. It is hurting their taxable income for a small business and then some.

Would making the Trump tax cuts permanent be good for small business?

Mr. HOLTZ-EAKIN. Yes. The uncertainty is a bad idea.

Mr. MEUSER. Predictability, keeping it where it is, they know where they are going to be the following year. Because as we well know, a tax is nothing more than added cost. And if we think it is a great idea to make cost of our businesses, large and small, higher than it is worldwide, well, then you know, somebody is going to have to dispute gravity for me because it simply does not work that way. And, of course, profits lead to more investment in your company, lead to higher taxable incomes, which in fact, lead to higher revenues in the coffers of our Treasury.

So are heavier regulations good for small business?

Mr. HOLTZ-EAKIN. No.

Mr. MEUSER. Dr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. No. I mean, there are——

Mr. MEUSER. Two hundred 10 billion dollars added this year, that is not something that small business is benefitting by?

Mr. HOLTZ-EAKIN. So there are benefits to regulation. They had better be bigger than $210 billion. So, I have some questions about that.

Mr. MEUSER. Very often government's intent is a far cry from what the end results are because it is ridiculous to think that the regulations of 14 months ago somehow are so much better today at a cost of $210 billion that are helping somebody, it is not helping anyone but a bunch of bureaucrats work on forcing it.

So is government spending, heavy government spending, trillions of dollars in government spending a cause or an inhibitor of inflation?

Mr. HOLTZ-EAKIN. It is one of the causes of the U.S.——

Mr. MEUSER. One of the causes of inflation.

Is inflation good for small business?

Mr. HOLTZ-EAKIN. No.

Mr. MEUSER. No. Inflation is not good for small business. It robs small business and it leads to higher interest rates. Are higher interest rates good for small business?

Mr. HOLTZ-EAKIN. No.

Mr. MEUSER. Okay. We are the Small Business Committee. We are supposed to be advocates for small business. These policies are not exactly advocating for small business, would you not agree?

Mr. HOLTZ-EAKIN. They are not good for the business community as a whole.

Mr. MEUSER. No. So how about workforce? Is government competing, providing benefits to workforce and making workforce less available? Is that good for small business?

Mr. HOLTZ-EAKIN. We have a very big workforce problem in the United States right now and it is in part due to the policies of the CARES Act and some successors. It is also due to a failure to have an effective public health mission against the pandemic which has harmed labor supply in both the number of people and how much they can work.

Mr. MEUSER. Big government meddling. No question.

Is higher gasoline prices good for small business?

Mr. HOLTZ-EAKIN. No.

Mr. MEUSER. Spikes in gasoline prices is an assault on our domestic energy industry, which in my district contains many, many small businesses, suppliers, providers. Is that assault that is taking place on our domestic energy, let alone the national security issues, is that good for small business?

Mr. HOLTZ-EAKIN. That was one of the success stories of the post-Great Recession recovery was——

Mr. MEUSER. Absolutely. Particularly in Pennsylvania.

Mr. HOLTZ-EAKIN. Yeah.

Mr. MEUSER. So I think we should let small business be the most competitive in the world and let large business be competitive as well and focus on the things that we actually can control which are government regulations and taxation.

I yield back.

Chairwoman VELÁZQUEZ. The gentleman yields back.

Now we recognize the gentleman from New York, Mr. Garbarino, for 5 minutes.

Mr. GARBARINO. Thank you, Madam Chair.

I have a couple of questions for Dr. Holtz-Eakin.

You just heard a couple of my colleagues mention $210 billion, $200 billion in regulatory costs. But I do not think people understand, you know, what that means in only a year. Can you explain? Can you just go a little further into, you know, we have seen $210 billion in additional regulatory costs. Can you talk about what we have seen in previous administrations and why that $210 billion is so big?

Mr. HOLTZ-EAKIN. So what we do is we keep track of all the regulatory costs as reported by the agencies themselves, and we simply total them by agency. And in this case, for the federal government as a whole. We do not have compete records of the Bush administration, so I cannot comment on that. The Obama administration, as I mentioned, had about $895 billion of regulatory costs over the 8 years of its time in office. The Trump adminsitratino

had, I forget the exact number, a modest double-digit increase, under $20 billion over its 4 years. And now the Biden administration, we have 1 year of data. It is $200 billion in the first year.

Mr. GARBARINO. What was the Obama number again over 8 years?

Mr. HOLTZ-EAKIN. Eight hundred ninety-five billion dollars in new costs.

Mr. GARBARINO. So $895 billion in new costs over 8 years.

Mr. HOLTZ-EAKIN. Yes.

Mr. GARBARINO. That is a little over 100. Twenty billion over 4 years for President Trump.

Mr. HOLTZ-EAKIN. Yes.

Mr. GARBARINO. And we are seeing $200 billion in 1 year alone under this current administration in regulatory costs. Prior to coming to Congress, I was a private practice attorney in New York which had high regulatory costs but my colleagues from New York are on this call also so they can also comment on the regulations coming out of New York. And we saw businesses leaving the state in droves because of these regulatory costs. I just know, I mean, can you talk about what these $200 billion in 1 year, what that will do to small businesses?

Mr. HOLTZ-EAKIN. We see some examples historically of what high regulatory costs do. So, for example, the Sarbanes-Oxley Law was intended to control big businesses and their accounting practices in the aftermath of the Enron and WorldCom scandals. That was a legitimate concern and public purpose. But it is extremely costly to comply with Sarbanes-Oxley. And as a result, we have seen the number of initial public offerings cut in half since the 2000s. That means that small businesses starting up are less likely to be able to pay off their venture investors by going public. They are going to have to be bought by somebody or have some other method of getting the money. So that hurts small business startups. There is no question about it. And it is from the regulatory costs of compliance with a well-intended public law.

Mr. GARBARINO. I appreciate those answers, Doctor.

When I talk to small businesses in my district, it is not just about high regulations, more regulations, and how tough it is to do business. But I am really starting to hear a lot about inflation. And my question specifically for you is, are the inflation levels that we are seeing here in the U.S. unique or is this something that is being experienced all over the world?

Mr. HOLTZ-EAKIN. There has been a rise in inflation globally but the levels in the United States and the increase in 2021 of inflation is unique to the United States. So, the headline number is 7.5 percent for consumer price inflation. If you look at the bundle of food, energy, and shelter, which is 50 percent of the typical family's budget, that went from 1.4 to 8.1 percent during the course of 2021. So, it is the sharpest rise on the globe.

Mr. GARBARINO. So what does that do to us as a country in competitiveness?

Mr. HOLTZ-EAKIN. Inflation is bad news from every dimension. And this will hurt our ability to compete with other countries.

Mr. GARBARINO. Two hundred and 10 billion dollars in regulation costs. Highest inflation compared to other countries in 1 year.

I think we are definitely going the wrong way, especially in how we can help small business.

I appreciate your testimony today, your answering the questions. Thank you very much for being here.

And Chairwoman, I yield back.

Chairwoman VELAZQUEZ. The gentleman yields back.

Now we recognize the gentlelady from California, Ranking Member of the Subcommittee on Innovation, Entrepreneurship, and Workforce Development, Ms. Young Kim, for 5 minutes.

Ms. YOUNG KIM. Can you hear me? All right.

So, I want to thank our Chair and Ranking Member. And I really want to thank you so much for opening our hearing today in honor of our colleague, Congressman Jim Hagedorn. I thought that was very special to give a special tribute for him. I also want to thank our witnesses for joining us.

I think we can all agree that we all want fair competition and a level playing field for our small businesses which are the backbone of our economy.

The reality is that most small businesses in my district are not raising the antitrust laws being discussed here. They are complaining about the labor shortages, higher prices, and increasing red tape to establish and expand their small businesses. While consolidation of businesses can destruct markets in certain industries, the Committee should be more focused on how the federal government can negatively impact competition and small business success through more regulations, higher taxes, and ill-timed fiscal expansionary policies.

So let me ask this question to Mr. Holtz-Eakin. On February 10, the Department of Labor reported that the CPI registered a 40-year high of 7.5 percent when measured year over year. So, can you describe how legislation that increases spending like the American Rescue Plan has contributed to higher costs for small businesses and families?

Mr. HOLTZ-EAKIN. Certainly. What we saw was an economy that in the first quarter of 2021 grew at 6.5 percent. That was how fast it was growing when the American Rescue Plan was passed. As you know, trillions of dollars were sent out in checks to state and local governments and other government spending. That produced for goods and services is broadly defined. And in the classic case of too much money chasing too few goods, we have seen prices rise beginning then and throughout 2021. This got exacerbated by some worldwide conditions, a pandemic. Also, worldwide increases in commodity prices and energy prices so that we now have producer price inflation that is running about 10 percent that leads to even further consumer price inflation in the future.

Ms. YOUNG KIM. Do you think we lack more coordination in our fiscal and monetary policies?

Mr. HOLTZ-EAKIN. That was an example of extremely loose fiscal and monetary policies simultaneously. Those generally produce more demand. Demand was not the problem in the pandemic. The problem was the virus and the inability of people to go out and conduct their economic affairs. Income rose throughout the pandemic. Wealth rose throughout the pandemic. There was no need for such excessive stimulus to demand which was already well in place.

Ms. YOUNG KIM. Thank you.

You know, we have discussed the decline of entrepreneurship in the last several decades. And in your written testimony, you stated between 1975 and 2011, an average of 183 new banks were chartered annually. However, between 2012 and 2019, that number dropped to just four. Only four banks were chartered in 7 years. So clearly, regulations are choking capital and credit access for entrepreneurs with less banks being chartered. Can you elaborate on how regulatory barriers are curtaining access to capital for small businesses and entrepreneurs?

Mr. HOLTZ-EAKIN. I think this example almost speaks for itself. The best discipline you can have for large banks that fail to serve different aspects of communities of color or geographic areas is to have new entrants who are willing to do that business to make money. But, the regulatory apparatus that came with Dodd-Frank is extremely expensive. Hard for a new bank to set up and comply. And we have seen very little entry as a result. So, we are not getting the discipline that comes from new entrants providing innovative services and products to underserved markets. And that is the most consistent route to success in the U.S.

Ms. YOUNG KIM. In the remaining time, I want to ask you for your opinion. What are the long-term repercussions for our economy for families and small businesses if the inflation continues to outpace nominal wages and income?

Mr. HOLTZ-EAKIN. We have seen long periods of inflation in the past in the United States. In the late 1960s, the government ran the economy very, very hot for 24 straight quarters and we got sustained high inflation in the 1970s and into the early 1980s. It was taken out of the economy only by a deep and very painful recession. And so, what you see in that period is sustained high inflation, sustained high unemployment, poor productivity growth, a failure to grow adequately as a nation, standards of living not rising. And the "solution" being a deep recession that harms everyone in America. That is not a future we want.

Chairwoman VELAZQUEZ. Time has expired.

Now we recognize the gentlelady from Texas, Ms. Van Duyne, for 5 minutes.

Ms. VAN DUYNE. Thank you very much, Chairwoman Velázquez and Ranking Member Luetkemeyer.

If the last 2 years have taught us anything through a global pandemic, supply chain troubles, and a rough labor market, our small businesses are the first to feel the dire consequences of economic difficulty. Yet, as large companies have tapped into their vast resources to ease supply chain issues and quickly have raised prices to counter high labor costs, our smallest employers do not have those options. As I have said many times before, our entrepreneurs do not want more handouts from the federal government. What they want is a fair opportunity to start and grow their businesses without government interference, something this administration has failed to provide.

Recently, the Small Business Administrator joined me for a roundtable with small business owners from across the district and they all repeatedly brought up the same issue. Their margins are being destroyed by the skyrocketing energy costs directly caused by

this administration's push to rely on foreign oil supplies, even amidst a global conflict. There is no doubt that our small businesses are continuing to struggle to compete with big companies. We need to stop the frivolous spending and antigrowth policies created by this administration.

I appreciate all the witnesses being with us today and I apologize. You have been under the wire a lot today. You have answered the majority of questions. The first time that you and I met I was really impressed when I asked the question about regulatory reform, regulations, the cost of regulations for all of us, but especially for small businesses. You gave me some very direct answers and solutions to those questions. Can you kind of explain what you explained to me at that time?

Mr. HOLTZ-EAKIN. Certainly. It is certainly within the purview of the Congress to place more constraints on the regulatory state in the rulemaking activities in every agency. The Regulatory Flexibility Act was intended to make sure that unnecessary regulations and excessively burdensome regulations went away. That does not happen. There is no genuine lookback to answer the question, if this regulation was once a good idea, is it still a good idea? So, you can do that. You can——

Ms. VAN DUYNE. Would you do that by like setting like a sunset provision on regulations?

Mr. HOLTZ-EAKIN. HHS did a preliminary rulemaking on a sunset where everyone of its own rules had to be examined. And if it was deemed to be unnecessary or not working it was going to go away. That just got repealed by the Biden administration. That is the only attempt to do that that I have seen in recent history. So, you could put that in as a statutory requirement and enforce it. You could put regulatory budgets in. That was the Trump administration administrative approach. You could make that a statutory approach.

Ms. VAN DUYNE. What was that?

Mr. HOLTZ-EAKIN. Regulatory budgets. At the Department of Interior, you get a number. You could do that.

Ms. VAN DUYNE. But expand on what that means.

Mr. HOLTZ-EAKIN. What it says is that if you are an agency and you have a regulatory budget of say $20 billion and you have a rulemaking that is going to cost $40 billion, you have to find a way to reduce other regulatory burdens by $20 billion because you have a budget for increased costs to be imposed on the private sector. That gives all sorts of good incentives. You do the original rulemaking as cheaply as possible. Forty has to be the cheapest possible way to get that done. And then you are also always reviewing old regulations to see if you do not need them so you can find your $20 billion dollars in savers. And the stabs are permanently incentivized to keep track of what the old ones are doing and what they cost so that you can have a saver in hand when you need to pay for something. It is the same phenomenon we see with pay-for regulations in the Congress for budgetary purposes. You have to have a way to go pay for a piece of legislation. You have to know what other pieces will provide those savings. So those are good incentives to instill into agencies. They do not exist at all right now. There are no incentives now.

Ms. VAN DUYNE. That is an easy statutory fix.

Mr. HOLTZ-EAKIN. It is an easy thing to pass and then you will have to build the culture to enforce it.

Ms. VAN DUYNE. But actually having built it in, look, I used to work for HUD. I understand how difficult it is within the bowels of our bureaucratic beast, how difficult it is. But if that is the regulations that they have to follow, if that is the budgetary, it is a lot easier to get things done, I guess to create the sense of policies that we are talking about.

Mr. HOLTZ-EAKIN. Heavily anecdotal evidence from talking with permanent staff and agencies during the Trump administration, but they certainly began to get the game which is, okay, we are not going to have any flexibility so we need to have ways to save money with rulemakings. Here is a couple we will put in our back pocket for when the top floor calls down and says we need something.

Ms. VAN DUYNE. And that would save money not only for the federal government, but then it would also relieve a lot of the regulatory red tape and burdens on small businesses.

Mr. HOLTZ-EAKIN. These costs are not federal budget cuts. These are costs imposed exclusively on the private sector and that is where the savings will accrue.

Ms. VAN DUYNE. Excellent. Thank you.

Chairwoman VELÁZQUEZ. The gentlelady's time has expired.

Now we recognize the gentlelady from New York, Ms. Tenney, for 5 minutes.

Ms. TENNEY. Thank you, Madam Chairwoman.

I, too, would like to join with my colleagues in recognizing and remembering Jim Hagedorn, Representative, who was just a great friend, great Member of the Committee, and my condolences to him, to his family, and to his friends. It is tough in the Committee without him.

But I wanted to say thanks again to the Chairwoman and the Ranking Member for holding this meeting today. And thanks to our witnesses for appearing before the Committee. This hearing will hopefully play an important role in the lively debate that we have across the nation and the future of antitrust in the United States.

In recent decades, increased corporate concentration, lagging dynamism, and lacking competitiveness prior to the COVID-19 pandemic, historically low rates of firm formation, and death point to the need for improvement. As the House Small Business Committee, we have an important role to play in investigating and highlighting the impacts of market concentration and antitrust measures of America's firms. In the Antitrust Law, a one dimensional emphasis on consumer prices or the consumer welfare standard is most certainly come at the cost of the interests of American producers and our national industry capacity. The key to getting the antitrust question right is to strike the proper balance between prioritizing low-cost goods for consumers, fair competition for U.S. producers, and the need for a self-sufficient national economy that can sustain stable, well-paying jobs, and provide for the common welfare during times of crisis.

In addition, the consumer welfare standard is not always the most applicable lens through which to evaluate antitrust matters.

Take for example the digital economy where products are often free to users, such as the case of meta platforms known as Facebook. Another example is Amazon which offers cheap goods to American households supported by subsidies from its web services for which the government is a major customer. In this example, American producers, including many small businesses like my own, are undercut by inexpensive, sometimes dangerous, counterfeit foreign goods while consumers receive lower prices. In this example it is obviously insufficient to look only at what consumers pay.

Small businesses are not only important because they are small but because they are often flexible and have great growth potential. In addition, they have connections to their communities and workers in ways that larger firms cannot replicate. We saw many examples during the pandemic. Policymakers must therefore be cautious of taking actions and passing laws that will make it more difficult for these small businesses to grow, hire more people, and benefit from the economies of scale, which can make work higher paying and contribute to technological growth.

On the other hand, lax enforcement of antitrust laws are in action in the face of serious market concentration also harms the ability of these smaller firms to form and grow. Antitrust measures can be a powerful tool. They must also be used judiciously and applied in ways that are not subjective. Instead, I would like to focus more on dynamism, innovation, and the ability to let small businesses grow. As a small business owner, I know that many of my customers that rely on their newspaper were negatively impacted by the onslaught of Walmart and big box stores.

So, I want to just take my first question and direct it to Dr. Holtz-Eakin. And some of the Members on the Committee have said that the market concentration has been the primary reason for rising costs and the rates if inflation. And I think my colleagues and I witnessed some of the things the Democrats have taken advantage of during the pandemic last year and the year before is to flood the economy with endless cash. To me, this seems to be far more likely an explanation for the crushing inflation Americans are experiencing. Is that something that you would agree with, Mr. Holtz-Eakin? Or Dr. Holtz-Eakin? I feel like it is the huge cash that is actually creating a lot of this problem as the primary reason. What would you say to that?

Mr. HOLTZ-EAKIN. I would agree with you, Congresswoman. On the issue of somehow concentration being the source of economy-wide inflation, there simply are no data that show across the board increases in concentration that would be a plausible explanation for the sharp rising prices across every sector and across all geography. So, the cash is a much more plausible candidate.

Ms. VAN DUYNE. What do you think that we should do in Congress to deal with this potential problem with anti-competitiveness and concentration? What would you do? What do you think we could do now other than, obviously to me, lowering regulations, less taxes would help our small business but what else do you recommend that we can do as a Small Business Committee?

Mr. HOLTZ-EAKIN. Well, I would be happy to give you a longer answer for the record since time has expired.

Ms. VAN DUYNE. Okay.

Mr. HOLTZ-EAKIN. But certainly, I think the focus should be on ease of entry and the dynamism you focused on.

Ms. VAN DUYNE. Thank you very much.

I yield back.

Chairwoman VELÁZQUEZ. The gentlelady yields back.

Now we recognize the gentleman from Wisconsin, Mr. Fitzgerald, for 5 minutes.

Mr. FITZGERALD. Thank you, Madam Chair. And I also wanted to thank you for your recognition of Congressman Hagedorn. Great guy and we are all going to miss him very, very much.

A question for Mr. Eakin. There has been a lot of discussion here today and we have spoken in the past about this assumption that big is bad and that the concentration is inherently harmful to competition. However, I think kind of the jury is out. And as we move through a new phase of America's post-COVID economy, it is probably settled that economics of scale yield efficiencies; right? And I am just wondering what your thoughts are on that. And I know it is a broad question but would love to hear your take on that.

Mr. HOLTZ-EAKIN. Well, thank you. Certainly, I do not think anyone should somehow say vigorous enforcement of antitrust is a bad idea. It is a good idea and there are reasons for this. But asking the right question and taking a disciplined approach to the analysis is very important. And I think the consumer welfare standard has provided tremendous discipline to the analysis of competition policy. It does not matter if you are big or small. The question is whether you are good or bad for Americans. And so, concentrating the analysis to make sure that you follow all the way through to the American household and the consumer is a very important part of this. The reason the United States has relied on private enterprise in competitive markets to deliver goods and services is that it has been the most effective way and has led us to be the largest, strongest economy on this globe. Having an antitrust approach that mirrors that is a perfectly sensible idea and I think we should continue to do that.

I am concerned about some of these other approaches. There are these pieces of legislation, in the Senate, for example, that target platforms and app stores and they single out those bigger than $600 billion. Why is that the right number? Why is that big and $500 billion is not big? What happens when you do that? Does it help small businesses? Well, if it inhibits their ability to acquire small businesses who cannot do an IPO and where that sale is how they pay off their venture investors, they are going to hurt small business. They are going to hurt that environment. I think there are some legitimate concerns about the privacy and national security implications of those proposed legislation. There is a Chamber of Commerce report on it.

So, I guess what I am concerned about is the unintended consequences of taking an ad hoc approach to doing competition policy—writing legislation, targeting a few American firms, some which you can name by name, and people do. Let's have a set of principles that make some sense and will support the capacity of every firm to succeed if it does good business.

Mr. FITZGERALD. Very good. And if I could just follow that up really quickly. I was also a Member of the Judiciary Committee.

What we have seen is that the FTC and to some extent even DOJ, I mean, these mergers have kind of ground to a halt. And that is kind of a strange message that is being sent to the private sector and I would also say that as a result of that, many of these small businesses that oftentimes find themselves in a position where they have to liquidate after first struggling for some period of time, the best way is to be acquired or some type of merger with a smaller entity and at the end of the day it is kind of a win-win for everybody. And I do not think we should ever take that off the table. I am wondering if you had a comment on that.

Mr. HOLTZ-EAKIN. Well, for me, I have never felt that it is the government's job to dictate business models. Firms can acquire new divisions. They can do capital investments, build new divisions. They can configure themselves as they see fit. What matters is their conduct in the marketplace and whether it is harmful to the American household. And that should be the focus, not how businesses choose to configure themselves and making decisions in advance about what is and is not an appropriate business model. I do not think the government should be in that business.

Mr. FITZGERALD. Thank you, Madam Chair. And I will yield back.

Chairwoman VELÁZQUEZ. The gentleman yields back.

Thank you again to all of our witnesses for your testimony today. Creating an environment where American small businesses can compete and thrive is one of the Committee's top priorities. So, we must ask ourselves, what type of economy do we want to foster for American entrepreneurs? One where small businesses have the chance to develop and reach their full potential. I think we can all agree we want to create a nurturing environment for our nation's small firms. As always, I look forward to working with my colleagues on both sides of the aisle to pursue policies that help level the playing field for American small businesses.

Without objection, Members have 5 legislative days to submit statements and supporting materials for the record.

If there is no further business to come before the Committee, without objection, we are adjourned. Thank you all.

[Whereupon, at 11:56 a.m., the committee was adjourned.]

APPENDIX

Competition and the Small Business Landscape:

Fair Competition and a Level Playing Field

United States House of Representatives

Committee on Small Business

Douglas Holtz-Eakin, President

American Action Forum*

March 1, 2022

* The views expressed here are my own and not those of the American Action Forum. I thank my colleagues Dan Bosch and Thomas Wade for their insights and assistance.

Chairwoman Velázquez, Ranking Member Luetkemeyer, and members of the Committee, thank you for convening this hearing and providing me with the opportunity to appear today and share my views on the regulatory burdens, financial barriers to entry, and macroeconomic headwinds impacting small businesses.

In my testimony I wish to make three main points:

- The recent focus on market concentration and large, publicly traded companies obscures the important fact that small businesses are the lifeblood of the economy and essential to continued recovery from the COVID-19 recession;
- Policies that support the ability of new firms to start-up, enter markets, and innovate are the most reliable route to and fair and effective competition across the economy; and
- Firms benefit from a macroeconomic environment characterized by price stability and full employment, in contrast to the damaging inflation and impaired labor markets currently facing small businesses.

Let me consider these in turn.

Small Businesses and the U.S. Economy

The heated public commentary about increasing market concentration, online giants, and new approaches to antitrust policy threatens to convey a misleading portrait of the U.S. economy. The United States is home to 32.5 million small businesses representing 99.9 percent of all businesses. Over 60 million employees constitute 48.6 percent of the total private workforce, and small businesses created 1.6 million new jobs in 2019 – over 80 percent of job creation in that year.

Small businesses contribute across the entire economy (see table below) and most small businesses are in sectors of the economy that also contain larger competitors. This implies that it is very important that policies not tilt the playing field among firm sizes, allowing the competition to continue in a fair fashion.

Small business employment and payroll by industry

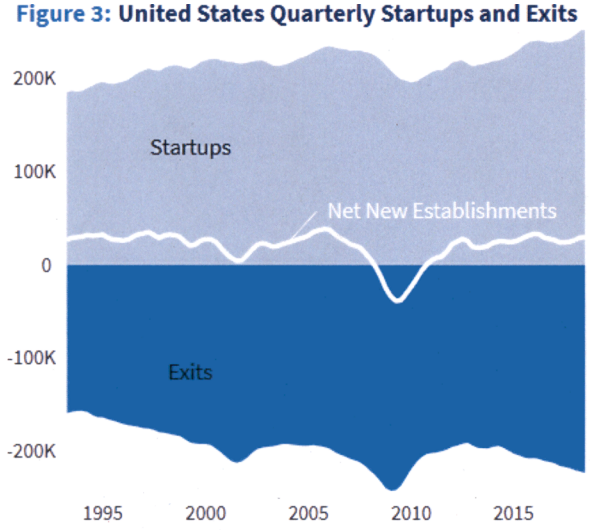
	Employers		Employment		Payroll ($1,000s)	
Industry	Small	%	Small	%	Small	%
Professional, Scientific, and Technical Services	817,775	99.6	5,259,413	57.7	403,772,227	50.4
Construction	718,285	99.8	5,572,962	81.8	329,198,011	76.8
Other Services (except Public Administration)	700,177	99.8	4,736,342	84.6	151,225,071	80.0
Health Care and Social Assistance	659,354	99.3	9,064,362	44.2	378,490,065	36.4
Retail Trade	640,558	99.6	5,498,587	35.1	188,107,293	41.1
Accommodation and Food Services	546,586	99.5	8,688,379	60.6	167,696,424	57.6
Administrative, Support, and Waste Management	347,975	98.8	3,802,335	30.9	150,476,792	29.4
Real Estate and Rental and Leasing	319,692	99.6	1,481,216	67.0	77,607,070	63.2
Wholesale Trade	290,794	98.9	3,390,716	55.0	213,346,333	47.4
Manufacturing	242,195	98.4	5,079,058	42.6	259,718,593	36.2
Finance and Insurance	237,533	99.3	1,903,886	29.3	162,022,396	24.1
Transportation and Warehousing	190,408	98.8	1,719,572	34.2	78,455,197	29.9
Arts, Entertainment, and Recreation	133,608	99.4	1,458,450	59.9	53,198,081	60.3
Educational Services	94,222	98.6	1,684,311	45.1	58,485,906	39.4
Information	81,001	98.5	987,519	27.4	77,881,093	20.2
Agriculture, Forestry, Fishing and Hunting	22,626	99.6	138,005	84.2	6,144,459	83.6
Mining, Quarrying, and Oil and Gas Extraction	18,706	98.1	261,547	43.2	22,019,535	38.5
Management of Companies and Enterprises	18,553	70.2	393,039	11.1	31,945,559	8.1
Industries not classified	12,157	100.0	13,875	100.0	448,866	100.0
Utilities	5,823	96.6	110,457	17.1	8,850,934	12.6
Total	6,055,421	99.7	61,244,031	46.8	2,819,089,905	39.7

Source: Statistics of US Businesses, 2018 (Census)

Small Business and Competition

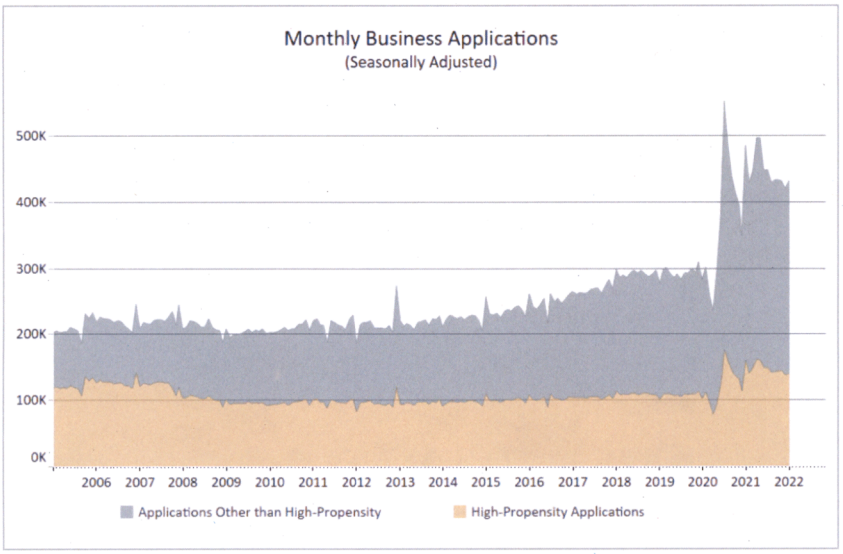
Looking at a single year, as in the table above, misses the dynamism brought to the economy by new businesses. In recent years, roughly 200,000 new businesses start up each year, and a slightly smaller number exit. This reflects competitive markets, and something that policymakers should preserve and enhance. For example, between 1985 and 2011, an average of 183 new banks were chartered annually. However, between 2012 and 2019 that number dropped to just four. This suggests that the policy environment in financial services is precluding sufficient entry to enhance competitive pressures.

Figure 3: United States Quarterly Startups and Exits



Source: Small Business Administration

These dynamics are especially visible and important in the recovery from the pandemic recession. There has been an increase in the number of applications to start companies. 2021 saw 5.4 million applications, a 53 percent increase over 2019 pre-pandemic figures. A third of these applications are considered "high propensity," or likely to themselves have payroll and create further jobs. Even though entrepreneurship is surging, 50 percent of these businesses will fail in the first five years.



Source: census.gov

Regulatory Burdens on Small Businesses

The disproportionate impact of regulatory burdens on existing small businesses, and their importance as a barrier to new entrants, has been well known for decades. This phenomenon is what prompted enactment of the Regulatory Flexibility Act (RFA) in 1980. While the RFA helped direct agencies' attention to the problem, it has not solved it. A series of studies conducted for the Small Business Administration's Office of Advocacy through 2010 consistently showed that small businesses bear a heavier burden from regulations than large businesses.[1] During the Obama Administration, when regulatory costs exceeded an average of $100 billion per year, the National Federation of Independent Business reported that "government regulation" was consistently a top-three answer in its Small Business Economic Trends survey when respondents were asked to identify their single biggest problem.

Early results from the current administration indicate that costly regulation will likely go beyond that of the Obama Administration. The American Action Forum has tracked the cost of final rules published in the Federal Register since 2005.[2] Last year was the second-costliest year on record, behind only 2012. And the costs in the first year of the administration, $201 billion, are the highest first-year total over that period.

These extraordinary regulatory costs will impose a disproportionate burden on small businesses, which often lack in-house compliance experts to handle mountains of paperwork and complicated technical requirements. In addition, overly burdensome regulations can erode the already small margins that many small companies operate on. Reducing these regulations can help improve the competitiveness of small businesses.

Congress should consider enacting regulatory reform legislation that requires agencies to better assess and take into consideration regulatory costs and benefits. Options include reforming the 76-year-old Administrative Procedure Act, which was not designed for some of today's massively expensive rules; reforming the RFA to require agencies to consider clearly foreseeable indirect costs and get feedback on possible regulatory options from small entities *before* a rule is ever proposed; codifying a regulatory budget similar to the one that worked to limit regulatory costs during the Trump Administration; and requiring agencies to identify at the time they publish rules how they will measure the success of those rules.

Tilting the Playing Field

An example of tilting the market playing field is the America Creating Opportunities for Manufacturing, Pre-Eminence in Technology, and Economic Strength (America COMPETES) Act. (Similar legislation, the United States Innovation and Competition Act (USICA), was passed by the Senate.) The stated intent of the bill is to raise the United States' domestic and global competitiveness, especially in relation to China. In doing so, however, the bill engages in industrial policy that would place a heavy federal hand in private industry. This raises two concerns. First, it introduces a bias toward current firms (with no provision for future entrants). Second, it interferes with competitive forces and could waste billions of taxpayer dollars.

The Macroeconomic Environment

Firms benefit from a macroeconomic environment of price stability and full employment. At present, this is hardly the situation. The January report on the Consumer Price Index (CPI) showed year-over-year inflation of 7.5 percent, up from 1.4 percent in January 2021. Even worse, the year-over-year composite inflation for food, energy, and shelter – over 50 percent of the typical family's budget – is up from 1.4 to 8.1 percent.

The 6.1 percentage point 12-month jump in CPI inflation has been rivaled only twice in the postwar era: In 1951, it jumped as much as 10.6 percentage points and in 1974, it rose 6.1 percentage points. Both episodes are instructive.

The 1951 episode is a cautionary tale about overstimulating the economy. In this case, year-over-year growth in gross domestic product entered the year in double-digit territory, and Korean War-related defense production layered on year-over-year growth in

government spending that peaked at 49 percent in the third quarter. The lesson is that excessive government spending in a hot economy can quickly fuel inflation.

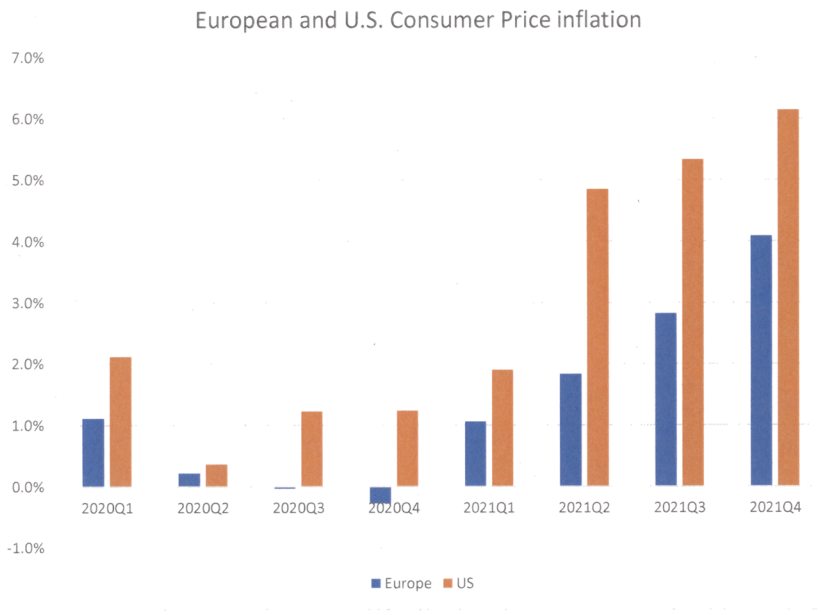
In contrast, the 1974 episode demonstrates the exact opposite of demand stimulus. Instead, it features a huge supply cost shock – the quadrupling of oil prices due to the OPEC oil embargo. Lesson: Cost increases borne by supply problems can quickly be passed along to consumers, even if the economy is moving toward recession.

The inflation of 2021 reflects a combination of these forces. The COVID-19 pandemic has wreaked havoc on labor markets worldwide, and the resulting disruptions in supply chains and goods production have been well-documented. The tangled supply chains in the United States and elsewhere reduced the effective aggregate supply, an impact similar to the 1974 experience. Given "normal" demand conditions (for a pandemic, that is), this might produce some inflation. Indeed, this was essentially the administration's argument for months: "We didn't do it. It just happened."

If that were true, then the pick-up in inflation would be the same across the globe. As shown in the chart below, consumer price inflation did pick up in Europe (and a similar chart exists for Asia, etc.). Inflation was about 1 percent in the 1st quarter of 2021, and then rose about one percentage point each quarter to close at 4 percent in the 4th quarter. (Data for only the first two months of the 4th quarter were available for this graph.) The United States looks very different, however, so something else must be going on. Rather than a smooth rise, inflation jumped from 1.9 percent in Q1 to 4.8 percent in Q2, before accelerating more smoothly and slowly the remainder of the year.

These supply constraints increased costs and generated higher inflation across the globe. European consumer price inflation, for example, increased about one percentage point each quarter and ended 2021 at 4 percent. Part of the U.S. experience is driven by supply chain issues, as well.

But there are also elements of the 1951 episode. Fiscal policy added fuel to the fire in the form of the $1.9 trillion, deficit-financed American Rescue Plan (ARP) stimulus in March 2021. At the time of its signing, the U.S. economy was growing at a red-hot 6.5 percent; additional stimulus was neither needed nor desirable. Inflation responded immediately to the policy error, jumping from 1.9 percent in the first quarter to 4.8 percent in the second quarter – nearly three times the increase of Europe's supply-driven inflation. The fiscal stimulus was reinforced by an aggressively accommodative monetary policy that featured zero-percent interest rates and large, continuous monetary infusions. Inflation continued to rise as the year went on.



What should policymakers do?

To diagnose the roots of this inflation is to identify the appropriate policy response. Ultimately, the supply chain issues boil down to the impact of the coronavirus. This is best offset with a more effective public health policy. Both administrations have botched the response to COVID-19 with reliance on vaccines as a silver bullet. It is not surprising that, as *The New York Times* reported, six former Biden transition advisers called on the president "to adopt an entirely new domestic pandemic strategy geared to the 'new normal' of living with the virus indefinitely, not to wiping it out."

Such a strategy would be composed of a greater range of responses to the pandemic, with more emphasis on testing and therapeutics, and less on mandates for lockdowns, vaccines, and masks.

There are, of course, traditional tools of economic policy available to slow the excess stimulus that is contributing to inflation. It is highly unlikely, however, that policymakers will soon embark on structural deficit reduction via higher taxes and lower spending.

Perhaps the best we can hope from policymakers is that they stop adding to the problem with massive new spending bills such as the Build Back Better Act.

Most of the focus is thus on the Federal Reserve, which must take its foot off the monetary accelerator and begin tapping the brakes with higher interest rates and withdrawals of the massive monetary infusion undertaken during the pandemic. If it taps too lightly, inflation will persist and become more entrenched. If it becomes too aggressive—as has habitually been the case in its postwar response to sharp rises in inflation—growth will stall, and a recession could ensue.

Thank you. I look forward to your questions.

[1] Crain, Nicole V. and Crain, W. Mark. *The Impact of Regulatory Costs on Small Firms*. Conducted for the SBA Office of Advocacy. Release Date: September 2010.
[2] Regulatory Rodeo. www.regrodeo.com.



Competition and the Small Business Landscape:
Fair Competition and a Level Playing Field

Testimony of Dr. Diana Moss
President, American Antitrust Institute

Before the United States House of Representatives
Committee on Small Business

March 1, 2022

Thank you, Chairwoman Velazquez, and Members of the House Small Business Committee. It is an honor to be here today to lend the American Antitrust Institute's (AAI's) perspective to the issue of competition and small business. AAI is an independent, nonprofit organization devoted to promoting competition that protects consumers, businesses, and society.[1] We serve the public through research, education, and advocacy on the benefits of competition and the use of antitrust enforcement as a vital component of national and international competition policy.

As the leading progressive organization dedicated to promoting competition, AAI commends House lawmakers for turning their attention to the question of how consolidation and market power affect American small business. As an economist and advocate for vigorous antitrust enforcement, my testimony will focus on four important topics that are relevant to the topic of today's hearing. They relate specifically to how rising concentration and the emergence of dominant firms and oligopolies in the U.S. economy affect small business.

- **Small business is an integral part of the U.S. economy. But indications that its role is declining poses challenging issues for legislators and policymakers.**
- **There is evidence that decades of weak antitrust enforcement in the U.S. has adversely affected competition. Small business may be implicated in this trend.**
- **Horizontal and vertical integration that has resulted from sweeping consolidation creates and reinforces high concentration that disrupts the role of small business.**
- **The goals of antitrust align, but sometimes misalign, with promoting the role of small business. A public policy approach to competition is therefore vital.**

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[1] For more information, please see https://www.antitrustinstitute.org.

I. Small Business is an Integral Component of the American Economy

Small business is an integral component of the U.S. economy. The Small Business Administration's (SBA's) Office of Advocacy estimates that in 2019, small businesses created two-thirds of all new jobs.[2] They also accounted for 44% of economic activity in the U.S., as measured by gross domestic product (GDP). Small business also drives innovation and competitiveness. However, the role of small business in the U.S. economy appears to be in decline. From 1998 to 2014, for example, the small business share of GDP fell five percent from 48% to 43%. And while the portion of real GDP accounted for by small business increased about 1.5% annually over the same period, the share accounted for by large business grew almost two times faster.

These may sound like tiny numbers, but they amount to hundreds of billions of dollars that would otherwise translate into economic benefits of innovation fostered by small business, support for economic development in smaller communities, and in injecting important competitive discipline in markets. The shift in shares of GDP accounted for by small business versus large business signals potentially troubling trends that should be considered in the context of microeconomic and macroeconomic research on concentration and market power. Lawmakers, policymakers, and antitrust enforcers might therefore ask, as the House Committee is doing here today, why this is happening and what the contours of a responsive policy approach should look like.

II. There is Mounting Evidence That Decades of Weak Antitrust Enforcement Has Adversely Affected Competition

The antitrust laws were originally passed to protect and promote competition in an era marked by the amassing and exercise of market power through harmful mergers, schemes to drive smaller rivals from the market, and anticompetitive agreements. While the vigor of antitrust enforcement in the U.S. has vacillated since the passage of the Clayton and Sherman Acts, the last 40 years have been particularly marked by relatively lax enforcement, especially in the areas of merger control under Section 7 of the Clayton Act, and monopolies under Section 2 of the Sherman Act.

This four-decade era of relatively lax antitrust enforcement was borne of conservative ideology that gave significant deference to claims that mergers and certain forms of conduct, despite having anticompetitive effects, would nonetheless increase efficiency, i.e., by lowering costs, increasing innovation, and protecting quality. "Error cost" analysis, a framework for decision-making under uncertainty, has guided conservative antitrust ideology for decades.[3] Under this approach, however, excess weight is given to the risk that antitrust enforcement will chill competition, and less weight is to the risk that consolidation and anticompetitive conduct will harm competition. The costs of this imbalance, of course, are borne by consumers through higher prices, lower quality, and less innovation.

As the first progressive competition research, education, and advocacy organization, AAI was founded almost 25 years ago expressly to advocate against conservative antitrust ideology and for a

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[2] Kathryn Kobe and Richard Schwinn, SMALL BUSINESS GDP 1998–2014, U.S. Small Business Administration, Office of Advocacy (Dec. 2018), at 4-5.

[3] *See, e.g.*, Jonathan B. Baker, *Taking the Error Out of 'Error Cost' Analysis: What's Wrong with Antitrust's Right*, 80 ANTITRUST LAW J. ((Jul. 2015).

progressive, pro-enforcement agenda and coherent competition policy. The fallout from this episode in American political-economic history has been, among other developments, the weakening of antitrust as a vital tool of law enforcement. The importance of competition, markets, and the democratic principles that support them are therefore at risk.[4] Indeed, lax antitrust enforcement has fostered a *new* generation of powerful dominant firms and domestic oligopolies in critical sectors such as healthcare, food and agriculture, media, telecommunications, and digital technology.

The exercise of market power by dominant firms and oligopolies distorts the competitive process and harms virtually all types of market participants. Consumers pay higher prices, and face lower quality products, less innovation, and a loss of choice. Producers are squeezed through lower prices paid for their products and services. And smaller businesses are harmed through higher costs and barriers to market entry, and the threat of retaliation.[5] These concerns should be considered in the context of economic evidence on rising concentration and declining competition.

For example, experts have identified increasing levels of concentration at the sector and industry levels. Sources include the Council of Economic Advisors (CEA), The Economist magazine, and Wall Street Journal.[6] These trends highlight the imperative of studying concentration at the market level and the "relevant" market level, i.e., markets that are defined in antitrust cases. They also spotlight the possible role of increasing concentration in driving up prices to consumers. For example, a leading meta-analysis of 50 studies encompassing more than 3,000 mergers over the last 25 years indicates that post-merger prices increased, on average, by 7.2%.[7] This body of research also raises serious questions about the role of increasing concentration in raising barriers to market entry as a possible reason for why the rate of firm entry in the U.S. is in a 40-year free fall.[8]

Moreover, there is concern that income and wealth inequality are major problems in the U.S.[9] The CEA cites recent research indicating that returns on investments in capital for the most profitable 10% of firms are five times the median.[10] Another study shows that the "prime driver of wage inequality is the growing gap between the most- and least-profitable companies."[11] As "wage setters," the most profitable firms drive wages down, shifting wealth from labor to capital.[12] There is a growing consensus that inadequate antitrust policy has contributed to the concentration problem and associated inequality effects. Leading law and economics experts offer that the

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[4] THE STATE OF ANTITRUST ENFORCEMENT AND COMPETITION POLICY IN THE U.S., AMERICAN ANTITRUST INST. (Apr. 14, 2020), at 3-4.
[5] *See, e.g.,* Comments of the American Antitrust Institute in re: Supply Chains for the Production of Agricultural Commodities and Food Products, Docket No. AMS-TM-21-0034, AMERICAN ANTITRUST INST. (Jun. 21, 2021), at 3.
[6] Council of Economic Advisers (CEA), Benefits of Competition and Indicators of Market Power, The White House (Apr. 2016), at 4; *Too Much of a Good Thing*, ECONOMIST, (Mar. 26, 2016); and Theo Francis & Ryan Knutson, *Wave of Megadeals Tests Antitrust Limits in U.S.*, WALL STREET J. (Oct. 18, 2015) (citing Gerard Hoberg and Gordon Phillips).
[7] *See generally*, John E. Kwoka, Jr., MERGERS, MERGER CONTROL, AND REMEDIES: A RETROSPECTIVE ANALYSIS OF U.S. POLICY (2014).
[8] *See, e.g.,* Jonathan D. Ostry, Andrew Berg & Charalambos G. Tsangarides, *Redistribution, Inequality, and Growth*, INTERNATIONAL MONETARY FUND (Feb. 2014); Bruce A. Blonigen and Justin R. Pierce, *Evidence for the Effects of Mergers on Market Power and Efficiency*, 24 (Fed. Reserve Bd., Working Paper No. 2016-082 (2016); and José Azar et al., *Labor Market Concentration*, NBER Working Paper No. 24147 (Dec. 2017).
[9] CEA, *supra* note 6, at 5.
[10] *Id. See also* Jason Furman and Peter Orszag, *A Firm-Level Perspective on the Role of Rents in the Rise in Inequality*: Presentation at "A Just Society" Centennial Event in Honor of Joseph Stiglitz, Columbia University (Oct. 16, 2015).
[11] Greg Ip, *Behind Rising Inequality: More Unequal Companies*, WALL STREET J. (Nov. 4, 2015).
[12] Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267 (Mar. 2016).

"adoption of more permissive antitrust rules during the past quarter century" likely increased the prevalence of market power, with the returns from it flowing disproportionately to the wealthy.[13]

III. Horizontal and Vertical Integration Can Create or Reinforce High Concentration That Disrupts the Role of Small Business

The dominant firms and oligopolies that can result from sweeping consolidation have a number of implications for small business. To better understand these dynamics, it is important to review key drivers of weaker enforcement over the last forty years. For example, horizontal mergers eliminate a competitor, resulting in a firm with a higher market share, and increased market concentration. Some horizontal mergers increase the risk that merged firm will act unilaterally (i.e., alone) to exercise market power, or coordinate with rivals in the market to raise prices, lower quality, or slow innovation. Over the last several decades, weaker horizontal merger enforcement has been revealed, for example, in the failure to enforce the "structural presumption," or the rebuttable presumption that a highly concentrative merger is presumptively illegal.[14]

In contrast, vertical mergers combine firms that operate at different levels in a supply chain, such as manufacturing and distribution, or upstream inputs and downstream outputs. While they do not increase market concentration, vertical mergers can enhance the ability and/or incentive for the merged firm to engage in conduct that restricts competition in one or more adjacent markets. Like the structural presumption in the case of horizontal mergers, vertical merger enforcement has also been weakened over time. This is most obvious in the deference that courts have given to efficiencies that are typically claimed in vertical mergers. These include costs savings associated with alleged elimination of double margins and claimed benefits of enhanced coordination on innovation.[15]

Integration can result in any number of challenges for smaller firms, especially when it enhances a dominant firm's ability or incentives to cut off smaller rivals' access to inputs or distribution, or to engage in predatory behavior. For example, a major concern in the merger of AB InBev and SAB Miller was enhanced incentives to exclude competitors from access to distribution.[16] Smaller beer producers, such as craft brewers, were particularly exposed to this risk. Another example is vertical integration into cattle supply by the oligopoly of beef packers in the U.S.. Such integration enhances incentives to force out smaller, independent ranchers and microprocessors. The court's opinion in the litigated merger of AT&T and Time Warner noted the adverse effect of combining content and distribution on frustrating innovation from smaller firms.[17] And in the FTC's monopolization case against Facebook, the government's complaint focused on conduct that eliminated competitive threats in the market for personal social networks to maintain a dominant position. This included Facebook's acquisition of smaller rivals or limiting their ability to compete on its platform.[18]

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[13] *See* Jonathan Baker and Steve Salop, *Antitrust, Competition Policy, and Inequality*, 104 GEO. L. J. ONLINE 1 (2015).
[14] United States v. Phila. Nat'l Bank, 374 U.S. 321, 363 (1963). Herbert J. Hovenkamp and Carl Shapiro, *Horizontal Mergers, Market Structure, and Burdens of Proof*, 127 Yale Law J. (May 2018), at 1997.
[15] Letter to the U.S. Dept. of Justice, *Re: Strategic Consolidation, Market Power, and Efficiencies in the Media/Entertainment and Distribution Markets: Implications for Antitrust Reviews of Proposed Mergers*, AMERICAN ANTITRUST INST. AND PUBLIC KNOWLEDGE (Sept. 21, 2021).
[16] U.S. v. Anheuser-Busch InBev SA/NV and SABMiller, No. 1:16-cv-01483 (D.D.C, filed Jul. 20, 2016), at 12.
[17] U.S. v. AT&T Inc. et al., Memorandum Opinion, No. 17-2511 (D.D.C., filed Jun. 12, 2018), at 18-20.
[18] *See* FTC v. Facebook, No. 1:20-cv-03590 (D.D.C. filed Dec. 9, 2020). *See also*, New York v. Facebook, No. 1:2020-CV-03589 (D.D.C filed Dec. 9, 2020).

IV. A Public Policy Approach to Competition is Important Because Antitrust Can Align, But Also Misalign, With the Goal of Promoting the Role of Small Business

Concerns over declining competition and rising concentration have risen to the level of a public policy problem in the U.S. As such, responses to it should make use of all of the tools in the "competition policy" toolkit. This includes antitrust enforcement, but also labor law, intellectual property law, consumer protection law, small business policy, and others. Strong public policy approaches make the best use of tools based on their comparative advantages, and are ideally designed to work in a complementary way. This toolkit approach is critically important for designing policies that are responsive to the effects of consolidation and concentration on small business. This is because antitrust enforcement can be both the most powerful tool in protecting and promoting the role of small business. But it is also true that antitrust enforcement may work in ways that run counter to the interests of small business.

Antitrust has a powerful competitive advantage in several major areas where small business can be adversely affected. As explained above, perhaps the most important is aggressively pursuing enforcement of mergers and strategic conduct by dominant firms and oligopolies with incentives to exclude or neutralize threats from smaller disruptive and innovative rivals.[19] Exclusionary conduct includes any number of strategies to foreclose rivals, raise their costs, or to erect entry barriers to markets. This includes denying access to inputs and distribution, predatory pricing or bidding, and frustrating interoperability—strategies that have an outsized effect on smaller competitors.

A second area in which antitrust enforcement plays a vital role in regard to smaller businesses is in a dominant firm's use of: intellectual property to shape or control competition, deceptive practices designed to maintain a market position, and sham litigation to limit competition. Examples of these cases include Retractable Technologies Inc. v. Becton Dickenson (retractable syringes), which highlighted deceptive practices by a dominant firm to exclude a smaller, disruptive rival.[20] Another is In re Suboxone Antitrust Litigation, where patients were coerced into using a patented film formulation of opioid addiction treatment, Suboxone, instead of a tablet form, just as the latter was on the brink of becoming open to generic competition.[21]

But there are also areas where antitrust enforcement may not align as well with a goal of promoting and protecting the role of small business. Generally, antitrust enforcement places no special or intrinsic value on the role of small business in the economy. Indeed, antitrust is concerned with the effects of anticompetitive consolidation and conduct on "competition," not individual "competitors." Specific areas where a misalignment may be apparent include more aggressive antitrust reviews of acquisitions of smaller rivals that pose an innovative threat to a large incumbent firm. These so-called "killer" acquisitions have particularly harmful effects on consumers through lower quality and less innovation.[22] Examples of acquisitions of nascent rivals that were met with a

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[19] *See, e.g.*, Tim Wu, *Taking Innovation Seriously: Antitrust Enforcement If Innovation Mattered Most*, 78 ANTITRUST L. J. 313 (2012).

[20] *See, e.g.*, Brad Perriello, *Appeals court upholds BD win in Retractable Technologies case, MassDevice.com*, MASSDEVICE.COM (Mar. 28, 2019).

[21] *AAI Urges Third Circuit to Preserve Product Hopping Case on Behalf of Victims of the Opioid Epidemic (In re Suboxone Antitrust Litigation)*, AMERICAN ANTITRUST INST. (Mar. 12, 2020).

[22] *See, e.g., See* Tim Wu and C. Scott Hemphill, *Nascent Competitors* (168 PENN. L. REVIEW 1879 (2020) and Carl Shapiro, *Protecting Competition in the American Economy: Merger Control, Tech Titans, Labor Markets*, (Jun. 12, 2019), at 30.

government challenge include Visa-Plaid and John Deere-Precision Planting.[23] However, the goals of smaller businesses that are sustained by the venture-capital backed startup model is to maximize the price for which they are acquired by a larger company. This exit strategy model contrasts with one of continuing to innovate as a standalone rival and to grow to potentially challenge the market position of a large incumbent.

Another example is the non-compete clause, which prevents workers from entering into or starting a similar profession or trade in competition against another party. Such clauses are often used by small businesses as a way to protect trade secrets, but they are increasingly under scrutiny by antitrust enforcers for their anticompetitive effects and role in restricting worker mobility. This is particularly true in markets, such as hospitals and physician practices, that are dominated by only a few players and where a non-compete clause can eliminate employment options in a geographic area.

Finally, some types of antitrust remedies can put small businesses into the crosshairs of dominant firms and oligopolies. For example, conduct remedies are often used by antitrust enforcers to settle antitrust violations. Such remedies spell out required conduct and proscribed conduct by a firm. This is particularly true in the case of vertical mergers, including cases like Live Nation-Ticketmaster where concerns over the exclusion of rivals were addressed through nondiscrimination requirements. But most of those requirements are enforceable only if the very same firms that are the target of anticompetitive behavior come forward to enforcers to complain. These often-smaller rivals, especially those the depend on larger firms as suppliers or customers, often fear retaliation from dominant firms.[24] Anti-retaliation provisions in antitrust consent decrees may not be effective in limiting retaliatory conduct.

V. Conclusions

In sum, there are growing concerns around troubling increases in concentration and declining competition in the U.S. Superimposed on these are further concerns over a potentially declining role of small business in the U.S. economy. As an integral driver of employment and economic growth, small business should be a policy focus. However, policies designed to promote the role of small business will have to reconcile a number of forces. The emergence of dominant firms and oligopolies from decades of weak antitrust enforcement pose numerous concerns, including various forms of exclusionary conduct and higher barriers to entry. There is much that more aggressive antitrust enforcement can do to promote and protect the role of small business. However, antitrust may not always align with the goals of promoting small business. For these reasons, it is essential that policy supporting the role of small business draw on multiple policy tools for promoting competition in the U.S. economy.

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[23] U.S. v. Visa Inc. and Plaid Inc., Complaint, No. 3:20-cv-07810 (D.D.C., filed Nov. 5, 2020) and U.S. v. Deere and Co. and Precision Planting LLC, Complaint, No. 1:16-cv-08515 (N.D. Ill., filed Aug. 31, 2016).

[24] See American Antitrust Institute, *Competition Roundtable: The Darkest Side of Rising Concentration — Fear and Retaliation in Antitrust* (Oct. 20, 2021).

Opening Statement of Professor Carl Shapiro

House Committee on Small Business

"Competition and the Small Business Landscape: Fair Competition and a Level Playing Field"

1 March 2022

Chairwoman Velázquez, Ranking Member Luetkemeyer, and Members of the Committee, thank you for giving me the opportunity to testify in front of you today.

My Background

I am an economist who has been studying competition policy for over 40 years. I am a Distinguished Professor of the Graduate School at the University of California at Berkeley. I have published extensively on issues related to antitrust, competition policy, and intellectual property. My writings and biography are available on my UC Berkeley website, https://faculty.haas.berkeley.edu/shapiro/.

I served as the Deputy Assistant Attorney General for Economics in the Antitrust Division of the Department of Justice during 1995-1996 and again during 2009-2011. In 2009-2010, I led the working group at the Antitrust Division that, together with the Federal Trade Commission, revised the DOJ/FTC Horizontal Merger Guidelines. I also served as a Senate-confirmed Member of the President's Council of Economic Advisers under President Obama during 2011 and 2012.

I have been an advocate of vigorous, principled antitrust enforcement for more than 25 years. Since leaving government service in 2012, I have provided testimony in Federal court as an economic expert witness on behalf of the government in a number of important antitrust cases.

Year	Antitrust Enforcement Case	Testitifed on Behalf of
2019	State AGs challenge to T-Mobile/Sprint Merger	Multiple State AGs
2019	FTC challenge to Qualcomm's licensing practices	FTC
2018	DOJ challenge to AT&T/Time Warner Merger	DOJ
2018	FTC monopolization case against AbbVie	FTC
2017	FTC pay-for-delay case against Actavis	FTC
2016	FTC challenge to Staples/Office Depot Merger	FTC
2013	DOJ challenge to BazaarVoice acquisition of PowerReviews	DOJ

Protecting and Promoting Competition

Our antitrust statutes talk explicitly about economic concepts: monopolization, restraint of trade, and lessening of competition. They are fundamentally *economic* in nature, and they contain prohibitions on conduct, not on status, such as being large or a monopoly. I encourage the Committee to reaffirm that the goal of the antitrust laws is to *protect and protect competition throughout the American economy*.

But what does that mean?

Competition is messy. Competition can be rough-and-tumble. Competition can feel deeply unfair when one loses. We all *say* we like competition, but who really welcomes a formidable, rival in any domain?

Competition is inherently an economic concept. My field of economics, industrial organization, studies competition and its absence, monopoly. We also study government policies to control monopoly power, through antitrust and regulation. Economists stress that competition is a *dynamic process*:

- Competition is the process by which businesses strive to attract *customers* by better serving their needs. These customers might be consumers or they might be small businesses.
- Competition also is the process by which businesses strive to attract *workers* by offering them attractive wages and fringe benefits. Today's small business owners certainly appreciate that they must compete to attract workers.

In many markets, the competitive process naturally results in a market structure with lots of suppliers. We see this outcome in markets for restaurants or dry cleaners or legal services in urban areas. In many other markets, where economies of scale are sizeable, the competitive process naturally results in a market structure with just a few large firms. We typically see this outcome in the manufacturing of highly sophisticated equipment, from aircraft to farm machinery to advanced microprocessors. There is nothing inherently wrong with that outcome, so long as it results from legitimate competition rather than anticompetitive mergers or exclusionary conduct. Moreover, government policies that try to prevent firms from exploiting economies of scale and scope would be both futile and counterproductive.

The key is to focus on the competitive process, not the resulting market structure. Economists and policy makers learned this many years ago, but it seems to be lesson very much in need of repeating today.

I favor replacing the term "consumer welfare standard" with the term "protecting competition standard" to clarify that the goal of antitrust is to promote and protect competition. More specifically:

> **Protecting Competition Standard**: A business practice is judged to be anti-competitive if it harms trading parties on the other side of the market as a result of disrupting the competitive process.

Promoting competition does not mean shielding *any* businesses from the buffeting winds of legitimate competition, be they large firms with outsize political influence or small firms that are struggling to compete against larger rivals with lower costs. As a champion of competition, I am instinctively skeptical of pleas by politically powerful businesses to be shielded from competition.

Promoting competition also does not involve hobbling a successful firm just because it has grown large, even if has come to dominate a market, so long as it gained that position fair and square.

How Antitrust Lost its Way – Twice

My recent paper, Antitrust: What Went Wrong and How to Fix It, explains how the courts lost their way in interpreting the antitrust laws, first in the 1960s and then again over the past thirty years.

During the 1960s, the Supreme Court issued a number of antitrust decisions in favor of plaintiffs were badly misguided. These decisions suffered from serious deficiencies in economic reasoning, or a complete lack of economic reasoning. These grave shortcomings caused the Court to reach faulty conclusions about the real-world economic effects of various business practices.

The fundamental problem is that the Court did not have a coherent view of the competitive process and thus lacked reliable principles to distinguish procompetitive business conduct from anticompetitive exclusion. The per se rule prohibiting a manufacturer from allocating geographic regions to retailers was not supported by microeconomics. Likewise, the Court's method of distinguishing legitimate price competition from predatory pricing was flawed, and its hostility to vertical and conglomerate mergers was unsupported by economic theory or evidence. Fortunately, from the late 1970s through the mid-

1980s the law changed significantly and became much better aligned with economic theory and evidence. The Harvard School and the Chicago School both deserve credit for this shift, although during this period of time the courts followed the Harvard School more closely.

But then, starting in the late 1980s, the courts increasingly came under the influence of a group of lawyers associated with the Chicago School. Antitrust law lost its way a second time. The drift was in the opposite direction, but the underlying cause was again a failure understand the real-world economic effects of various business practices. That judicial narrowing of the Sherman Act continues to this day.

A Positive Program to Strengthen Antitrust Enforcement

What is to be done? In broad terms, there are three choices: (1) continue with the status quo, (2) strengthen antitrust law to better promote and protect competition in the modern economy, or (3) dramatically change antitrust law by adopting bright-line rules to deconcentrate our economy.

As explained in my attached paper, Antitrust: What Went Wrong and How to Fix It, the Chicago School, which has persistently advocated to narrow the reach of antitrust law and raise obstacles to antitrust plaintiffs, is associated with the status quo. The Modern camp, to which I belong, favors the second approach. So far as I can determine, the Neo-Brandeisians advocate the third approach.

In my opinion, the approach taken by the courts to the Sherman Act over the past 25 years never had a sound basis in economic evidence or theory and has now been proven to be a failure. So I reject (1). On the other hand, calls for the courts to rewind the clock and restore antitrust from the 1960s ignore the fact that the approach taken back then proved to be confused, unworkable, and harmful. So I reject (3).

My attached paper lays out a positive program for option (2), strengthening antitrust law to better promote and protect competition in the 21st century economy.[1] If the courts were receptive, these changes could be effectuated through the evolution of the case law in the common law tradition. But that would be a slow process and would require a judiciary that is willing to acknowledge recent errors. Enabling legislation would be far better from a democratic perspective and far faster. If done right.

The basic idea is to establish a number of *rebuttable presumptions* in favor of antitrust plaintiffs that would simplify the analysis needed in court and eliminate the excessive obstacles that the courts have placed in front of the antitrust enforcement agencies.[2] I generally favor rebuttable presumptions over per se rules because per se rules are only appropriate for conduct that almost always harms competition. If per se rules are applied too broadly they stifle pro-competitive conduct.

Here are a few examples of rebuttable presumptions, taken from my attached paper:

- Create a rebuttable presumption against any large transfer of value from a branded pharmaceutical company to a potential generic entrant as part of their settlement of a patent infringement case. This would build on the Supreme Court's decision in the *Actavis* case.[3]
- Create a rebuttable presumption that when a firm with market power prevents its trading partners from steering their customers to lower-priced alternatives, that disrupts the competitive process and violates the Sherman Act. This would overrule the Supreme Court's decision in the *American Express* case.[4]

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[1] My attached paper is the third in a trilogy. The first paper is Antitrust in a Time of Populism (2018). The second paper is Protecting Competition in the American Economy: Merger Control, Tech Titans, Labor Markets (2019).

[2] In some cases, per se rules can be used to condemn certain practices. However,..

[3] *FTC v. Actavis,* 133 S. Ct. 2223 (2013)

[4] *Ohio v. American Express* 138 S. Ct. 2274 (2018).

- Create a rebuttable presumption that if a dominant firm imposes costs on its customers when they purchase from the dominant firm's rivals, that disrupts the competitive process and violates the Sherman Act. This would overrule the Ninth Circuit's decision in the *Qualcomm* case.[5]
- Create a rebuttable presumption that if a dominant firm requires its customers to deal with it exclusively, that disrupts the competitive process and violates the Sherman Act.
- Create a rebuttable presumption that if a dominant firm acquires a significant actual or potential rival, that may substantially lessen competition and violates the Clayton Act.
- Create a rebuttable presumption that if a dominant firm sacrifices profits by pricing below incremental cost, that such pricing is predatory and violates the Sherman Act. This would overrule the Supreme Court's decision in the Brooke Group case.[6]
- Allow the government to successfully challenge a horizontal merger based on direct evidence of competition between the two merging firms without the necessity of defining a relevant market.
- Clarify that, in horizontal merger cases where the government has established its prima facie case that the merger may substantially lessen competition, clear and convincing evidence is required to rebut that presumption.

The evidence required to rebut these presumptions will vary from one practice to another. For example, a dominant firm might defend below-cost pricing by pointing out that selling one product below cost generates profit margins on a complementary product, so it was not actually losing money on the sales in question. That defense could apply if the dominant firm is offering a free service to consumers to generate advertising revenue or selling a piece of durable equipment to generate profitable aftermarket sales of parts and service. My point is that the burden would rest on the dominant firm to explain why it is sacrificing profits by pricing below cost, not on the plaintiff to prove that entry barriers are sufficiently high that recoupment will be possible in the future.

My recent paper with Nancy Rose, What Next for the Horizontal Merger Guidelines?, explains how the DOJ and the FTC can strengthen merger enforcement in a manner that is well grounded in recent economic evidence, supported by economic theory, and consistent with the evolving case law.

Implications for Small Business

With these principles in mind, let me turn specifically to the implications for small and mid-sized businesses, which I will refer to as SMBs.

Competition policy, done right, is neutral with respect to firm size. Smaller firms should not be disadvantaged, but nor should they be favored. By way of contrast, competition policy is *not* neutral with respect to market power. Protecting competition means limiting how a firm with market power can use that power, and protecting competition means preventing firms from colluding to exercise market power or merging to enhance their market power. Naturally, these restrictions on the behavior firms with market power tend to fall more heavily on larger firms.

I do not envy the position many SMB owners find themselves in these days. Starting and running a small business has never been easy, and the disruptions caused by the pandemic have made things harder than ever for many SMB owners and for their employees. I commend Congress for providing substantial support to many SMBs in the two years since the pandemic gravely disrupted our economy.

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[5] *FTC v. Qualcomm Inc.*, 969 F.3d 974 (9th Cir. 2020).

[6] *Brooke Group vs. Brown & Williamson*, 509 U.S. 209 (1993).

However, our commitment to competition should not flag during tough times. We made that mistake back in the 1930s by allowing many firms to collude under the National Industrial Recovery Act. That prolonged the Great Depression.[7] I do not support antitrust exemptions for smaller firms to collude.

The truth is, SMBs in many sectors of our economy face formidable competition from larger businesses. The economic evidence shows that much of the growing share of economic activity accounted for by large businesses likely results from highly efficient "superstar" firms growing at the expense of other firms.[8] That competitive process has been fueled by massive advances in information technology, the growing importance of intangible assets, and globalization.[9] Consistent with this, increases in concentration at the national level have in many cases been associated with decreases in concentration in more local geographies and at the level of relevant antitrust product markets.[10]

While it may be tempting for this Committee to take actions to shield SMBs from competition from larger firms that may have lower costs or other competitive advantages, that would not be consistent with promoting and protecting competition. Instead, I encourage the committee to consider actions in three areas of antitrust: (1) enabling SMBs to cooperate so they can compete more effectively against larger firms; (2) preventing dominant firms from engaging in exclusionary conduct directed at SMBs, and (3) preventing anti-competitive mergers that harm SMBs by reducing their options for acquiring customers or distributing their products and services.

Regarding (1), the Supreme Court's decision in the *Topco* case provides an cautionary tale of how antitrust law can mistakenly disfavor SMBs.[11] Topco was a cooperative association of small and medium-sized regional supermarket chains. These chains formed Topco to develop a private label products so they could compete more effectively against larger national and regional chains. Under their agreement, Topco members had the exclusive rights to sell Topco-branded products in their assigned areas. The evidence clearly showed that this arrangement promoted competition and benefitted consumers, but the Supreme Court struck it down as a per se violation of Section 1 of the Sherman Act. A better approach – for competition, for consumers, and for SMBs – would be the following:

> **Rebuttable Presumption in Favor of Cooperation Among Small Businesses**: If a group of businesses agree to cooperate to better serve their customers by replicating what their larger rivals do internally, that is presumptively pro-competitive.

Regarding (2), see my discussion above about establishing rebuttable presumptions against exclusionary conduct by dominant firms. SMBs may be especially vulnerable to conduct such as predatory pricing or exclusive dealing simply because they are not as well capitalized. Young, innovative firms also may be especially vulnerable. That is particularly worrisome as they can grow into disruptive forces that erode to power of entrenched incumbent firms, delivering substantial benefits to the public along the way.

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[7] See my May 2009 speech, Competition Policy in Distressed Industries, when I was at the DOJ during the Great Recession.

[8] *E.g.*, David Autor, David Dorn, Lawrence Katz, Christina Patterson, and John Van Reenen, *The Fall of the Labor Share and the Rise of Superstar Firms*, 135 Q.J. ECON. 645 (2020). John Van Reenen, *Increasing Differences Between Firms: Market Power and the Macroeconomy*, (Ctr. for Econ. Performance Discussion Paper No. 1576, 2018).

[9] *E.g.*, Nicolas Crouzet and Janice Eberly, *Understanding Weak Capital Investment: the Role of Market Concentration and Intangibles* (NBER Working Paper No. 25869, 2019).

[10] C. Lanier Benkard, Ali Yurukoglu, and Anthony Zhang, *Concentration in Product Markets* (NBER Working Paper No. 28745, April 2021) (median concentration levels in consumer products have declined since the mid-1990s, reflecting modest declines in concentration for the most highly concentrated product markets at the start of that period); Esteban Rossi-Hansberg, Pierre-Daniel Sarte, and Nicholas Trachter, *Diverging Trends in National and Local Concentration*, 35 NBER MACROECONOMICS ANNUAL 115 (2020) (showing declines in concentration measured at the local level across most sectors).

[11] *United States vs. Topco Associates*, 405 U.S. 596 (1972).

Regarding (3), the DOJ and the FTC could devote more resources to investigating whether mergers harm SMBs by reducing their options for acquiring customers of distributing their products and services. The groundwork for doing this was laid in 2010 when a new section was added to the Horizontal Merger Guidelines, "Mergers Between Competing Buyers." For example, if a merger combines two important distributors for the products or services sold by SMBs, that merger could harm competition and harm SMBs, quite apart from any resulting harm to consumers. Analytically, this type of harm to SMBs from a merger is very similar to how workers can be harmed by a merger between competing employers. For further details, see my paper with Nancy Rose, What's Next for the Horizontal Merger Guidelines?

Antitrust Enforcement in Just One Component of Competition Policy

Many of those who are calling for stronger antitrust enforcement are motivated by concerns about the political power of large corporations, or about the extreme levels of inequality in income and wealth found in the United States today. I very much share these concerns. We very much need campaign finance reform, and greater transparency regarding money in politics, to control the excessive political power of large corporations (and of billionaires). We very much need a more progressive tax system. We very much need to provide better nutrition, health care and educational opportunities for all Americans, especially children, to reduce levels of inequality.

But asking antitrust to solve these problems is very likely to be counterproductive. Antitrust enforcement agencies and courts are ill suited to handle these broader problems. Those who over-promise what antitrust can realistically deliver are doing a disservice to the very people they profess they are trying to help. They also threaten to breed skepticism regarding the value of antitrust policy and enforcement if antitrust fails to deliver the broader social and economic transformation that has been promised. Furthermore, the core mission of antitrust, to promote competition, could easily be undermined if we ask antitrust to solve problems unrelated to competition. For example, asking the DOJ to block mergers that enhance political power, as distinct from economic power, would necessarily politicize antitrust enforcement, which strikes me as extremely dangerous and unwise.

Finally, it is important to recognize that antitrust enforcement is just one arrow in the quiver of available policies to promote competition and protect consumers. The Federal Communications Commission has the authority to promulgate rules that protect media diversity, and the Federal Energy Regulatory Commission can promote competition in wholesale electricity markets. The Food and Drug Administration can promote competition in pharmaceutical drugs and medical devices. The Department of Transportation has the authority to promote international airline competition. And so on.

President Biden's Executive Order on Promoting Competition in the American Economy (July 2021) identifies a large number of policies that can and should be used to promote and protect competition, above and beyond antitrust enforcement. For a wide-ranging set of recommendations for reinvigorating competition policy, see Restoring Competition in the United States: A Vision for Antitrust Enforcement for the Next Administration and Congress (November 2020).

Antitrust rules necessarily apply across the entire economy. They cannot and should not substitute for tailored rules needed to regulate specific sectors, including the tech sector.

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Antitrust: What Went Wrong and How to Fix It

BY CARL SHAPIRO

MANY AMERICANS ARE DISTRUSTFUL of the federal government and feel that our governing institutions have been captured by powerful special interests, especially large businesses. Wealth and income inequality have grown to extreme levels. The share of the economic pie going to labor has dropped while the share going to the owners of large businesses has grown, and price/cost margins have generally risen in the United States in recent decades. Perhaps most visibly, the tech titans seems to grow without bound, and their market caps signal that their market dominance is durable.[1] On top of all that, the pandemic has gravely weakened many small businesses or caused them to fail, shifting yet more revenue and profits to larger firms. These established facts are my starting point.

Many people look to antitrust to reverse these changes in the structure of the American economy. After all, the body of law intended to control monopolies is a natural place to look to solve problems caused by concentrated private power. Looking to antitrust is all the more tempting once one recognizes that these problems have noticeably worsened over the past 30 to 40 years, roughly the period during which antitrust law shifted markedly in favor of antitrust defendants. However, antitrust is not a cure-all. For example, while stronger antitrust enforcement tends to lessen income inequality, the primary policies for that purpose are the tax system and government programs that help lower-income households obtain various goods and services, including nutrition, education, and health care. Those who over-promise what antitrust can realistically deliver are doing a disservice to the very people they profess they are trying to help. They also threaten to breed skepticism regarding the value of antitrust policy and enforcement if antitrust fails to deliver the broader social and economic transformation that has been promised.

Our antitrust statutes talk explicitly about economic concepts: monopolization, restraint of trade, and lessening of competition. They are fundamentally economic in nature, and they contain prohibitions on conduct, not on status, such as being a monopoly. Part of my thesis today is that the goal of antitrust law should be to *protect and promote competition*. Period.

Antitrust law does have broad social impacts. For example, low-income households especially benefit from the lower prices that result from competition, and under-represented groups with few stock market holdings especially benefit when competition reduces the profits of public companies by increasing the wages of workers or the quality of consumer products.[2] These beneficial byproducts of greater competition support the case for *strengthening* antitrust enforcement, but they do not provide a sound basis for changing the *mission* of antitrust. So long as the focus truly is on competition, economic concepts will continue to be fundamental to the substance of antitrust law.

As I see it, three camps are now engaged in a debate over the Future of Antitrust:[3]

- **Chicago School**. The approach to antitrust developed by Chicago School lawyers is heavily based on laissez faire ideology that gained ascendency during the 1980s and is now woven deeply into the case law. Market forces are generally counted on to erode monopoly power, despite economic theory and evidence to the contrary. Chicago School adherents have persistently advocated to narrow the reach of antitrust law and raise obstacles to antitrust plaintiffs, with considerable success. They do not see any fundamental failing with how antitrust law has evolved in recent decades.
- **Modern**. The Modern approach recognizes that antitrust law and policy have not been vigorous enough in recent years. Modernists favor stronger antitrust

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enforcement, building on what antitrust scholars and practitioners have learned in recent decades and reflecting how the economy has evolved over time, although they differ in the magnitude of the necessary corrections. Modernists understand that markets differ greatly and favor fact-based inquires as the best way to assess economic effects. They support the ongoing evolution of antitrust law in the common law tradition based on continuous learning. Modernists believe that antitrust should continue to focus on protecting and promoting competition, which is fundamentally about economic effects.

- **Populists**. Populists are deeply concerned about the political power of large companies. They favor deconcentrating the economy to reduce that power and thereby open up opportunities for small businesses, benefit workers, and lessen racial and economic inequities. They favor simple, bright-line rules and are highly skeptical of the role of economics and expertise in antitrust. They see the consumer welfare standard, which is deeply embedded in antitrust case law, as fundamentally flawed.

I put myself squarely in the Modern camp, which I believe offers the most promising path for the Future of Antitrust. This is because the Modern camp is the only one whose agenda for the Future of Antitrust is to protect and promote competition using the best current economic theory and evidence. Our antitrust statutes are general enough and flexible enough to accommodate the changes necessary to fix antitrust, if the courts cooperate. However, there are good reasons to doubt that the Supreme Court will adopt the Modern approach any time soon, so legislation may well be needed.

As explained below, the necessary changes could be accomplished by creating a number of rebuttable presumptions that would allow antitrust plaintiffs to shift the burden of proof to defendants. For example, in cases involving dominant firms, presumptions could be established against acquisitions of significant actual or potential rivals, below-cost pricing, and exclusive dealing requirements imposed on important trading partners. More generally, the courts could open routes for antitrust plaintiffs to prevail by showing likely harm to competition without the need to define a relevant market. Replacing the term "consumer welfare standard" with the term "protecting competition standard" would help foster these changes by clarifying that the goal of antitrust is to promote and protect competition, which can benefit workers and suppliers as well as consumers, and that the DOJ and the FTC need not quantify competitive harm to prevail.

A Brief History of Industrial Organization Economics

My central message is that the Future of Antitrust should be based in significant part on learning from the field of Industrial Organization (IO) Economics. IO Economics is the branch of microeconomics that studies market structure and market power. The mission statement of the Industrial Organization Program at the National Bureau of Economic Research, which was founded by former Deputy Assistant Attorney General, MIT Professor Nancy Rose, explains: "The Industrial Organization Program analyzes firm behavior and industry dynamics, including the determinants of market competition and of pricing decisions, as well as the effects of public policies such as anti-trust law and government regulation."[4]

My hope is that the disciplines of law and economics will work hand in hand as partners to restore sound antitrust enforcement. The partnership I have in mind is simple and powerful: IO Economics, motivated in part by important issues in antitrust policy, advances our understanding of market structure, market power, and various business practices, both in general and in specific cases. Then lawyers and judges rely upon those findings, together with other evidence, to effectuate the intent of Congress that our antitrust laws promote and protect competition by building sound economics into our legal standards.[5]

Fundamentally, IO Economics offers value to antitrust law in two reinforcing ways. First, IO economists have thought deeply about the implications of the profit motive for business strategies and market outcomes. The North Star of antitrust economics is the assumption that businesses are operated to maximize profits. IO theory helps us identify circumstances in which pursuing that profit motive will lead businesses to further the public interest, as per Adam Smith's invisible hand, versus circumstances in which the profit motive will lead them to harm the public interest by enhancing market power. Second, IO economists have studied many firms and markets empirically in considerable detail. This body of work tests various theories, offers valuable econometric tools, and provides an underlying empirical basis for antitrust policy.

During the first half of the 20th century, much of the research in IO Economics followed an "institutionalist" approach, which involved detailed case studies of various industries. But by the middle of the 20th century, IO Economics came to be dominated by the "Structure Conduct Performance" (SCP) framework. That framework was associated with University of California at Berkeley Professor Joe Bain, a student of Joseph Schumpeter at Harvard. The principal tenet of the SCP framework was that market structure determined conduct and thus industry performance. Good performance was measured by low prices and low price/cost margins. The focus of the SCP framework was on oligopolistic industries, especially in the manufacturing sector. The central implication of the SCP framework was that highly concentrated industries with entry barriers would be prone to tacit or express collusion and thus would perform poorly, exhibiting high prices or high price/cost margins.

But economic science does not stand still. By the time Bain retired from Berkeley in 1975, the SCP framework was

being replaced within IO Economics. Emerging empirical evidence confirmed that there was a connection between market structure and performance, but it was not as strong as Bain and his followers had believed, and (equally important) concentrated markets can *result* from vigorous competition.[6] In part, this new learning reflected changes in the American economy, as the share of GDP generated by manufacturing declined, as the share of GDP generated by services grew, and as the rest of the world recovered from World War II, causing international trade to grow. But the decline of the SCP framework also reflected the fact that industries differ widely in their supply and demand characteristics. There was much to be said for the older case study methods that looked more closely at individual firms and markets.

By the end of the 1970s, IO Economics was looking in a more wide-ranging and open-minded way at the richness of the many markets and business strategies observed in the real world. IO Economics was freed from an excessive focus on market shares and market structure, and instead looked more closely at a far wider range of business conduct, focusing less on cartels and tacit collusion. IO Economics carefully examined strategic behavior and innovation. Schumpeter was back in vogue, and deservedly so.

As applicable to antitrust economics, while the SCP framework advanced our understanding of the relationship between market concentration and various forms of horizontal coordination, subsequent research in IO Economics provided the means for addressing a plethora of other antitrust challenges, such as the unilateral effects arising from horizontal mergers, potential adverse effects on competition resulting from vertical mergers, and the identification of anticompetitive harm resulting from various exclusionary business practices.[7]

IO Economics has made great strides over the intervening 40 years in addressing issues critical to the enforcement of antitrust law. Examples include the incentives of monopolists to build extra capacity or tie up critical inputs to deter entry, vertical contracting generally (Nobel prizes have been earned in contract theory), firms competing in the presence of network effects, firms engaging in patent licensing and cross-licensing and forming patent pools, the economics surrounding standard-essential patents, and firms merging with their rivals or their suppliers. Modern IO Economics offers a rich set of tools. In any given case, the antitrust economist uses the tools that work best given the details of the market and the antitrust issues raised. Antitrust lawyers routinely see antitrust economists use IO models and techniques in antitrust cases.

These advances, on the theoretical side, derived from the game theory revolution, which transformed IO Economics.[8] By employing well-grounded game theory, IO economists were able to go far beyond the classic questions about cartels and collusion. IO economists created a rich set of tools that we now use routinely to study the economic effects of many business strategies in markets with a few firms. This work also has profoundly influenced the field of competitive strategy for businesses, which has become a core part of the MBA curriculum.

On the empirical side, there was a great flowering of work using new econometric techniques to identify and quantify market power.[9] Today, the field of IO economics is dominated by researchers who build detailed models of demand and estimate those models using available data. Here too, antitrust lawyers routinely see antitrust economists using these techniques. For example, it is standard fare for antitrust economists to use econometric models to estimate damages in cartel cases and to predict price effects in merger cases using upward pricing pressure or merger simulations. There is a healthy, ongoing debate among IO economists over how to improve these techniques and make them more reliable.

During the past decade, economists in IO and related fields have identified systematic changes that have been taking place in the U.S. economy. I cannot do justice to that work here, but a few of these research findings are worth emphasizing: large and efficient "superstar firms" are responsible for a growing share of U.S. economic activity; market power has grown in some sectors, as reflected by larger price/cost margins and higher profits; and the overall body of evidence from merger retrospectives indicates that merger enforcement has been too lax.[10]

How Antitrust Law Lost its Way—Twice

But enough about economics. Let's get back to antitrust law—its past and then its future.[11]

During the 1960s and 1970s, both law and economics professors were explaining that a number of the Supreme Court antitrust decisions in favor of plaintiffs were badly misguided. These decisions suffered from serious deficiencies in economic reasoning, or a complete lack of economic reasoning. These grave shortcomings had caused the Court to reach faulty conclusions about the economic effects of various challenged business practices.

The fundamental problem is that the Court did not have a coherent view of the competitive process and thus lacked reliable principles to distinguish procompetitive business conduct from anticompetitive exclusion. The per se rule prohibiting a manufacturer from allocating geographic regions to retailers was not supported by microeconomics.[12] Nor was the Court's treatment of tying. Likewise, the Court's method of distinguishing legitimate price competition from predatory pricing was flawed, and its hostility to vertical and conglomerate mergers was unsupported by economic theory or evidence. Notably, the Court's treatment of horizontal mergers in *Philadelphia National Bank* does *not* belong on this list.[13]

Put simply, the Supreme Court lost its way during the 1960s by failing to incorporate sound microeconomics into its antitrust decisions. This failure embedded into legal *doctrine* a number of unsupported and incorrect assumptions

about the economic effects of various business practices.[14] Because the antitrust statutes are so broad and vague, the courts must breathe life into them and interpret them using a heavy dose of economics. That gives the Supreme Court enormous influence over how the antitrust laws actually operate, which makes it crucial that the economic assumptions underlying legal doctrine be well supported by economics.

Fortunately, and precisely because of the common law nature of the antitrust laws, these errors by the Supreme Court could be corrected—and many of them were. Many legal scholars and economists pointed out problems with the Supreme Court's economic reasoning. As a result, from the late 1970s through the mid-1980s the law changed significantly and became much better aligned with economic theory and evidence. The Harvard School and the Chicago School both deserve credit for this shift, although during this period of time the courts followed the Harvard School more closely.[15]

During the late 1970s and early 1980s, as scholars well-versed in the game-theoretic tools were revolutionizing industrial organization theory, the flawed Supreme Court antitrust cases noted above were just begging to be analyzed. They did not hold up well. Seeing some of the new learning from IO Economics incorporated into antitrust law was a welcome development.

But then, starting in the late 1980s, our story takes an unfortunate turn. The courts increasingly came under the influence of a group of lawyers and economists associated with the Chicago School. Antitrust law lost its way a second time. The drift was in the opposite direction, but the underlying cause was the same: a failure to follow the findings of IO Economics.[16]

Looking back, we can now see that what started in the 1970s as a healthy correction to antitrust law was taken too far by free-market Chicago School ideologues intent on dramatically shrinking antitrust law.[17] Under their continuing influence, antitrust case law has become encrusted with a constellation of pro-defendant doctrinal assumptions that are unsupported by the research findings of IO Economics. Take, for example, the assumption that predatory pricing can rarely, if ever, be profitable for a monopolist. This assumption is demonstrably false, especially in markets with significant entry barriers and in situations where a firm can establish a reputation for predatory behavior, which itself can deter entry.[18] However, once enshrined in doctrine, this proposition and others like it effectively become immune from continued advances in economic learning. The law has been unable to adjust in recognition of new facts and circumstances because those facts conflict with legal doctrine that only the Supreme Court can update. As a result, these doctrinal assumptions have prevented antitrust law from evolving to reflect new learning. Antitrust law ossified.[19]

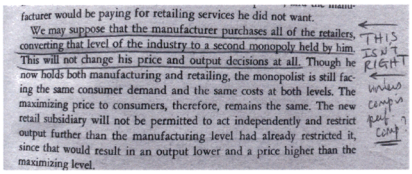
The problem has now grown acute as, for decades, the courts have added more of these doctrinal assumptions to antitrust law. Initially, the courts largely followed well-reasoned reforms also supported by the Harvard School, but, over time, the courts increasingly adopted more extreme and unjustified doctrinal changes championed by the Chicago School. As a result, some parts of antitrust law are now far out of date as regards economic learning in a manner that systematically leads to under-enforcement. Much of this shift in favor of antitrust defendants has been political and ideological, in the sense that it occurred because the Supreme Court has become increasingly pro-business. The shrinking of antitrust law by the Supreme Court is part of a far broader story which encompasses that Court's general hostility to government regulation of business.

How did these forces play out in antitrust? Several highly influential lawyers associated with the Chicago School—most notably Robert Bork, Frank Easterbrook, and Richard Posner—managed to dramatically weaken the ability of our antitrust laws to control monopoly power. The approach they advocated went far beyond the changes to 1960s antitrust that were supported by economic theory or evidence. All the more striking, they achieved this coup by putting forward a series of assertions that sounded as if they were the work of economists but that were, in fact, deeply flawed and had not been subjected to the normal scientific process of peer review. Citing these authors, the Supreme Court began making broad doctrinal pronouncements that did not reflect mainstream IO Economics and were rooted in laissez faire philosophy.[20]

The mode of analysis often employed by these Chicago School lawyers was deeply *unscientific*. They would make a basic argument that had some validity in certain circumstances and then wildly over-generalize based on that argument. Robert Bork's enormously influential 1978 book, *The Antitrust Paradox*, perfectly illustrates the approach taken by these Chicago School lawyers.

My copy of Bork's book is heavily annotated with comments I made 40 years ago indicating that while some of Bork's economic arguments were valid, a great many were not. On top of that, his sweeping policy conclusions were quite detached from economic theory or evidence.

Chapter 11 in *The Antitrust Paradox*, "Vertical Mergers," offers a fine example of Bork's signature move. He lays out his position early in the chapter, writing: "Antitrust's concern with vertical merger is mistaken. Vertical mergers are a means of creating efficiency, not of injuring competition."[21] How did Bork support such a sweeping statement? He offered a series of theoretical economic propositions about the economic effects of vertical mergers. However, Bork was not an economist, and these propositions are either false or, at best, hold only in certain very fragile and overly simplistic economic models. Here, for example, is my notation from 40 years ago regarding Bork's assertion that prices and output would be unchanged if a monopoly manufacturer were to purchase all relevant retailers:[22]


facturer would be paying for retailing services he did not want.

We may suppose that the manufacturer purchases all of the retailers, converting that level of the industry to a second monopoly held by him. This will not change his price and output decisions at all. Though he now holds both manufacturing and retailing, the monopolist is still facing the same consumer demand and the same costs at both levels. The maximizing price to consumers, therefore, remains the same. The new retail subsidiary will not be permitted to act independently and restrict output further than the manufacturing level had already restricted it, since that would result in an output lower and a price higher than the maximizing level.

Bork conveniently omits from his reasoning any actual or potential rivals to the manufacturer. Even though the basic concern with a dominant manufacturer purchasing retailers is the foreclosure of rival manufacturers, Bork relies on an economic model in which that concern cannot arise because there are none. If one expands the model to include rival manufacturers, foreclosure can easily occur.[23] A bit later, Bork mentions the theory that entry may be deterred if a new firm must enter at both the manufacturing level and the retail level, but he summarily dismisses this perfectly valid theory by stating without evidence that "the effort to block entry in this manner will surely prove both costly and fruitless."[24]

Bork's book is a full of faulty arguments that follow this same structure: rely on an overly simple economic model and then misuse that model to reach broad antitrust policy conclusions that are biased against antitrust enforcement. Examples include his assertion that price cutting "does not provide a likely means of predation," his claim that placing restrictions on "any firm size created by internal growth," regardless of the tactics used to grow, will with "high probability" be harmful, and his argument that exclusive dealing "creates efficiencies and does not create restriction of output."[25]

The approach taken by Bork and other Chicago School lawyers would not withstand peer review, for two basic reasons. First, fragile conclusions based on very simple models are not reliable for policy recommendations. The Chicago School lawyers never checked the robustness of the simple models upon which they were relying, and they lacked the tools to do so.[26] Second, and directly contrary to what Chicago School *economists* proudly stood for, the Chicago School lawyers based their dramatic policy conclusions on little or no systematic empirical evidence.[27]

The advances in IO Economics during the 1970s and 1980s did not support the laissez faire approach to antitrust that we now associate with the Chicago School. There was no empirical finding that predatory pricing is rare or theoretical result that predatory pricing is irrational. There was no empirical or theoretical finding that all vertical mergers are procompetitive, and economic theory teaches otherwise. There was no empirical finding that exclusive dealing provisions used by a firm with substantial market power typically promote competition, and economic theory warns otherwise. Much of this was clear to many economists in the 1980s, and indeed starting in the 1980s a steady stream of "Post-Chicago" publications appeared.[28]

Yet Bork's cavalcade of errors still matters today because the courts have often adopted his reasoning and cited his work, and because similar errors have been propagated by other Chicago School lawyers. Put simply, these lawyers and their followers have successfully embedded into antitrust case law a series of propositions that were never established empirically and were never valid as a matter of economic theory in the first place. Jonathan Baker has identified a number of erroneous arguments put forward by the Chicago School using these tactics: markets self-correct through entry; markets self-correct because oligopolies compete and cartels are unstable; monopolies innovate; monopolists cannot obtain more than a single monopoly profit; and business practices prevalent in competitive markets cannot harm competition.[29]

Based on this distorted view of how markets operate, and freed from the strictures of sound economic analysis, Chicago School lawyers convinced the courts to erect greater and greater hurdles to antitrust plaintiffs, dramatically weakening antitrust enforcement, under the false pretense that they were bringing sound economics to the law. As a leading example, Frank Easterbrook undermined antitrust enforcement under cover of purportedly neutral "error cost" analysis.[30] Easterbrook's entire analysis was based on an economic *assumption* he made that "Monopoly is self-destructive. Monopoly prices eventually attract entry."[31] But his assumption that monopoly power erodes soon enough was based on ideology, not evidence. Then and now, IO economists understand that monopolies can last for a long time, especially (and ironically) if antitrust enforcement is as lax as Easterbrook favors. Easterbrook mirrors his economic assumption with a legal one: "If the court errs by condemning a beneficial practice, the benefits may be lost for good."[32] His assumption that erroneous condemnations are rarely if ever corrected was demonstrably false in 1984 and dramatically so today given how antitrust law has evolved. During the decade just before Easterbrook wrote his article, antitrust case law had been evolving rapidly, leading a number of older, pro-plaintiff cases to be narrowed or overruled.[33]

After stacking the deck, Easterbrook argued that antitrust courts should err on the side of defendants, because "judicial errors that tolerate baleful practices are self-correcting, while erroneous condemnations are not."[34] Like Bork, Easterbrook achieved his desired result based not on economic theory or empirical evidence, but by making strong and unjustified assumptions.[35]

I do not mean to suggest that the Chicago School has run the table over the past 40 years. There are certainly many sound antitrust decisions that rely on IO Economics, and even an occasional decision by the Supreme Court in favor of antitrust plaintiffs. But plaintiffs in antitrust cases now

face undue burdens in many cases as a result of Chicago School arguments that have been deeply embedded into the case law, especially as regards unilateral conduct.

Before discussing how we can fix this problem, it is worth noting that the story relating to cartels and horizontal mergers is quite different from that relating to monopolization and vertical practices. In other words, the story regarding coordination and collusion is very different from the story regarding exclusion. By and large, the Chicago School lawyers have supported vigorous antitrust enforcement against cartels, and antitrust law has been steadfast in condemning them. And horizontal merger enforcement has followed quite a different path, in part because the Supreme Court has not ruled on a horizontal merger in decades.

For horizontal mergers, IO Economics has greatly influenced agency enforcement and the development of the case law over the past 60 years. Back in the 1950s and 1960s, the SCP framework animated a generalized concern among IO economists about market concentration. The SCP framework lay behind the structural presumption that the Supreme Court articulated in 1963 in *Philadelphia National Bank*.[36] The primary antitrust concern with horizontal mergers during that era was what we now call "coordinated effects," which were the focus of the SCP framework. The SCP framework also provided the intellectual foundation for the 1968 Merger Guidelines. While the market concentration thresholds went up markedly in 1982, and then more in 2010, market concentration remains a central element of horizontal merger analysis.[37]

Over the past 50 years, the antitrust treatment of horizontal mergers has incorporated many aspects of new learning from IO Economics, most notably by including and elevating the role of unilateral effects in merger analysis and by giving greater consideration to innovation effects. I attribute this in large part to the influence of the Horizontal Merger Guidelines, first issued in 1968, and to the significant role played by economists at the DOJ and the FTC.[38] Nonetheless, the Chicago School influence can be felt in the area of horizontal mergers. The courts erected higher hurdles that the government must surmount to establish its prima facie case, weakened the structural presumption, became overly receptive to the entry defense, and required the government to do more to prove that a proposed remedy—usually behavioral—would not be adequate.[39] These obstacles to horizontal merger enforcement have become more problematic as evidence has mounted that mergers have harmed competition in some sectors of the economy.

Restoring Effective Antitrust Enforcement

In this section I sketch out how antitrust law can shed itself of Chicago School ideology unsupported by economics to adopt a Modern vision for the Future of Antitrust.[40]

I confine myself here to antitrust enforcement, which is but one part of competition policy. For a broader discussion of competition policy in the years ahead, including regulation, see Restoring Competition in the United States: A Vision for Antitrust Enforcement for the Next Administration and Congress.[41]

Protecting and Promoting Competition. My discussion in this section takes as a given that the goal of antitrust is to protect and promote competition. I revisit that below when I address Populist proposals to broaden antitrust's goals.

The courts commonly address whether a merger or challenged conduct is procompetitive or anticompetitive. Under current case law, this assessment is often made by applying the "consumer welfare standard." That term has outlived its usefulness and should be retired. I advocate replacing the term "consumer welfare standard" with the term "protecting competition standard" to make clear that the goal of antitrust is to protect and promote competition. This proposal involves a change in language, *not* a substantive change in the goal of antitrust law. Here is my definition of the protecting competition standard:[42]

> **A business practice is judged to be anticompetitive if it harms trading parties on the other side of the market as a result of disrupting the competitive process.**

By the "competitive process," I mean the dynamic process by which market participants seek to grow by offering more attractive terms and conditions to those with whom they trade. Disrupting the competitive process can involve blocking rivals by impeding their ability to make attractive offers to customers as well as short-circuiting competition by colluding with or merging with rivals. A firm does not disrupt the competitive process by taking an action that makes its offerings more attractive and does not block its rivals from competing on the merits.

I favor this change in language because the term "consumer welfare standard" has become confusing and counterproductive. Understanding how that happened is instructive.

During the middle of the 20th century, the courts struggled to distinguish business behavior that was a legitimate form of competition from behavior that harmed competition. The courts eventually came to understand one of the basic principles of IO Economics: many forms of legitimate competition harm rivals but benefit customers. In the canonical situation, a firm that lowers its price or improves the quality of its products harms its rivals and benefits its customers. Indeed, that is a fundamental property of competition to serve customers. In that context, the term "consumer welfare standard" usefully directed attention away from the impact of such business practices on rivals and toward their impact on customers. For the same reason, antitrust developed the mantra that "antitrust protects competition, not competitors."[43]

Unfortunately, the term "consumer welfare standard" never did a good job conveying the deeper underlying idea of protecting and promoting competition. To see why, consider a merger between two large employers that harms workers by creating or enhancing employer buyer power in a

local labor market. This merger lessens competition among employers for workers and thus is a problem under the "protecting competition standard." But a sensible person might well query whether the merger is a problem under the "consumer welfare standard." That term directs one's attention toward consumers, which is a distraction in this example.

As a substantive matter, antitrust law understands that a merger can enhance market power on the buyer side and anticompetitive conduct can harm sellers, including workers. In my example, the local labor market would be a relevant market, and one concern would be enhanced power on the buyer side of that market, i.e., by employers. But the public can all too easily be left with the impression that antitrust is just about final consumers and ignores the interests of workers, farmers, or business customers. Why keep using a term that is so prone to misunderstanding?[44]

A further problem with the term "consumer welfare standard" is that the courts have used it to impose additional burdens on antitrust plaintiffs to *quantify* consumer harm. That has led the courts in some cases to focus excessively on short-term price effects and discount longer-term effects on prices, product quality, or innovation that are harder to quantify. Naturally, merging parties respond strategically. For example, in the *T-Mobile/Sprint* merger case, the merging firms promised not to raise prices to consumers for three years, as though such a promise could turn an anticompetitive merger into a procompetitive one. In other cases, merging firms sign multi-year contracts with customers and then assert that these customers are protected so the merger should be allowed under the consumer welfare standard. That is dangerous. Under the "protecting competition standard," attention would be directed less toward short-term price effects and more toward how the merger would alter competition.

Above all, the protecting competition standard, with its language about "disrupting the competitive process," speaks more directly to the goal of antitrust and evokes market dynamics and innovation. Under the protecting competition standard, the claim that a monopolist can exclude a small rival because that rival is less efficient would fall flat.

Protecting Competition Using Existing Antitrust Statutes. The DOJ and the FTC can substantially influence the development of antitrust case law by using their authority and resources to persuade the courts to fashion legal rules that treat business practices based on their probable real-world economic effects, supported by accepted economic theory and reliable evidence, not based on outdated assumptions or laissez-faire ideology. If the DOJ and FTC are successful in this effort, I have some modest hope that, in time, the courts will reduce some of the obstacles to sound antitrust enforcement that are present today.[45] Here, I give a flavor for how that can be done. I do not attempt to offer a comprehensive enforcement agenda.

Create Rebuttal Presumptions in Favor of Antitrust Plaintiffs. The courts could create more paths by which antitrust plaintiffs can establish a rebuttable presumption that certain conduct harms competition, reduce the quantum of proof required to establish these presumptions, and/or require defendants to present stronger evidence to rebut them. This type of "quick look" analysis would follow the three-step burden shifting framework that is familiar to antitrust lawyers. This approach would greatly focus and simplify antitrust cases. By building better economics into the law, the scope and complexity of the economic expert testimony in many individual cases would be reduced. I am betting that judges and litigating attorneys would welcome that![46]

Economics provides an indispensable way to sift through a mountain of evidence to better understand the likely economic effects of various business practices in comparison with some suitable counterfactual. Economics is not "pro-defense" or "pro-plaintiff." Properly used, economics instructs us *what to look for* in a given case to assess effects. Economics is not about *what can never happen*. Those aiming to downplay the use of economics in antitrust confuse the role of economics in assessing economic effects with the distinct issue of how the courts have set legal standards and apportioned burdens of proof. In my examples below, I suggest building sound economics into the legal standard. That will strengthen antitrust enforcement, improve the accuracy of antitrust decisions, and simplify litigation.

Here are a few examples of some recent cases that would have been decided in a more plaintiff-friendly manner had the courts properly used economic theory and evidence and applied the protecting competition standard.[47]

- ***Actavis***:[48] The Supreme Court would have adopted a rebuttable presumption against any large transfer of value from a branded pharmaceutical company to a potential generic entrant as part of their settlement of a patent infringement case. The burden would then shift to the defense to show that any such transfer of value was made for a purpose other than delaying generic entry. The plaintiff would not have to prove that the transfer of value is "unexplained." This would be a very focused inquiry, simplifying these cases; there would be no need to define a relevant market. This approach is strongly supported by economic theory and overwhelming evidence that generic entry lowers prices.[49]
- ***American Express***:[50] The Supreme Court would have upheld the district court's opinion in favor of the plaintiffs based on the factual finding that American Express's no-steering rule disrupted the competitive process and elevated merchant acceptance fees by stifling price competition among credit cards for merchant acceptance. Those factual findings should have created a presumption that the rule was anticompetitive, which American Express failed to rebut.

  This case illustrates how Chicago School ideology has displaced common sense and sound economics

at the Supreme Court. Applying IO Economics, the Court would have started with deep skepticism about American Express blocking merchants from offering discounts on transactions *that do not involve American Express.* Yes, American Express should have the freedom to choose its own business model—high merchant acceptance fees and high rewards to cardholders. But that freedom does not extend to disrupting the ability of *other* payment systems to deploy their own distinct business models—lower merchant fees and lower rewards—especially if they threaten American Express by fomenting price competition. Instead, the Supreme Court went down a distracting and irrelevant rabbit hole relating to market definition.

- ***Qualcomm***:[51] The Ninth Circuit would have upheld the district court's opinion based on the district court's factual finding that Qualcomm's no-license/no-chip policy had the economic effects of raising the costs of Qualcomm's rivals (modem-chip makers) and raising the all-in price of modem chips to customers (manufacturers of cell-phones).

  Something is deeply wrong with antitrust law when the facts show that a monopolist has engaged in conduct that excludes competitors by raising their costs and harms customers by raising prices, yet an appellate court does not see an antitrust violation. My reading of the Ninth Circuit opinion is that the appeals court had difficulty understanding the economic effects of Qualcomm's no-license/no-chips policy, so it defaulted in favor of the defense. That instinct is very much in the Chicago School tradition.
- ***T-Mobile/Sprint***:[52] The district court would have blocked this merger if stronger evidence were required to rebut the structural presumption. The district court would not have discounted Sprint's ability to compete, given Sprint's sizeable market share and its own market share projections. The district court would have required more convincing evidence of Sprint's coming decline before accepting a speculative efficiency defense and a dubious, slow-acting remedy containing many conduct elements for years to come.

Many other areas of antitrust law would benefit from a recalibration in favor of plaintiffs, based on the current state of knowledge in IO Economics. To be clear: I am talking here about reducing the burden on plaintiffs for various types of conduct that already can be illegal under current antitrust case law. I generally favor the use of rebuttable presumptions rather than per se rules, but views on this differ among Modernists based on how they trade off accuracy vs. simplicity. To give a few more illustrative examples, presumptions against the following conduct by dominant firms are well worth considering: (1) acquisitions of significant actual or potential rivals; (2) open early/closed late strategies that exclude rivals; (3) below-cost pricing; and (4) exclusive dealing requirements imposed on important trading partners.[53]

The evidence required to rebut these presumptions will vary from one practice to another. For example, a dominant firm might defend below-cost pricing by pointing out that selling one product below cost generates profit margins on a complementary product, so it was not actually losing money on the sales in question. That defense could apply if the dominant firm is offering a free service to consumers to generate advertising revenue or selling a piece of durable equipment to generate profitable aftermarket sales of parts and service. My point is that the burden would rest on the dominant firm to explain its below-cost pricing, not on the plaintiff to prove that entry barriers are sufficiently high that recoupment will be possible in the future.

Allow Plaintiffs to Prevail Without Defining a Relevant Market. The courts also can simplify antitrust cases and make fewer errors by giving more weight to direct evidence of the economic effects of challenged practices and providing more plaintiffs with a path to success that does not require defining a relevant market.

The courts could first look for direct evidence of economic effects. This evidence might be qualitative or quantitative. Alternatively, the courts could define a relevant market in situations where market shares are informative about economic effects. This is by and large what the DOJ and the FTC do in their investigations. If they see harmful effects, they can reverse-engineer a relevant market in which those effects are situated, as part of preparing to litigate cases where the courts will require them to define a relevant market.

For example, in horizontal merger cases, the courts could allow the government to establish a presumption of harm to competition by showing that the two merging firms are substantial, direct rivals, without the need to define a relevant market. This would not prevent the government from alternatively invoking the *Philadelphia National Bank* structural presumption, which remains well grounded in economic research, as large increases in market concentration caused by horizontal mergers tend to lead to a substantial lessening of competition.

IO economists know that the actual economic effects of a practice do not turn on where one draws market boundaries. I have been involved in many antitrust cases where a great deal of time was spent debating arcane details of market definition, distracting from the real economic issues in the case. I shudder to think about how much brain damage among antitrust lawyers and economists has been caused by arguing over market definition.

Both the Chicago School and the Populist camps use the technical step of defining the relevant market as a vehicle to achieve the results they want—less or more antitrust enforcement as the case may be—rather than seeking to assess economic effects directly.

The Chicago School emphasizes market definition because antitrust defendants often win by arguing that the plaintiff has not properly defined the relevant market. Defendants have managed to turn market definition into a gating item under the case law, even if there is direct evidence of anticompetitive effects.[54] We see this in the *American Express* case, where the Supreme Court ruled in favor of the defendants based on the government's failure to properly define the relevant market, despite the district court finding *direct* evidence of significant anticompetitive effects.[55] This same tactic was used in the second *Staples/Office Depot* case where the defendants extensively cross-examined the FTC's economic expert (me) on the relevant market and market shares, but studiously avoided the most significant economic evidence in the case, which showed that the merging firms were the two leading bidders in many procurements for office supplies by large businesses.[56] In addition, after the relevant market has been defined, antitrust defendants often attempt to use market share metrics in an asymmetric way that favors them.[57]

Similarly, the highly structural approach favored by the Populists as a means to deconcentrate the economy necessarily relies heavily on defining relevant markets and measuring market shares in a way that is intended to favor plaintiffs. The Populists gloss over major challenges posed by their very heavy reliance on market definition. A highly structural approach driven by market definition may end up making antitrust more arcane and detached from reality, as even more cases turn on how the relevant market is defined. Such a focus may make antitrust cases harder, not easier, for plaintiffs to win.[58] Antitrust litigators know well that the more weight one puts on market definition and market shares, the more effort litigants will spend on those topics. Yet, as any economist will tell you, the economy is not partitioned neatly into various "relevant markets," especially today, where products and services are highly differentiated. In many cases, emphasizing market definition instead of economic effects would draw attention away from the real story and to an arcane boundary-drawing exercise.

Take horizontal mergers—which I consider critical for antitrust enforcement. In my experience, the government needs to tell a convincing story of harm to the public to convince a federal judge to block a proposed merger. I suspect this will remain true even if the law were to change so that lower concentration levels would trigger a stronger structural presumption. In that world, if the government does not tell a textured, coherent story about how the merger will harm trading partners, it will still be at serious risk of losing. The loss just would come in the form of an unconvinced court rejecting the government's relevant market, ruling that the government has not properly established the structural presumption. For this reason, I favor presumptions that are well connected to the underlying economic effects. The structural presumption based on the level of the HHI is well suited for mergers involving coordinated effects; the change in HHI and upward pricing pressure are well suited for mergers involving unilateral effects.[59]

By way of contrast, the Modern approach seeks to more accurately assess economic effects using the best available methods. Antitrust law can do that by establishing rebuttal presumptions that certain categories of conduct often harm competition, calibrating the legal standards of proof to reflect economic reality, and then narrowing attention in individual cases to the most probative evidence of economic effects.

In summary, the Modernist vision for the Future of Antitrust under the current antitrust statutes is to vigorously challenge mergers and business conduct that harm counterparties by disrupting the competitive process, based on the best evidence of likely economic effects. That will require perseverance. Antitrust defendants are well-counselled and well-funded and they will not readily cede ground, especially if they believe they have precedent on their side and will receive a favorable hearing on appeal, not an unreasonable expectation given the current judiciary.

This state of affairs is unsatisfactory in many ways. Based on my experience in antitrust litigation, I fear that any progress along these lines will be painfully slow. So let me turn to . . .

Updating the Antitrust Statutes. Many observers, myself included, are unwilling to wait 30 to 40 years for antitrust to correct itself through the slow evolution of the case law. Plus, one can hardly be confident that the case law will move at all in the direction of stronger antitrust enforcement over the next decade or two, based on recent decisions by the Supreme Court and its current makeup. For these reasons, I support legislative changes that codify the approach supported by the Modernists. To that end, along with a group of experienced antitrust practitioners and academics, I endorsed the bill recently introduced by Senator Amy Klobuchar, the "Competition and Antitrust Enforcement Reform Act of 2021."[60] I applaud Senator Klobuchar's efforts to strengthen horizontal merger enforcement and to overrule a number of faulty, pro-defendant Supreme Court cases involving conduct by large firms. For more details on the type of legislation that I support, see Restoring Competition in the United States: A Vision for Antitrust Enforcement for the Next Administration and Congress.

Even with new legislation, antitrust can and should only do so much. We very much need new sector-specific regulations, especially to deal with the tech titans. Article III courts are poorly suited to provide ongoing regulation of the terms and conditions on which one firm must deal with another, especially in the presence of rapidly changing technology. Plus, *ex post* antitrust enforcement is not a substitute for *ex ante* industrywide rules. As the rest of the world has realized, we very much need sector-specific regulation to reign in the power of the tech titans and to cure problems

associated with the misuse of personal data and with the spread of misinformation. Many of the ills requiring regulation do not involve the abuse of market power. For now at least, the United States will be watching from the sidelines as the UK and the EU move forward to regulate core platform providers who are "gatekeepers" in digital markets.

The Populist Challenge to Antitrust

I now turn to address the Populists, who are often called Neo-Brandeisians.

My starting point is that I share many sympathies with the Populists. Like them, I am deeply concerned about the excessive political power of large corporations. Like them, I believe that today's extreme levels of income and wealth inequality in America are very unhealthy for our democracy and for our society. Like them, I believe that the growing share of the economic pie going to shareholders and the declining share going to workers has contributed to this inequality. Like them, I believe that better public policies can go a long way to fixing these problems, if only we can find the political will to enact them. Like them, I believe that antitrust enforcement has been too lax, largely as a result of the durable influence of the Chicago School.

However, my assessment of what is *causing* these social and economic ills differs from the Populists' assessment. We both read the accumulating economic evidence as showing that market power has risen in a number of sectors of the U.S. economy and that antitrust enforcement has generally been too lax. However, where the Populists see an economy infested with monopolists, I see an economy that is dynamic and competitive in many respects, but can and should be more so. I see grave problems with market power in the health care sector and a number of others, but I also see vigorous competition in large portions of the U.S. economy.

The Populists implicate lax antitrust as the central cause of many of our social and economic problems, while I see other public policy failures—including weak voter-protection and anti-corruption laws, inadequate protections for workers, highly unequal access to education and health care, and a tax system that contains many regressive elements—as the central culprits. Indeed, many of the social and economic problems we are facing in the United States today can also be found in countries such as the U.K. and France, where competition policy has by no means been captured by free market ideology.

The Populists also implicate the use of economics in antitrust as counterproductive. Obviously, I strongly disagree with that assessment. Antitrust is about economic concepts, and the problems with antitrust law have come when it has departed from economic learning. Economics is a neutral tool that helps us understand the economic effects of various business practices. Louis Brandeis himself was deeply concerned about real economic effects, not legal formalisms.

What do these differences in diagnosis imply for antitrust policy? There are a number of distinct Populist voices, and the Populist approach to antitrust is still evolving, but some clear themes have emerged.[61] For starters, Modernists and Populists agree on many antitrust policy proposals that would reverse the Chicago School excesses. As one example, they agree that the Biden administration should rescind the Trump administration's misguided and poorly reasoned approach to standard-essential patents.[62] Both camps want more vigorous antitrust enforcement.

But there are some major differences between the policy proposals of the Populists and the Modernists, which stem from fundamental differences in what they want antitrust to accomplish. The Populists want to use antitrust to deconcentrate private power, while the Modernists want antitrust to protect and promote competition. Populists associate the "Curse of Bigness" with large firms, while Modernists recognize that many "superstar firms" have grown large by being highly efficient.

Here is a good litmus test: What should be done with companies that grow organically and come to have durable monopoly power solely as a result of effectively and efficiently serving the needs of their customers? Populists are quite willing to break up such companies. Modernists are not.

The basic idea of deconcentrating the U.S. economy to disperse private power is not new. In 1969, the Neal Report recommended that Congress pass the Concentrated Industries Act, which would have empowered the Attorney General to break up "oligopoly industries" so that the leading firm's market share would be no larger than 12.5 percent.[63]

William Kovacic has masterfully explained the recurrent impulse to use antitrust to break up large firms, and why this impulse has repeatedly met with failure. He also astutely predicted, some 30 years ago, that the impulse would emerge again.

> Why, then, will a new collection of enforcement officials set off to climb a mountain that routinely has conquered its challengers? The answer may be that the durability of the deconcentration impulse ultimately has little to do with realistic expectations that a broad-based program of Sherman Act divestiture suits will dissolve existing aggregations of market power. Its recurring hold on public policy instead derives from its attractiveness as a symbolic outlet for public antipathy toward large corporate size.[64]

Breaking up successful, efficient, and innovative companies merely because they have grown too large or powerful is antithetical to the competitive process. Economic theory and evidence indicate that a widespread campaign to break up large firms on a "no-fault" basis would slow economic growth by making our economy less competitive and less innovative. So would imposing line of business restrictions that block firms from exploiting economies of scope and thereby injecting competition into adjacent markets. In my opinion, these blunt deconcentration policies would cause the prices of many goods and services to go up, harming many American households. More fundamentally, breaking

up monopolies and oligopolies on a "no-fault" basis would be fighting against powerful, underlying economic forces associated with economies of scale and scope that are a pervasive feature of advanced economies around the world.

In any event, I do not believe that the American people would tolerate an economic system under which successful firms that have done nothing wrong are routinely broken up by the government. I shudder to think what Donald J. Trump would have done with that power, and I doubt very much that Congress will want to put such power in the hands of the executive branch. I hope not.

As much as I am concerned about the excessive political power of large corporations in the United States, I do not see widespread deconcentration of the economy as a wise response. The economic costs would be enormous. If there is sufficient political will to reduce the political power of large corporations, there are far better solutions that would not cause such damage to our economy. For example, shareholder votes could be required for any political contributions by public companies, public funding of candidates could be increased, and vastly more transparency into how corporations interact with and lobby the government could be mandated.

Conclusion

Antitrust law urgently needs to free itself of the laissez-faire ideology that the Chicago School has successfully embedded into the case law over the past several decades. This article explains how that can be done by replacing Chicago School doctrine with a constellation of rebuttable presumptions favoring antitrust plaintiffs that are based on economic theory and evidence. I hope that Modernists and Populists will make common cause with this effort.

In the months and years ahead, I expect to see the Biden administration generally pushing the boundaries of antitrust enforcement in a pragmatic way, recognizing that the case law in many respects is favorable to defendants and that losing cases weakens enforcement. I especially expect—and hope—to see challenges in cases where dominant firms are seeking to acquire nascent competitors that pose a real threat to their dominance. Protecting competition requires preserving those threats, especially when they are few in number. Those cases will likely involve both horizontal and vertical issues. How the agencies and the courts deal with the inherent difficulty of predicting the path of innovation and with claimed synergies will be critical.

We also will see a noticeable increase in enforcement activity if Congress substantially increases the budgets of the enforcement agencies. Those extra resources would do a great deal to turbocharge the efforts of the Biden administration to better deter anticompetitive mergers and conduct and to push the boundaries of antitrust law.

Finally, we have the prospect of major, substantive changes to the antitrust statutes to strengthen antitrust enforcement. Others are more qualified than I am to assess the likelihood of Congress passing such legislation, but if it does, we will see a wave of cases testing the boundaries of these new provisions. I would like to think that the courts would then get the message and finally move past the Chicago School biases against antitrust plaintiffs that have seeped into the case law over the years. Only time will tell. ■

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[1] *See, e.g.*, David Autor et al., *The Fall of the Labor Share and the Rise of Superstar Firms*, 135 Q.J. Econ. 645 (2020); John Van Reenen, *Increasing Differences Between Firms: Market Power and the Macro-Economy* (Ctr. for Econ. Performance, CEP Discussion Paper No. 1576, 2018), https://ideas.repec.org/p/cep/cepdps/dp1576.html. The proper interpretation of this economic evidence for antitrust policy are emphasized in Jonathan B. Baker, The Antitrust Paradigm 11 (2019) (Ch. 1, Market Power in an Era of Antitrust); Carl Shapiro, *Antitrust in a Time of Populism* 61 Int'l J. Indus. Org. 714 (2018); and Carl Shapiro, *Protecting Competition in the American Economy: Merger Control, Tech Titans, Labor Markets*, 33 J. Econ. Persps., Summer 2019, at 69.

[2] As a recent report explains: "Strong antitrust enforcement directed at business conduct that harms competition can deliver many beneficial byproducts, among them reducing inequality, advancing the diversity of voices (a First Amendment goal), discouraging threats to democracy from concentrated political power, and expanding opportunities for small businesses to compete." Bill Baer, Jonathan Baker, Michael Kades, Fiona Scott Morton, Nancy Rose, Carl Shapiro & Tim Wu, *Restoring Competition in the United States: A Vision for Antitrust Enforcement for the Next Administration and Congress* (Wash. Ctr. for Equitable Growth, Nov. 2020).

[3] Of course, people have a wide range of views, so any attempt to create just a few categories will be imperfect and some members of each group will inevitably disagree with how I characterize that group. This is a global caveat.

[4] Nat'l Bureau of Econ. Rsch., *The Industrial Organization Program*, https://www.nber.org/programs-projects/programs-working-groups/industrial-organization?page=1&perPage=50.

[5] Jonathan Baker argues that this view of antitrust is democratic in that the courts and enforcement agencies are following Congressional intent. See Baker, *supra* note 1, at 9 (Section I, "The Market Power Paroxysm and the Antitrust Paradigm"). In Baker's view, the technocratic antitrust that operates day-to-day and case-by-case "is the means by which antitrust enforcers and courts implement the political bargain." *Id.* at 65. Part of that political bargain is that effective antitrust reduces the need for regulation.

[6] See Richard Schmalensee, *Inter-Industry Studies of Structure and Performance*, *in* 2 Handbook of industrial organization 951 (Richard Schmalensee & Robert Willig eds., 1989); Michael Salinger, *The Concentration-Margins Relationship Reconsidered*, 21 Brookings Papers on Econ. Activity 297 (1990). For a brilliant and creative synthesis, see John Sutton, Sunk Costs and Market Structure: Price Competition, Advertising, and Market Structure (1990).

[7] The Handbook of Industrial Organization, *supra* note 6, is a good place to look to get a sense of the breadth and depth of these advances. The first two volumes were published in 1989 and a third volume was published in 2007. A fourth volume is currently in the works.

[8] To get a flavor of this body of work, see Carl Shapiro, *The Theory of Business Strategy*, 20 RAND J. Econ. 125 (1989). For an extensive and masterful treatment, see Jean Tirole, The Theory of Industrial Organization (1988). Tirole's book has served to train a generation of economists on IO theory.

[9] See Timothy F. Bresnahan, *Empirical Studies of Industries with Market Power*, *in* 2 Handbook of Industrial Organization, *supra* note 6, at 1011.

[10] Autor et. al., *supra* note 1, find that the most efficient firms have expanded and gained share in many industries. Jan De Loecker, Jan Eeckhout & Gabriel Unger document rising price/cost margins since 1980 together with shifts in market share from lower-margin to higher-margin firms, in *The Rise of Market Power and the Macroeconomic Implications*, 135 Q.J. Econ.

561 (2020). Esteban Rossi-Hansberg, Pierre-Daniel Sarte & Nicholas Trachter, show that, in many industries, large national firms have expanded by entering more local markets and injecting competition into those markets, causing national measures of concentration to rise while local measures of concentration have fallen, in *Diverging Trends in National and Local Concentration*, 35 NBER MACROECONOMICS ANN. 115 (2020). Bruce Blonigen & Justin Pierce find that mergers and acquisitions are associated with higher price/cost markups but do not increase plant-level productivity, in *Evidence for the Effects of Mergers on Market Power and Efficiency* (Nat'l Bureau of Econ. Rsch., Working Paper No. 22750, 2016).

[11] For a short history of the use of economics in antitrust law up to 2000, see William E. Kovacic & Carl Shapiro, *Antitrust Policy: A Century of Economic and Legal Thinking*, 14 J. ECON. PERSPS. Winter 2000, at 43.

[12] Cont'l T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36 (1977), *overruling* United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967).

[13] United States v. Phila. Nat'l Bank, 374 U.S. 321 (1963). The animating principle behind this decision, that highly concentrated oligopolies tend to perform poorly, was widely recognized by economists as having both theoretical and empirical support. Indeed, that was the central teaching of the SCP framework. The key passage reads: "Specifically, we think that a merger which produces a firm controlling an undue percentage share of the relevant market, and results in a significant increase in the concentration of firms in that market, is so inherently likely to lessen competition substantially that it must be enjoined in the absence of evidence clearly showing that the merger is not likely to have such anticompetitive effects." *Id.* at 363. The Court added that this test "is fully consonant with economic theory," and provided supporting citations. Regarding what constituted an "undue" market share, the Court cited George Stigler for the position that "any acquisition by a firm controlling 20% of the market after the merger is presumptively unlawful." *Id.* at 397 n.41. The post-merger market share of Philadelphia National Bank was at least 30% in the market for commercial banking in the Philadelphia metropolitan area.

[14] *See, e.g.*, Brown Shoe Co. v. United States, 370 U.S. 294 (1962); United States v. Arnold, Schwinn & Co., 388 U. S. 365 (1967); United States v. Topco Assocs., 405 U.S. 596 (1972).

[15] Herbert Hovenkamp summarizes this shift nicely in Herbert J. Hovenkamp, *Whatever Did Happen to the Antitrust Movement?*, 94 NOTRE DAME L. REV. 583 (2018). *See also* William Kovacic, *The Intellectual DNA of Modern U.S. Competition Law for Dominant Firm Conduct: The Chicago/Harvard Double Helix*, 1 COLUM. BUS. L. REV. 1 (2007).

[16] This story has been told before. For a very nice recent treatment, see Herbert J. Hovenkamp & Fiona Scott Morton, *Framing the Chicago School of Antitrust Analysis*, 168 U. PA. L. REV. 1843 (2020). "The early strength of the Chicago School was that it provided simple, convincing answers to everything that was wrong with antitrust policy in the 1960s, when antitrust was characterized by over-enforcement, poor quality economics or none at all, and many internal contradictions. The Chicago School's greatest weakness is that it did not keep up. Its leading advocates either spurned or ignored important developments in economics that gave a better accounting of an economy that was increasingly characterized by significant product differentiation, rapid innovation, networking, and strategic behavior. . . . As a result, the Chicago School went from being a model of enlightened economic policy to an economically outdated but nevertheless powerful tool of regulatory capture." *Id.* at 1844. And this pithy summary: "The [Chicago School] movement created what might be called 'Opportunistic Economics' by using economic analysis when it delivered the desired answer and ignoring it when it did not." *Id.* at 1853.

[17] There is abundant evidence that the program at Chicago led by Aaron Director was "derived from what might be called a deeply held belief system that political interference in market activities interfered with freedom and reduced societal welfare." George L. Priest, *The Limits of Antitrust and the Chicago School Tradition*, 6 J. COMPETITION L. & ECON. 1, 2 (2009). *See also* Hovenkamp & Scott Morton, *supra* note 16.

[18] *See, e.g.*, C. Scott Hemphill & Philip J. Weiser, *Beyond* Brooke Group: *Bringing Reality to the Law of Predatory Pricing*, 127 YALE L.J. 2048 (2018). *Brooke Group* is an example of the court imposing an undue burden on the plaintiff to prove recoupment, in part by relying on a prior case involving an alleged conspiracy lasting 20 years to engage in predatory pricing, *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986). A decade after *Brooke Group*, the DOJ lost a case where predation was likely taking place. See United States v. AMR Corp. 335 F. 3d 1109 (10th Cir. 2003).

[19] Robert Pitofsky called attention to this nearly 15 years ago. *See* HOW THE CHICAGO SCHOOL OVERSHOT THE MARK: THE EFFECT OF CONSERVATIVE ECONOMIC ANALYSIS ON U.S. ANTITRUST (Robert Pitofsky ed., 2008).

[20] For a vivid recent illustration of this phenomenon, see Ohio v. American Express, 138 S. Ct. 2274 (2018). "The Supreme Court's American Express decision ignored fundamentals and embraced a series of economically incoherent principles in the guise of applying antitrust economics." Herbert J. Hovenkamp, *The Looming Crisis in Antitrust Economics*, 101 B. U. L. REV. 489, 513 (2021).

[21] ROBERT BORK, THE ANTITRUST PARADOX 226 (1978).

[22] *Id.* at 229.

[23] Foreclosure does not arise in the special case where there is perfect competition and free entry among retailers, so rival manufacturers can easily create or sponsor their own retailing operations. That was the point of my note in the margin. However, in that special case, the retailing assets being acquired by the monopoly manufacturer are easily replicated. Vertical mergers in which the assets being acquired are easily replicated and not subject to economies of scale are not of practical concern. Here again, Bork assumes away the problem.

[24] BORK, *supra* note 21, at 239.

[25] *Id.* at 148, 178, and 303.

[26] Take, for example, the "one monopoly profit" argument that tying cannot be used to expand or entrench monopoly power. One can write down a very simple model in which that result holds, but there are many realistic models in which tying or a vertical merger can profitably be used to exclude rivals.

[27] George Stigler stands out as the pre-eminent industrial organization economist at the University of Chicago during this period. Stigler won the Nobel Prize in Economics in 1982 "for his seminal studies of industrial structures, functioning of markets, and the causes and effects of public regulation." Press Release, The Nobel Prize, This Year's Prize in Economics Is Awarded for Research on Market Processes and the Causes and Effects of Public Regulation (Oct. 20, 1982), https://www.nobelprize.org/prizes/economic-sciences/1982/press-release/. His publications do not suffer from the flaws found in Bork's writings.

[28] For a fine example of applying IO Economics to antitrust from the 1980s, see Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price*, 96 YALE L.J. 209 (1986).

[29] *See* BAKER, *supra* note 1; *see also* Jonathan B. Baker, *Taking the Error Out of 'Error Cost' Analysis: What's Wrong with Antitrust's Right*, 80 ANTITRUST L.J. 1 (2015).

[30] Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1 (1984).

[31] *Id.* at 2.

[32] *Id.*

[33] Notable examples include *Continental T.V. Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977) (ruling that vertical nonprice restraints must be analyzed under the rule of reason); *U.S. Steel Corp. v. Fortner Enterprises., Inc.*, 429 U.S. 610 (1977) (requiring plaintiffs in tying cases to establish that the defendant has significant market power); and *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477 (1977) (requiring a private antitrust plaintiff to show that it suffered "antitrust injury.").

[34] Easterbrook, *supra* note 30, at 3.

[35] I have no objection to "error cost analysis" in principle. After all, it is nothing more than an example of decision-making under uncertainty, which is widely taught to MBAs. But Easterbrook's pro-defendant policy recommendations all flow from his biased assumptions, not from "error cost analysis" as such.

[36] *Philadelphia National Bank*, 374 U.S. 321.

[37] *See, e.g.*, U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines 18 (2010) (Section 5.3, "Market Concentration") [hereinafter

Horizontal Merger Guidelines]. The decline of the structural presumption has weakened merger enforcement. See Herbert Hovenkamp & Carl Shapiro, *Horizontal Mergers, Market Structure, and the Burden of Proof*, 127 YALE L.J. 1996 (2018).

[38] See Carl Shapiro, *The 2010 Horizontal Merger Guidelines: From Hedgehog to Fox in Forty Years*, 77 ANTITRUST L.J. 49 (2010). Recent economic evidence warrants moving to stricter enforcement of horizontal mergers—but not going all the way back to the 1968 Merger Guidelines in form or in substance. See also Jonathan Baker, *Why Did the Antitrust Agencies Embrace Unilateral Effects?*, 12 GEO. MASON L. REV. 31 (2003).

[39] Herbert Hovenkamp & Carl Shapiro, *Horizontal Mergers, Market Structure, and Burdens of Proof*, 127 YALE L.J. 1996 (2018) (discussing the evolution of merger law and the weakening of the structural presumption).

[40] Of course, not all of those in the Modern camp will agree with every policy proposal offered here, but I am confident that many will agree with most of them.

[41] Bill Baer et al., *supra* note 2. I am one of the co-authors of this report.

[42] See Carl Shapiro, Address at the FTC-Georgetown University Hearings on Competition and Consumer Protection in the 21st Century The Protecting Competition Standard (2018), http://faculty.haas.berkeley.edu/shapiro/protectingcompetitionstandard.pdf; *The Consumer Welfare Standard in Antitrust: Outdated, or a Harbor in a Sea of Doubt?, Hearing Before the Subcomm. on Antitrust, Consumer Protection and Consumer Rights. of the S. Comm. on the Judiciary*, 115th Cong. (2017) (statement of Carl Shapiro), http://faculty.haas.berkeley.edu/shapiro/consumerwelfarestandard.pdf.

[43] Of course, any simple phrase can be taken out of context and abused. Exclusionary practices harm *both* competitors and competition, so the objections of competitors to a practice does not mean it is procompetitive. The Chicago School often dismisses the complaints of rivals even when they reflect anticompetitive exclusion.

[44] An additional problem with the term "consumer welfare standard" is that Robert Bork improperly used the term to refer to a *total* welfare standard (basically, consumer welfare plus profits), creating more confusion. Not coincidentally, his misuse of a well-established term in microeconomics served to favor antitrust defendants.

[45] My hope is very much tempered by the fact that case law, for good reasons, evolves slowly, and by the fact that the Supreme Court contains a number of justices who are enthusiastic adherents of the Chicago School. Hence my support for legislative change, as discussed below.

[46] When training economists as expert witnesses, I consistently press them to simplify their testimony. I often cite the famous dictum of Albert Einstein: "Everything should be made as simple as possible, but no simpler." I also employ a variation on Arthur C. Clarke's well-known third law, which states: "Any sufficiently advanced technology is indistinguishable from magic." My version for economic experts: "Any sufficiently complex economic testimony is indistinguishable from gibberish."

[47] I was an economic expert witness for the FTC in the *Actavis* and *Qualcomm* cases, I was Deputy Assistant Attorney General for Economics when the DOJ brought the *American Express* case, and I testified on behalf of a number of state attorneys general in the *T-Mobile/Sprint* case.

[48] FTC v. Actavis, 570 U.S. 136 (2013).

[49] See, *e.g.*, Aaron Edlin, Scott Hemphill, Herbert Hovenkamp & Carl Shapiro, *The* Actavis *Inference: Theory and Practice*, 67 RUTGERS U. L. REV. 585 (2015).

[50] *American Express Co.*, 138 S. Ct. 2274.

[51] FTC v. Qualcomm Inc., 969 F.3d 974 (9th Cir. 2020).

[52] New York v. Deutsche Telekom, 439 F. Supp. 3d 179 (S.D.N.Y. 2020).

[53] See BAKER, *supra* note 1, at 97 (2019) (Section II, "Antitrust Rules and the Information Economy"). Baker argues that "courts should be encouraged to adopt a number of rules and (rebuttable) presumptions defended in this book." *Id.* at 208. *See also* Andrew I. Gavil & Steven C. Salop, *Probability, Presumptions and Evidentiary Burdens in Antitrust Analysis: Revitalizing the Rule of Reason for Exclusionary Conduct*, 168 U. PA. L. REV. 2107 (2020).

[54] The "smallest market principle" is a good example of how defendants use arcane market definition to win. The 2010 Horizontal Merger Guidelines walked away from this principle, stating: "The Agencies may evaluate a merger in *any* relevant market satisfying the [hypothetical monopolist] test." Horizontal Merger Guidelines, *supra* note 37, Section 4.1.1 at 9–10 (emphasis added).

[55] *American Express Co.*, 138 S. Ct. at 2286. Writing in dissent, Justice Breyer stated: "Consumers throughout the economy paid higher retail prices as a result, and they were denied the opportunity to accept incentives that merchants might otherwise have offered to use less-expensive cards. I should think that, considering step 1 alone, there is little more that need be said." *Id.* at 2294 (internal citations omitted).

[56] See FTC v. Staples, Inc., 190 F. Supp. 3d 100 (D.D.C. 2016).

[57] Defense-oriented economists (and defense-oriented lawyers) regularly argue in merger cases that low market shares should create a safe harbor but high market shares should not create a presumption of harm to competition.

[58] The Populists make much of how certain metrics show a trend of increasing concentration in the U.S. economy. However, the data sources they cite generally measure product categories and geographic regions far broader than the relevant markets defined by antitrust courts. Furthermore, the levels of concentration that the Populists regard as alarming are far below those that the enforcement agencies or the courts have found problematic in horizontal merger cases.

[59] The problem with the level of the HHI is that it can be driven by how the market is divided among non-merging firms, which is of secondary significance in cases involving unilateral effects. In contrast, the change in HHI is driven by the market shares of the merging firms. For some very nice, recent work on this point, see Volker Nocke & Michael D. Whinston, *Concentration Screens for Horizontal Mergers* (Nat'l Bureau of Econ. Rsch., Working Paper No. 27533, 2020). In cases involving differentiated products and unilateral price effects, upward pricing pressure is an even better simple metric. "The Agencies rely much more on the value of diverted sales than on the level of the HHI for diagnosing unilateral price effects in markets with differentiated products." Horizontal Merger Guidelines, *supra* note 54, at 21.

[60] S. 225, 117th Cong. (2021) (referred to the Senate Judiciary Committee on Feb. 4, 2021).

[61] For an excellent treatment of different strands of thought among the Populists and how those strands relate to recent antitrust practice, see Leon B. Greenfield, Perry A. Lange & Nicole Callan, *Antitrust Populism and the Consumer Welfare Standard: What Are We Actually Debating?*, 83 ANTITRUST L.J. 393 (2020).

[62] See Mark A. Lemley & Carl Shapiro, *The Role of Antitrust in Preventing Patent Holdup*, 168 U. PA. L. REV. 2019 (2020).

[63] Phil C. Neal et al., *Report of the White House Task Force on Antitrust Policy*, 2 ANTITRUST L. & ECON. REV. 11 (1969).

[64] William Kovacic, *Failed Expectations: The Troubled Past and Uncertain Future of the Sherman Act as a Tool for Deconcentration*, 74 IOWA L. REV. 1105, 1150 (1989).

Competition and the Small Business Landscape

Fair Competition and a Level Playing Field

Testimony before the:

U.S. House of Representatives

Committee on Small Business

Barry C. Lynn
Executive Director
Open Markets Institute

March 1, 2022



INDEPENDENT BUSINESS IN AMERICA TODAY

The Declaration of 1776 was not simply about the independence of nation from nation. It was also about the independence of every individual person from all forms of coercive control. From the first, the American people understood that an essential measure of such independence was liberty to work one's own land, one's own ideas, one's own business, ones own labor, without interference from people with more money or more power.

This vision was not foremost an economic vision, as we understand the word today. Nor was it foremost a material vision. Rather it was a vision fundamentally political. It was based on the idea that only someone who is fully independent can be trusted within political debate, that to be fully in control of one's own mind and one's own voice requires being in control of one's own means. As W.E.B Du Bois put it in his foundational work Black Reconstruction, America was a "vision of democratic self-government: the domination of political life by the intelligent decision of free and self sustaining men."[1]

Thus, ever since, the American people have fought two great battles. The first was to establish systems of laws and rules – what we can call The American System of Liberty - to protect the property of the individual from all forms of predation. This meant building and developing systems of open markets where every individual was free to succeed based on their own efforts. The second was to extend the protections of this America System of Liberty to every member of our society, no matter the color of their skin, gender, religious belief, or sexual orientation.[2]

James Madison, in a 1792 essay titled simply "Property," made clear what the System of Liberty had to address. "That is not a just government, nor is property secure under it, where arbitrary restrictions, exemptions, and monopolies deny to part of its citizens that

free use of their faculties, and free choice of their occupations, which not only constitute their property in the general sense of the word; but are the means of acquiring property strictly so called."

Almost a century later, Senator John Sherman, in a speech defending his bill to establish federal antitrust law, as a main part of this System of Liberty, echoed Madison in even stronger tones. "It is the right of every man to work, labor, and produce in any lawful vocation and to transport his production on equal terms and conditions and under like circumstances. This is industrial liberty, and lies at the foundation of the equality of all rights and privileges."[3]

In 1980, when the American people elected Ronald Reagan, America was a nation of giant industrial corporations – IBM, Boeing, General Electric, United Technologies, General Motors, Alcoa. And the sophisticated material goods these corporations manufactured – and the mass production techniques they had mastered – made America the most powerful nation in the world. Yet in every sector of the economy where concentration of capital and capacity was not necessary for such forms of production, America remained very much a nation of independent businesses and independent farms, of small businesses and small farms. Two centuries after the founding, almost 100 years after Congress established federal antitrust law, most retail, farming, services, light manufacturing, and publishing remained family enterprises.

But in the first months of his administration, President Reagan introduced a new set of political economic goals. No longer would the aim be to protect and expand human liberty and democracy. Rather the aim was now to be to deliver more material things. And to this end, his administration took steps to overturn all the laws and rules Americans had put in place since the founding to protect individual property and individual liberty within the political economy.



The result? If we are honest, the result has been nothing less than a social and political revolution, which played out in the expropriation of the businesses and farms of millions of American families, and a crushing of individual liberty across vast swaths of our economy and society.

The result, if we are honest, has been the erection of systems of feudal control and private taxation over millions more independent businesspeople who have yet to be driven entirely off their properties. Under the rule of Amazon, the rule of Google, the rule of Facebook, the rule of Uber, millions of America's most energetic and creative citizens wake every day to find themselves living in a company town, forced to borrow from the company bank, forced to buy from the company store, forced to pay tax to the company treasury.[4]

Their only alternative? To walk away, with their debt.

The result is a catastrophe for the American independent businessperson, the American entrepreneur. It is also a catastrophe for economic stability, national security, the free press and free debate, racial and gender equity, innovation, and even our ability to see and process the basic information about how the world works, and the threats we must overcome if we are to survive.

The result is also a catastrophe for democracy. America was founded on the promise of rough equality of opportunity and voice for every human being. What we see today is an ever more extreme concentration of wealth and control, and a pyramiding of power to a point where even many of the strutting plutocrats of a decade ago now look over their shoulders in fear.

In 1913, President Wilson defined domestic tyranny as "the conduct of our affairs and the shaping of our legislation in the interest of special bodies of capital and those who organize

their use."[5] By that definition, the American people live today under a "tyranny" of capital. Of no one is this more true than America's entrepreneurs.

In my testimony today, I will make three main points:

First, traditional antimonopoly law and policy is the foundation for all independent business.

Second, the "consumer welfare" competition philosophy, by overturning traditional antimonopoly law, cleared the way for the destruction of America's independent businesses.

Third, the political, social, and economic effects of this concentration of power and control threaten our democracy, individual liberty, prosperity, and security.

I will then conclude by listing a few key actions we can take today to begin to address the crisis.

ANTIMONOPOLY LAW IS THE FOUNDATION OF INDEPENDENT BUSINESS

Our first task is to remember what exactly is antitrust law, or more broadly, what exactly is antimonopoly (or competition) policy. For 40 years, we have been taught that antimonopoly policy is a purely economic issue, and that the main goal is to promote efficiency in the manufacture of goods and delivery of services. We have been taught that the only way to tell whether a particular concentration of corporate power is good or bad is whether it will result in lower prices, as measured by carefully trained economists using scientific methods.



The price we pay for our food, shelter, clothing, transportation, and entertainment are indeed very important. I will get back to that subject shortly. But the idea that the only purpose of antimonopoly policy is to drive prices down is a grotesque myth. It is a myth manufactured for the precise purpose of overthrowing the American System of Liberty, which is the true foundation of all independent business and entrepreneurship.

Antimonopoly policy is the full suite of tools that people use to engineer markets and corporations to structure power within society. The American people developed these tools over the course of more than two centuries. They did so based on an honest recognition of one of the essential truths of human society – that competition itself is inevitable and that political economics is the art of governing how people compete with, and exercise power upon, one another. From the first, the tools were designed to achieve particular political, social, and economic ends, including the liberty and wellbeing of the individual, the ability of citizens to make wise decisions within democratic institutions, and the security and prosperity of the nation.

What kind of society do we want? What kind of communities do we wish to live in? What kind of citizens do we wish to be? What kind of world do we intend to build? Once we have answered those questions, antimonopoly policy provides us with the means to achieve our ends.

In addition to the Declaration, with its essential challenge to ensure the rough equality of every American, two other documents established the foundations for American antimonopolism, or rather the American System of Liberty. One was the Constitution. With its intricate system of checks and balances designed to break all concentrations of power, the Constitution is the single most important antimonopoly document in human history.



The other was the Northwest Ordinance, passed in 1789 to guide the development of the territories held in common by the people of the original 13 states. This document, passed by the first Congress and signed into law by America's first president, George Washington, makes clear exactly the nature of the society Americans intended to build. The Ordinance was designed to break all concentrations of private power in the new society. It did so by carefully dividing the land into family-sized farms, by prohibiting large land holdings and development corporations, by promoting free education, and by outlawing slavery and guaranteeing the vote to every adult male, no matter the color of his skin, no matter whether he had ever been enslaved.[6]

Upon this broad antimonopoly foundation provided by the new federal government, Americans then added a complex body of practical antimonopoly regulation using their state and local governments. This included extensive regulation of the local marketplace.[7] And it included direct regulation of the corporation, through charters approved by the people working through their state legislatures. Indeed, for the first hundred years in America, a time of truly astounding economic growth and innovation, nothing like today's corporations existed. As the historian Henry Adams himself put it in 1879, "The people of the United States have learned... that they hold all corporations at their mercy."[8]

During this early period, the American people also routinely used Congress to establish rules to address the particular challenges posed by the rise of new technologies and new concentrations of capital, passing laws that directly aimed to break the power of big banks and powerful financiers, to protect against the trading power of mercantilist nations like Great Britain and France, and to meet the challenges posed by new communications technologies such as the telegraph.

In the aftermath of the Civil War and Reconstruction, powerful actors in America managed for a period to disrupt large portions of this carefully structured system of power. They did

so by exploiting the power of the new railroad monopolies and the wealth that had been concentrated on Wall Street during the Civil War. We called these people Robber Barons, because they were so good at exploiting monopolistic chokepoints in the economy to manipulate, extort, and often simply to take other peoples properties and businesses.

But faced with this new threat, the American people set out once again to establish a rule of law fit for the independent citizen. Most important, in 1887, they passed the Interstate Commerce Act, which banned railways from discriminating between individuals, companies, and towns in the provision of basic services. This act, by requiring the monopolist to provide the same terms and same prices to all comers, ensured that even the most powerful and essential of private network monopolies could not be leveraged to undermine democracy in America.

Three years later, the American people acted again. They did so by passing the Sherman Antitrust Act to address the power of corporations such as the Standard Oil Company and Carnegie Steel, which had exploited the power of the railroad corporations to monopolize control over entire swaths of the American economy.

Neither the Interstate Commerce Act nor the Sherman Antitrust Act proved entirely sufficient to the task. Time and again during these years, those who had captured power and prominence used their money and their sway over the judiciary to rebuild their arbitrary monopolistic powers. But time and again the American people, acting through Congress, acted to update the American System of Liberty for the new era. One way they did so was by passing a long list of additional laws to reinforce America's federal antimonopoly regime. These included the Mann-Elkins Act of 1910, the Federal Reserve Act of 1913, the Revenue Act of 1913, the Clayton Antitrust Act of 1914, the Federal Trade Commission Act of 1914, the Glass-Steagall Act of 1933, the Public Utility Holding Company



Act of 1935, the Robinson-Patman Antitrust Act of 1936, the Miller-Tydings Act of 1937, and the Celler-Kefauver Act of 1950.

And these laws worked, as intended.

Beginning in the early years of the 20th century, Americans succeeded in using these laws to restore the traditional democratic balances of the U.S. political economy. They did so by separating the economy into three distinct realms of antimonopoly policy, each governed by specific limits on the size and behavior of corporations.

In the case of corporations that provide essential goods and services – such as transportation, communications, and power – the core rule was an absolute prohibition against discrimination in pricing and terms of service. The aim was to ensure that the people who controlled these corporations focused on serving their fellow citizens, not on taking advantage of arbitrary power to manipulate and exploit them.

In the case of industrial firms engaged in applying science to manufacturing, the core rule was that there never be fewer than four corporations competing in any industry, be it the manufacturing of chemicals, metals, automobiles, or, later, semiconductors. The aim was to allow corporations to be of a sufficient scale and scope to master the challenges of manufacturing quality goods for every member of society, but also to enforce sufficient competition to drive true efficiency and innovation.

In the case of farming, retail, light manufacturing, and services, the core rule was to protect the independent businessperson and farmer from Wall Street predators armed with chain stores, processing monopolies, and banks.

The result was a phenomenal accomplishment. Even as Americans made their nation the

most prosperous, innovative, and powerful in the world, they also made it the most free and equal.

To understand just how effectively Americans had protected their businesses and farms from concentrated power, consider two facts from the years just before Reagan took power. First, that the average working family farm in America was hardly any larger than the 160-acre limit established two centuries earlier, by the Northwest Ordinance.[9] Second, that the Supreme Court held it illegal for any one grocery chain to hold more than about 5% of the market in a single region.[10]

In other words, when Ronald Reagan first walked into the White House in January 1981, the American businessperson was still truly independent.

THE OVERTHROW OF ANTIMONOPOLY LAW IN THE 1980s[11]

In his 1978 book The Antitrust Paradox, Yale law professor Robert Bork made a long, intentionally arcane, often contradictory, and historically erroneous argument. But what would change America, and the world, was a four-point assertion early on in the text.

First, Bork held that "history" teaches that the sole goal of antimonopoly law is to promote the "welfare" of the "consumer."

Second, the one clear means to achieve this end of consumer welfare is to promote "productive efficiency" that results in a lowering of the price of goods and services.

Third, antitrust law, like economics, is "a science."

Fourth, the only way to understand how to enforce the law "with logical rigor" is to use economic "science" to understand the purpose of the law and to judge behaviors.[12]

A more radical restatement of American antimonopoly law, and of the System of Liberty put into place at the founding, is hard to imagine.

For two centuries, Americans had used a vision of the liberty and independence of the citizen to guide their use of antimonopoly law. The result, as we have seen, was a wide and systematic distribution of power where possible, and where concentration was necessary, a reining in and neutralization of power.

Bork's line of reasoning now led in the exact opposite direction. The logic of consumerism, after all, goes like this: What do consumers want? Bigger piles of stuff. How do we get bigger piles of stuff? More efficient production. How do we produce more efficiently? Bigger manufacturers, bigger distributors, and bigger retailers. Who, ultimately, is the best friend of the consumer? The big monopolist.

Bork was anything but alone in promoting such a radical new approach to political economics in the 1970s. Richard Posner, then a professor of law at Stanford, promoted an even more revolutionary rethinking of the entire concept of justice in America, based on the "the application of economics to law." Judges, Posner wrote in his book Law and Economics, would deliver better verdicts if the were "led to use efficiency to guide decision."

During the first two centuries in America, the idea that any legal scholar would attempt to reorient the law away from justice and toward a pursuit of efficiency would have been unthinkable. The most pro-monopolistic and reactionary of judges in the late 19th and early 20th centuries always couched their thinking in terms of competing claims to liberty, to



competing forms of rights. But in 1981, President Reagan appointed Posner to the Seventh Circuit Court of Appeals, and in early 1982 he appointed Bork to the DC Circuit. And his Department of Justice used Bork's reasoning in The Antitrust Paradox to reorient America's antimonopoly regime upon the goal of efficiency, as measured by the price of a good or service.

They did so by rewriting the "guidelines" that the DOJ and other antitrust enforcement agencies rely on to evaluate what corporate structures and behaviors to prosecute and what market structures to create.

The most recent guidelines published before Reagan took office dated to 1968, the last year of the administration of President Lyndon Johnson. According to these guidelines, the main goal of antitrust enforcement was the "identification and prevention of those mergers which alter market structure in ways likely now or eventually to encourage or permit non-competitive conduct." And what was acceptable market structure? According to the Justice Department in 1968, it was that the top four companies within a market could together control no more than 75 percent of that market. The 1968 guidelines then made absolutely clear that the U.S. government would challenge any merger whatsoever if pursued by any corporation that already controlled 25 percent of any market. Further, the 1968 guidelines emphasized that this simple rule would hold fast even if the corporations pursuing the merger could absolutely prove that the deal would result in efficiencies in the production and distribution of goods and services. On this issue, the guidelines were blunt. "[T]he Department will not accept" any such efficiency argument "as a justification for an acquisition.

Reagan administration officials published new guidelines in 1982 then again in 1984. At a glance, the guidelines don't read all that differently than those published in 1968. But there were two profound changes. First, the prime goal of enforcement was now the promotion



of "efficiencies" within the economy. Or as the 1984 guidelines put it, "The primary benefit of mergers to the economy is their efficiency-enhancing potential." Therefore, the Justice Department would henceforth "allow firms to achieve available efficiencies through mergers without interference."

Second, the Justice Department now intended to measure such efficiencies – and in the case of a proposed merger, potential efficiencies – by looking only at how different structures and behaviors might affect the price of the good or service being produced. In the 1968 guidelines, the words "price" and "pricing" appear eight times. In the 1984 guidelines, Reagan administration officials wrote the words "price" and "pricing" 117 times.

From this moment on, as long as executives could make the most rudimentary case that a merger would result in efficiencies that might eventually lower the price of some good or service, they had a license to consolidate, no matter what the political or social effects of the deal, no matter how much power was concentrated over buyers, sellers, workers, engineers, scientists, communities, or taxpayers.

Bork, Posner, and the other radicals within the Reagan Administration did not stop with overturning America's two-century-old limits on concentration of private power and the size and structure of the private corporation. They also targeted something even more important – namely the ancient requirement that the monopolist treat all people the same, and provide all customers with the same service on the same terms, in ways that prevent all discrimination and manipulation of people, companies, and communities.

Here again, it was Bork, in The Antitrust Paradox, who made the key arguments in favor of changes that would clear the way for the radical concentration not merely of power within the political economy but also of direct control over the lives and livelihoods of individual citizens and businesses. Bork began his attack on the laws designed to prevent price



discrimination acknowledging that Americans had always considered the issue to be of fundamental importance. He then proceeded to dismiss the question based on nothing more than personal whim. "[I]t seems to me... that antitrust policy would do well to ignore price discrimination."

A few pages later, Bork went much further and delivered a straightforward defense of price discrimination from the point of view of the seller. "The basic theory of price discrimination is quite simple," he wrote. "When the demand elasticities of customers are different, no single price can extract the maximum return from each. If they can be segregated . . . the monopolist can charge them different prices and so extract the maximum return from each class."

In other words, price discrimination was good precisely because it empowered the monopolist to exploit and manipulate whatever individual person or individual business had fallen under its direct control.

Thus, in a few strokes in the early 1980s, was the rule of law overthrown in American political economics. Thus, in a few strokes in the early 1980s, was the concentration of absolute power and control made possible.

Both Bork and Posner fully understood what they had achieved.

In 1986, Posner wrote of the "outrage" of "traditional legal scholars" who found his ideas to be "repulsive" and who believed that "it is inconceivable that the legal system would... embrace them." Yet by 1986 Posner also understood that he and Bork had won, and that they had given birth to a "movement" that had overturned the basic "methodological" approaches of the American justice system. And indeed, in place of the will of the American people, acting through Congress, control over the most fundamental questions of how to

organize our society and democracy had been turned over to a tiny clique of "professional" economists, the most successful of whom were in the direct pay of the corporations they were regulating.

Bork, more simply, in 1996 wrote that "what has happened to antitrust amounts to a revolution."

Yet from 1981 until the election of President Biden, the great majority of Americans have gone along with no idea that such a far-reaching coup had been staged at the very heart of our democracy. And the simple reason is that every administration since Reagan, both Democratic and Republican, have largely or entirely embraced the Bork-Posner ideology of monopoly.

AMERICA'S MONOPOLY CRISIS AND THE DESTRUCTION OF SMALL BUSINESS

Why are there fewer good jobs than 40 years ago? And why do almost all jobs pay less than they did back then, even after the disruptions caused by COVID-19?

Why must Americans drive farther to get to a hospital? And why does routine care cost so much more than a few years ago?

Why do drugs and medical devices cost so much? And why are there so many shortages, even of the most basic forms of drugs and equipment like facemasks?

Why is rent in America so high? And why will your mortgage debt never go away?

Why did the stores on your Main Street close, even before the pandemic? And why are your



public schools out of money?

Why are so many American farmers leaving the land? And why are the prices even of the most basic of food items skyrocketing?

Why did so many American factories move to China? And why are the international transportation systems so broken?

Why are our newspapers firing all their reporters? And why is our public debate driven by so much misinformation and disinformation and downright lies?

Why is it so hard to put solar panels on our roofs and why are their no recharging stations for our electric cars?

We are so many of our family members and friends dying from diabetes and heroin and cirrhosis?

Why has it become so hard to make money as a musician, author, filmmaker?

Why is it so hard to get the water utility and gas utility and electrical utility to answer your phone calls or fix your service or adjust your bill?

Why is it so expensive to buy a car or even a door for your garage?

In every instance, the answer is simple. A monopolist has captured control of something you need. And they mean to charge you more for less, to deny you service entirely, and to force you to buy things you don't need, sometimes even what might kill you.



Every one of these crises is the direct result of the overthrow of the American System of Liberty, and of the antimonopoly laws and policies designed to achieve these aims.

No one has suffered more from this extreme concentration of power and control than American independent businesses.

Consider a few facts.

Between 1979 and 2009, the per capita rate at which Americans created new businesses fell by half.[13] And it has continued to fall since.

In the 20 years up to 2007, the number of hog farmers declined some 70 percent, and the number has continued to decline since then.[14] Just since 2003, America has lost more than half its dairy farms.[15]

Walmart now captures more than 50 percent of all grocery sales in at least 43 metropolitan areas in the United States.[16]

Between 1982 and 2017, the number of small retailers fell by half, while their share of overall retail business fell even further.[17] This is true for just about every category of shop. The number of independent pharmacies in America, for instance, declined by half since 1980, even while the U.S. population was growing by almost half.[18]

We can see the effects of this concentration of power over commerce in the concentration of wealth in the hands of a few. For two centuries, Americans aimed to distribute control over farming and business as a way to distribute opportunity and wealth. Today, 40 years after the embrace of the consumer welfare ideology of monopoly, we see the exact opposite. Consider, for instance, the immense amount of power now held by two families –

the Waltons and the Bezos. In 1980, it was all but illegal in America for a chain to own more than 100 stores. Today Walmart alone owns more than 5,000 giant stores. And the Walton family today is richer than 150 million Americans put together. The Bezos family is richer yet, and their wealth is growing faster than the Waltons ever imagined.

The problem affects more than just long established enterprises. The consolidation of power and control is even more dramatic in new sectors of the economy, such as online businesses. Developers of new online apps, for instance, must operate within systems that are almost entirely controlled, and in which every one aspect of their businesses is both monitored and regulated by the corporations that are supposed provide them with the basic services they need.[19]

In a growing number of instances, these corporations use the data they collect on their captive clients to target their clients' businesses. Amazon, for instance, routinely goes into direct competition with companies that depend on it, as this Wall Street Journal article makes clear.[20]

The result is a growing enfeudalization of large proportions of America's population of independent businesses, and the imposition of a regime of fear, in which entrepreneurs dare not speak out in public lest Amazon and the other platforms retaliate, by squeezing them that much harder, or by simply disappearing them from their sites.[21]

As I testified in the Senate last March, what we see today within the political economy of America is the rise of automated, algorithmic-powered autocracy.[22]

In 1935, Du Bois described the concentrated wealth and control of the plutocrats thus: "It was a new rule of associated and federated monarchs of industry and finance wielding a vaster and more despotic power than European kings and nobles ever held."



Indeed. Yet today's bosses control powers that no Gilded Age plutocrat could ever dream of controlling. Google, Amazon, Facebook have harnessed all the power of modern computing and automated intelligence behind business models designed for pure, ruthless, predation.

REBUILDING THE AMERICAN SYSTEM OF LIBERTY AND PROSPERITY

The good news is that the American people have finally awakened to these threats. And they have begun to take steps to deal with the crisis of monopoly in America.

President Joe Biden and his administration have taken especially important steps. This includes naming a set of people who fully understand the problem to run the Federal Trade Commission, the Antitrust Division of the Department of Justice, and other agencies. And it includes a dramatic renunciation of the consumer welfare theory of monopoly, and the restoration the thinking that for two centuries served as the foundation for the American System of Liberty.

Congress too has taken dramatic action, and it has done so in bipartisan fashion, pushing forward important new legislation in both the House and the Senate. So too states across the nation. We see both new legislation, such as an important antitrust reform bill in New York. And we see new enforcement actions, including multi-state bipartisan actions against Google, Facebook, and other corporations.

But all of this is just a start. Given the magnitude of the crisis and the pressing nature of the threats to our democracy, liberty, prosperity, and security, it is vital that Congress move much more swiftly and aggressively. This must include voting a large increase in funding for the law enforcement agencies. And it must include passing new laws that will make it



easier for the enforcers to protect the fundamental liberties and rights of the American people.[23]

This hearing is a vitally important demonstration of the fact that Congress has awakened to the moment. As the members of this committee continue with your work, it is essential to keep in mind the questions that must shape all of our decisions about how to shape and use our antimonopoly laws. These are, foremost, what kind of society do we want to live in? What sorts of security do we need? What kind of citizens do we want to be? What sort of world do we want to build?

OPEN MARKETS
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ACT | The App Association

March 7, 2022

The Honorable Nydia Velazquez
Chairwoman
House Small Business Committee
Washington, District of Columbia 20515

The Honorable Blaine Luetkemeyer
Ranking Member
House Small Business Committee
Washington, District of Columbia 20515

Re: Competition and the Small Business Landscape: Fair Competition and a Level Playing Field

Dear Chairwoman Velazquez and Ranking Member Luetkemeyer,

As committees across Capitol Hill debate options to address competition in markets with large platform companies, we especially appreciate that the House Small Committee on Small Business (the Committee) continues to shine a light on the perspectives of small, innovative companies. ACT | The App Association (the App Association) is the leading trade group representing small mobile software and connected device companies in the app economy, a $1.7 trillion ecosystem led by U.S. companies and employing more than 300,000 in New York and 88,000 in Missouri alone.[1] Our member companies create the software that brings your smart devices to life. They also make the connected devices that are revolutionizing healthcare, agriculture, public safety, and virtually all industry verticals. They propel the data-driven evolution of these industries and compete with each other and larger firms in a variety of ways, including on privacy and security protections.

Two antitrust-related proposals in particular have gained traction in both the House and Senate: the American Choice and Innovation Online Act (H.R. 3816)—and its substantive companion measure the American Innovation and Choice Online Act (S. 2992)—and the Open App Markets Act (H.R. 5017 / S. 2710). These proposals are not identical but would have similar effects in the software platform (app store / mobile operating system) context. For example, both bills would diminish and close off distribution options for App Association members. Driven by complaints from the largest competitors on software platforms, H.R. 3816 and H.R. 5017 would reform software distribution to better suit the needs of big business while raising barriers to entry and overhead costs for small app makers.[2] To smaller companies that opt to reach customers and consumers through software platforms, H.R. 3816 and H.R. 5017 are rooted in a conception of platform markets as being divided between the interests of small companies and consumers on one hand, and the interests of large platforms on the other. But that premise, among others that undergird the bills, as well as their proposed remedies, do not reflect reality for App Association members. In fact, App Association members demand and pay for services H.R. 3816 and H.R. 5017 would prohibit.

Small app companies are constantly pushing platforms to do better, but they do not take the services they buy for granted. As Mark Liber of Brooklyn-based Kaia Health said in one of our Developed | The App Economy tour events in New York, "with platforms, we can bring chronic

[1] ACT | The App Association, State of the U.S. App Economy: 2020 (7th Ed.), *available at* https://actonline.org/wp-content/uploads/2020-App-economy-Report.pdf.
[2] *See* Graham Dufault, "Antitrust and You Part 3: Nondiscrimination Provides a Platform for Me but Not for Thee," ACT | The App Association Blog (Nov. 12, 2021), *available at* https://actonline.org/2021/11/12/antitrust-and-you-part-3-nondiscrimination-provides-a-platform-for-me-but-not-for-thee/.

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pain management to our customers and meet them where they are."[3] And as Lois Lewis of Missouri-based CoCreate Collective said in another Developed event, "if you can, beta test. Put the product in the hands of users before you officially release. The ability to do that is built into the platform. It's easy to forget how helpful these built-in tools are."[4]

We hope that the Committee rejects the overly simple idea that in markets with natural consolidation, large company interests are categorically incompatible with small company interests. In our case, maintaining an even playing field requires Congress to avoid advantaging big businesses by diminishing services and security measures that benefit smaller companies more than larger rivals. Note that the proponents of software platform nondiscrimination are the largest sellers on the app stores,[5] while the smallest oppose legislation that would prohibit software platforms' gating functions.[6] There are a few potential consequences of these bills that are worth considering, from the perspective of App Association members:

1. **H.R. 3816 and H.R. 5017 would make it easier for targeted behavioral advertising-supported businesses to further the aspects of their business models that disrespect privacy expectations and choices.**[7] For example, Facebook has indicated that it does not want to be subject to platform-level privacy controls software platforms provide for users. Both bills would certainly presume the illegality of privacy restrictions at the platform level that apply to across apps. The relevant provision of H.R. 3816 would ban practices that "restrict or impede a business user from accessing data generated on the covered platform by the activities of the business user, or through an interaction with the business user's products or services." The rule of construction in the Manager's Amendment to the Senate version of the bill, S. 2992, does not appear to address this issue because it only shields a platform operator from liability for "promptly requesting and obtaining the consent of a covered platform user prior to providing access to non-public personally identifiable information of the user . . .." The language seems to only cover real-time prompts for consent as opposed to the expression of a privacy preference that would apply across all apps on a device.

   H.R. 5017 includes analogous provisions that together require platforms to allow cross-app tracking by third parties without interference. For example, Section 3(d) requires platforms to provide the "readily accessible means" for users of operating systems to sideload unvetted software and app stores. That provision bolsters a requirement in 3(f) for platforms to provide "access to operating system interfaces, development information, and hardware and software features" on equivalent terms to the platform's own similar apps. Even though

[3] ACT | The App Association, Developed | The App Economy Tour: New York, New York (Sept. 19, 2019), *available at* https://actonline.org/wp-content/uploads/NYC-Report-V2.pdf.
[4] ACT | The App Association, Developed | The App Economy Tour: St. Louis, Missouri (Feb. 20, 2020), *available at* https://actonline.org/wp-content/uploads/STL-Report-V2.pdf.
[5] *See* Hearing before the Senate Judiciary Committee, Subcommittee on Competition Policy, Antitrust, and Consumer Rights, "Antitrust Applied: Examining Competition in App Stores," 117th Cong., 1st Sess., (Apr. 21, 2021) (statements of Spotify, Match Group, Inc., and Tile, Inc).
[6] *See* Letter from Morgan Reed, president, ACT | The App Association, to Senate Judiciary Committee re: markup of American Innovation and Choice Online Act (S. 2992) (Jan. 20, 2022), Appendix, *available at*
[7] *See* Graham Dufault, "The Great Manipulation: Are Dark Patterns Leading Congress to Help its Biggest Targets?" ACT | The App Association Blog (Oct. 13, 2021), *available at* https://actonline.org/2021/10/13/the-great-manipulation-are-dark-patterns-leading-congress-to-help-its-biggest-targets/.

the Manager's Amendment to the Senate's version of this bill would allow platforms to cite a broader range of security and privacy protection reasons for removing an app, the underlying mandate to maintain sideloading still presumptively bans removal of sideloaded software for privacy reasons. Moreover, the evidentiary path for a platform to effectively use the affirmative defense in both the House and Senate versions is so narrow as to be unlikely to inspire any confidence or reliance. Specifically, it requires a defendant to show that the removal was "applied on a demonstrably consistent basis to apps of the [platform] . . ., *not used as a pretext* to exclude, or impose unnecessary or discriminatory terms on, third-party Apps . . ., *and* narrowly tailored and *could not be achieved through a less discriminatory* and technically possible means" (emphasis added). In other words, Facebook's attorneys could easily challenge any sort of decision to remove the Facebook app from mobile operating systems for refusing to adhere to a consumer's decision to have the platform limit tracking by Facebook across apps. Creating a pathway for Meta to evade privacy preferences of smartphone users without a credible threat of removal from the platform, as these bills would do, is plainly counter to Congress' own efforts to address the harms of social media.[8] But it is also counter to the interests of App Association members that rely on a marketplace that cultivates trust by respecting and empowering consumers to enforce privacy expectations.

2. **H.R. 3816 and H.R. 5017 would invite the proliferation of security threats like stalkerware and other cyberattacks, which would undermine the trust consumers have in the app ecosystem.**[9] For example, by requiring software platforms to allow sideloaded software on consumer devices, the bills would erase the security advantage mobile devices have. For the most part, mobile devices are only targets of consumer-level threats if the device runs on an Android operating system (or another operating system that allows sideloading) and someone overrides the default setting that prevents sideloading. The security advantage of iOS' approach is so lopsided that 98 percent of malware on mobile devices is aimed at Android devices.[10] In other words, cyber attackers see iOS devices as "hard targets" because there is no way to manipulate a consumer into sideloading an app that abuses or exceeds the permission a user gives it to access information and features on the phone like pictures, the camera, the microphone, messaging, and other sensitive things. For iOS users, if they receive phishing messages that link to a direct download of malware, it is likely only because the attacker is hoping they are using Android. And even then, Android is difficult to abuse because consumers must override the default prohibition on sideloading and click through multiple warnings about the security risks of sideloading. Unfortunately, H.R. 5017 and H.R. 3816 would make *all smartphones* soft cybersecurity targets at a time when Congress is calling on small app makers to strengthen their security posture and

[8] *See, e.g.,* Hearing on "Holding Big Tech Accountable: Targeted Reforms to Tech's Legal Immunity," before the House Committee on Energy and Commerce, Subcomm. on Comm. And Tech. (117th Cong., 1st Sess.).

[9] *See* Letter from Morgan W. Reed, president, ACT | The App Association, to United States Senate Judiciary Committee (Sept. 15, 2021), *available at* https://actonline.org/wp-content/uploads/2021-09-15-ACT-Antitrust-and-Spyware-FINAL.pdf (discussing the consequences of requiring software platforms to allow sideloading in the stalkerware context).

[10] Joshua Sophy, "98 Percent of Mobile Malware is Aimed at Android Users," SMALL BUSINESS TRENDS (last updated Sept. 1, 2021), *available at* https://smallbiztrends.com/2014/02/98-percent-mobile-malware-aimed-android-users.html.

protect against attacks on their customers and clients from cyber attacks.[11] Russia's invasion of Ukraine has brought these threats ever closer, pushing American private and public sector entities to work together to fend off attacks from State-backed foreign adversaries. Small app makers cannot fight this alone and rely on platforms to secure the marketplace for software.

Specific examples of bad actors taking advantage of the sideloading vulnerability are unfortunately common. The Federal Trade Commission (FTC) recently entered a consent order with SpyFone, a stalkerware app that required its customers to sideload the apps it offered in order to avoid platform controls. Similarly, the recent Anatsa Trojan horse apps[12] and the 1Byte suite of apps have justifiably raised alarms and concern over how consumers can avoid these stalkerware scams.[13] But, as described above, H.R. 3816 and H.R. 5017 both include provisions that appear to bar a software platform from removing any app, unless it can offer the rather narrow affirmative defense with evidentiary burdens described above. As a result, the bill creates a presumption that removing bad actors found to be surreptitiously stealing consumer data or money is prohibited.

The overall effect of H.R. 3816 and H.R. 5017 in this context would be to create a default presumption barring the removal of stalkerware like SpyFone and the 1Byte or Trojan horse apps like Anatsa's from a platform, unless the platform is able to overcome that presumption, likely in narrower forms, in an expensive process of case-by-case litigation. Although some software firms may have grown large enough that their reputations stand on their own, App Association members generally depend on software platforms to bar bad actors from the marketplace so that consumers feel comfortable downloading software made by otherwise unknown app makers. As Betsy Furler of Texas-based For All Abilities argued during our recent virtual fly-in event, or Mini AppCon (MAC), the platform requirements on companies for baseline security and privacy protections benefit companies like hers that provide smart device-centered accessibility tools and advice. She observed that sideloading, especially if a platform is required to allow it without any security checks, is a major threat vector, as it often leads to malware and viruses being uploaded onto devices unknowingly. She noted that therefore, prohibitions on security and privacy protections would not only seriously hurt her business but would also have a significant impact on the accessibility community that often relies on apps to access and participate in the world.

Lastly, both bills provide a private right of action enabling aggrieved app companies to sue. This authority broadens the penumbra around the bills' prohibitions by inviting interpretations that go beyond what government enforcers would seek to enjoin. The result would be to directly empower those with agendas that subordinate privacy to data

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[11] Hearing on "Strengthening the Cybersecurity Posture of America's Small Business Community," before the House Committee on Small Business, (Jul. 20, 2021) (117th Cong., 1st Sess.), *available at* https://smallbusiness.house.gov/calendar/eventsingle.aspx?EventID=3835.

[12] Dan Goodin, "Google Play apps downloaded 300,000 times stole bank credentials," ARSTECHNICA (Nov. 29, 2021), *available at* https://arstechnica.com/information-technology/2021/11/google-play-apps-downloaded-300000-times-stole-bank-credentials/.

[13] Zach Whittaker, "Behind the stalkerware network spilling the private phone data of hundreds of thousands: A flee of apps share the same security flaw," TechCrunch (Feb. 22, 2022), *available at* https://techcrunch.com/2022/02/22/stalkerware-network-spilling-data/.

collection and surveillance to reshape the platforms to suit their aims. But even if the private right of action were removed, leaving only state attorneys general and federal enforcers to bring suit, the breadth of the bills' prohibitions would create unintended issues for the app economy. First, if an enforcement agency brings a lawsuit against a platform for restricting, for example, Meta's access to personal information, the effect on the platform's conduct would not be limited to just Meta. An ongoing lawsuit involving restrictions on access to data for any business user on the platform could easily cause the platform to err on the side of easier access for any business user (including borderline or actual bad actors) as their privacy controls draw public scrutiny from an antitrust lens that deprioritizes privacy. Second, if a law prohibits certain conduct, businesses would be taking extraordinary risks if they were to engage in it anyway, on the hope that enforcement agencies will not notice it or try to enjoin it. This Committee cannot predict the personalities or political agendas that will animate future antitrust enforcement agencies at the federal or state levels. Assuming none of them will bring an action that in some way helps shield a parental control app that people also use to stalk victims—when the text of the bill plainly bars their removal from a platform—is a poor basis for legislative drafting.

3. **H.R. 3816 would prohibit a range of software platform activities and offerings that App Association members pay for at lower cost than they could produce themselves or buy separately on the open market.** App Association members are not necessarily well-known to consumers across the globe. They both demand and pay for access to a marketplace in which consumers trust that software small companies offer is safe to download and that they meet baseline privacy requirements, despite the lack of a prominent profile. H.R. 3816's prohibition on conduct that "advantages the covered platform operator's own products, services, or lines of business over those of another business user" would limit bundled platform offerings for both consumers and developers. On the consumer side, the prohibition would likely limit the availability of pre-installed apps and default features like the software that operates the camera and the default mail app—this in turn limits the usefulness of smart devices, devaluing the products our member companies provide on the platform. On the developer side, the prohibition would likely limit the provision of developer tools, security features, and payment processing, which many developers prefer to sourcing those items on an unbundled and usually more expensive basis.

   As Parag Shah of Minnesota-based Vēmos pointed out during a recent virtual MAC meeting with congressional staff, prohibiting the provision of a bundle of services for developers hurts not just the small competitors that use them, but their clients as well. Vēmos serves bars and restaurants, providing analytics and other digital tools that have proven essential for these brick-and-mortar businesses during the pandemic. As Parag explained, if Vēmos' offerings go away, its customers would have to rely on more expensive hardware and software that can't be updated quickly, is not easy to use, and cannot keep up with security and privacy threats. Forcing bars and restaurants to turn to lower-tech, less secure, and more expensive options is surely not what the Committee intends to do. But this is a likely consequence of mandating the dis-integration of services for developers like Vēmos. Stephen Forte, of California-based Fresco Capital, reinforced this point, noting that investors benefit from being able to back companies that can pay a small fee for a set of vertically-integrated platform services. Investment either goes toward these basic overhead elements or it goes into business development and job-creating growth. A requirement to break up the offerings the companies Fresco invests in must start "at zero" with the same size check from investors. This creates a set of conditions that

make it nearly impossible to gain a foothold and then start growing, ultimately causing investors to look to companies that are already more well-resourced and entrenching entrepreneurs with legacy advantages. Put differently, H.R. 3816 would result in higher barriers to entry for small app makers, more difficulty attracting investment, higher costs for App Association member customers like bars and restaurants, and increased costs for developers in the form of cultivating trust on their own without the help and much lower cost distribution avenue provided by software platforms.

4. **H.R. 3816 and H.R. 5017 would prohibit the removal of stolen content and the harmful activity of bad actors using stolen content as bait.**[14] For example, if a fraudster specializing in stolen video content, posing as a fake Disney+, sought to have consumers sideload their video apps in order to upload malware on to as many personal devices as possible, H.R. 3816 would bar a software platform from removing that app and from blocking its access to device features or personal information. The presumption of illegality applies even if Disney filed a takedown notice under Section 512 of the Digital Millennium Copyright Act. Although the software platform could theoretically overcome the presumption by showing the narrow affirmative defense applies, the legal hassle and expense is more likely to deter a platform from squeezing itself between the two sets of obligations just to help the smallest app makers. We appreciate that the Manager's Amendment to the Senate versions of both bills include provisions exempting "an action taken by a covered platform operator that is reasonably tailored to protect the rights of third parties under [copyright laws]." This could shield meaningful efforts by platforms to remove copycat apps *from the platforms' own app stores* on behalf of App Association members, but the underlying requirement to allow sideloading in both bills appears to require platforms to do little or nothing about sideloaded software from copyright thieves. Efforts to stop them would also encounter needless challenges, since the platforms would not have been able to vet those apps for proper permissions to access parts of the device and personal information. As a result, App Association members would have to accept a far higher risk that their app will be stolen and that they would have no meaningful recourse, if either of the bills were enacted. This scenario benefits large companies that can do their own policing for content theft while harming small companies that lack the resources to do so in-house.

5. **H.R. 3816 could deter software platforms from providing the accessibility features App Association members use to serve clients and consumers with accessibility needs.** As Betsy Furler of App Association member For All Abilities describes, "Apple's App Store has built-in accessibility features, developer tools, and [application programming interfaces] for everything from speech and Guided Access to VoiceOver and display customization. Features like these ensure that the app works with other accessibility features built into the operating system and are crucial to creating apps for people of all abilities." The provision of these wraparound services may run afoul of a couple of H.R. 3816's provisions, including the prohibition on conduct that "the covered platform operator's own products,

[14] *See* Debbie Rose, "Sideloading Apps: Mandating That Software Platforms Allow It Will Cost Copyright Owners and Their Customers," ACT | The App Association Blog (Sept. 17, 2021) *available at* https://actonline.org/2021/09/17/sideloading-apps-mandating-that-software-platforms-allow-it-will-cost-copyright-owners-and-their-customers/ (discussing the consequences of requiring software platforms to allow sideloading in the copyright context).

> services, or lines of business over those of another business user."[15] Certainly, a software platform offering its own Guided Access feature as part of its bundle of developer services provides a clear advantage for the platform's own offering over a potential competitor offering such a feature on a standalone basis for developers. Ultimately, the platform's accessibility features benefit the platform's consumers on both sides of the market (both end users and app makers) as well as competition, especially in markets defined more broadly than only the offerings on a single software platform—a market definition courts continue to reject.[16]

In general, our member companies are worried that large, well-resourced companies may successfully bend the market in their favor by reorienting antitrust law so that it protects larger competitors to the detriment of smaller companies and consumers. We urge Congress not to accede to these demands because doing so would create unacceptable risks to the app ecosystem, and the smallest app makers would suffer the most as a result. We appreciate this opportunity to weigh in with our perspectives on the antitrust legislation Congress is actively considering and look forward to further engagement with you throughout the 117th Congress and going forward.

Sincerely,

Morgan Reed

Morgan W. Reed
President
ACT | The App Association

[15] ACT | The App Association, "Developed: The App Economy Tour – Houston, TX," ACT | THE APP ASSOCIATION BLOG (Sept. 14, 2019), *available at* https://actonline.org/2019/09/14/developed-the-app-economy-tour-boulder-co-2-2/.

[16] *See Epic Games, Inc., v. Apple Inc.*, Case No. 4:20-cv-05640-YGR (N.D. Cal. 2021), at 131.

Dear Matt and Lauren,

Regarding the Committee's hearing tomorrow March 1, 2022 entitled "Competition and the Small Business Landscape: Fair Competition and a Level Playing Field," the Center for American Entrepreneurship, a nonpartisan research, policy, and advocacy organization, appreciates the opportunity to submit the following materials as additional background material for the Committee's consideration:

- Amid the pandemic, digital platforms and technologies have played a critical role in helping new and small businesses endure the economic crisis.

- Indeed, a recent study by the National Bureau of Economic Research found dramatic differences in the impact of Covid on small- and medium-sized businesses: whereas businesses whose income was generated through offline channels experienced an average decline in sales of 39 percent during the crisis, businesses operating online incurred losses of only 23 percent.

- Digital tools are of particular value to minority-owned businesses. A recent report by the Connected Commerce Council found that while Covid disproportionately impacted minority owned businesses, such businesses relied on digital platforms and tools to an even greater extent than other businesses to survive the crisis.

- Given the importance of digital platforms and tools to new and small businesses, CAE conducted a roundtable with ten entrepreneurs from six states on November 18, 2021 to assess the likely implications of antitrust legislation currently before Congress. Their critical feedback is summarized in this short essay. As one participating entrepreneur stated: "We don't need the sledgehammer of legislation, we need a surgeon's scalpel, and that scalpel resides with the regulators (the FTC and the Antitrust Division of the Justice Department)."

- CAE board member and three-time entrepreneur, Bettina Hein, testified on December 15, 2021 before the Competition Policy, Antitrust, and Consumer Rights Subcommittee of the Senate Judiciary Committee on the Platform Competition and Opportunity Act and its likely implications for the nation's entrepreneurial ecosystem.

Again, thank you for the opportunity to submit these background materials.

If you or Members of the Committee have any questions about any of these materials, please let me know.

John

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John Dearie

In addition to its devastating toll in human lives, the Covid-19 pandemic has careened through the landscape of America's new and small businesses like a run-away bulldozer. According to a study released last month by the Federal Reserve Board, the virus has resulted in the permanent closure of roughly 200,000 U.S. businesses above historical levels. Many thousands more remain vulnerable.

Amid the storm, the key to conquering the virus – technology – has also emerged as a lifesaver for new and small businesses, specifically online platforms of communication, marketing, sales, and delivery. As they continue to scrutinize online technology platforms, policymakers should carefully think through the likely implications of any legislative or regulatory action to avoid unintended consequences that could potentially undermine the post-Covid economic recovery.

The severity of the 2020 storm and its impact on new and small businesses was truly unprecedented. Between February and April, the number of active businesses in the United States plummeted by 3.3 million, or 22 percent, the largest drop ever – including 17 percent of white-owned businesses, 26 percent of Asian-owned businesses, 32 percent of Hispanic-owned businesses, and a staggering 41 percent of Black-owned businesses.

Meanwhile, record numbers of young businesses – "startups" – failed or laid off employees, as many were shut out of the Paycheck Protection Program (PPP) and the Federal Reserve's Main Street Lending Program.

Such damage cuts to the very core of the U.S. economy. Businesses with fewer than 20 employees account for 98 percent of all U.S. businesses and employ about a fifth of the nation's workforce. Meanwhile, repeated research has demonstrated that startups are responsible for an outsized share of the innovations that drive economic growth and job creation. New and small business destruction, therefore, not only damages the economy now, it undermines the economy's capacity to grow and create jobs after the pandemic.

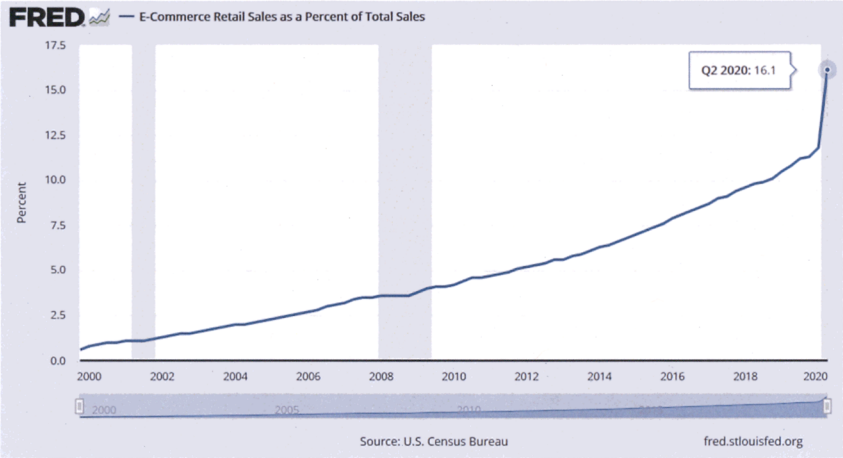
Fortunately, there is reason for optimism. Amid the wreckage, there are signs of hope and even new life, as new and small businesses have improvised and adapted to the realities imposed by the pandemic. While some businesses have pivoted completely, re-working themselves to meet new Covid-generated demand – such as breweries producing hand sanitizer – many others have digitized their operations to survive and even thrive in a socially-distanced marketplace.

Forced by local restrictions to limit foot traffic in stores, or to close physical locations entirely, businesses have increasingly turned to online platforms like Facebook, Ebay, and Amazon to open digital storefronts, social media sites like Instagram and Twitter to market to customers, video conferencing platforms like Zoom and Microsoft Teams to interact with suppliers and pitch potential investors, and digital payment tools like PayPal, Venmo, and Square to facilitate sales.

According to a State of Small Business Report published last May by the Small Business Roundtable and Facebook, 51 percent of small businesses reported increasing their online interactions with customers, 35 percent had expanded the use of digital payments, and more than a third of businesses that use online tools reported conducting *all* of their sales online. In July, PayPal reported 1.7 million new merchant accounts in the second quarter – triple the typical quarterly growth.

The trend toward the digitalization of business has been underway for years, but Covid has dramatically accelerated the shift – in large part because of the warm embrace by the American consumer. According to a recent analysis by consulting firm McKinsey & Co., the pandemic compressed

into months the adoption of e-commerce by customers that would have otherwise taken 10 years, with three out of four Americans having tried a new shopping method due to the coronavirus.



Particularly significant is that the acceleration to online shopping extends to older consumers. A survey released in November by digital consulting firm Mobiquity found a 47 percent increase in the number of baby boomers reporting that they had ordered delivery from a restaurant through a website or app; a 193 percent increase in the number ordering groceries online; and a 469 percent increase in the number who have used tele-medicine.

And such trends are likely to persist. Speaking at a European Central Bank forum on November 12th, Federal Reserve Board Chairman Jerome Powell said: "We're not going back to the same economy. We're recovering, but to a different economy – one that is more leveraged to technology…I think you'll see more telework. You'll probably see an acceleration of automation. All of that was in the process of happening, but you're going to see much more of it."

Christopher Mims, technology columnist at *The Wall Street Journal*, agrees. Citing four powerful sustaining forces of pandemic-related changes to commerce – huge investment by businesses in the infrastructure needed to deliver goods and services to homes quickly and efficiently, investments by households in technologies to keep their families safe, accelerated adoption of e-commerce by consumers, and the re-deployment of hundreds of thousands of American workers from on-site retail jobs – Mims concludes "the stay-at-home economy is here to stay."

In the Mobiquity survey, 9 in 10 baby boomer respondents said they will continue to use remote e-commerce technologies even after the pandemic ends.

Given this reality, digital platform storefronts and sophisticated e-commerce capability are no longer novelty complements to businesses' principal identity, they are core operations. According to a recent survey by Visa, more than 80 percent of consumers indicated that digital tools such as a user-friendly website or online loyalty program are motivating factors when deciding where to shop. In addition, 61 percent of respondents said they plan to increase their online purchases over the next five years, while 78 percent plan to maintain or *decrease* their in-store purchases.

A report released last May by the Connected Commerce Council found that small businesses without an e-commerce presence were twice as likely to close during the Covid crisis.

Covid-19 has accelerated the shift to technology-powered e-commerce by at least a decade, significantly altering the nature and operation of the U.S. economy and the competitive requirements of business success. As a result, America's post-Covid economic recovery depends in large part on new and small businesses operating, selling, growing, and thriving online.



Written by:
John Dearie
John Dearie is the founder and President of the Center for American Entrepreneurship. He is the former Acting CEO of the Financial Services Forum, a financial and economic policy organization comprised of the chief executive officers of the largest financial institutions with operations in the United States.



John Dearie

On January 20th, the Senate Judiciary Committee voted on a bipartisan basis to approve the **American Innovation and Choice Online Act**, despite significant reservations expressed by many Senators regarding the details and implications of the bill. "It's difficult to see the justification for a bill that regulates the behavior of only a handful of companies while allowing everyone else to continue engaging in that exact same behavior," said Senator Dianne Feinstein (D-CA). Senator Mike Lee (R-UT) worried the bill could accomplish the opposite of what policymakers intend: "It may actually entrench the very four companies at which it is aimed by creating a strong incentive to simply cease doing any business with third parties. This could crush thousands of small businesses, and it could actually worsen the state of competition in online markets."

Senator John Kennedy (R-LA) was more blunt: "I'm a co-sponsor on this bill, but this bill is going to change. It's going to change dramatically, hopefully for the better...or I'll be off this bill faster than you can say, 'Big tech.'"

The bill is one of a number introduced over the course of 2021 intended to address antitrust and competition concerns associated with large technology companies. The bills would, among other things, potentially break-up large technology companies, mandate a fundamental re-working of their highly successful business models, and impose severe restrictions on their ability to acquire smaller companies in the future.

To assess the likely implications for new and small businesses of the various antitrust bills, the Center for American Entrepreneurship conducted a roundtable of ten entrepreneurs from six states on November 18, 2021. The principal conclusion of the discussion confirms the concerns of Senators Feinstein, Lee, and Kennedy: If enacted, the antitrust legislation currently before Congress would have profound and far-reaching implications for the nation's entrepreneurial ecosystem – at a time when the economic growth and job creation driven by thriving entrepreneurship is more important than ever.

Pointing out that legislation by its very nature is blunt, focused on structural limits and activity restrictions, and inevitably introduces market distortions that often entail potentially severe unintended consequences, one participant stated: "We don't need the sledgehammer of legislation, we need a surgeon's scalpel" to carefully dissect, understand, and appropriately address the unique circumstances, details, and market implications of particular issues. That scalpel, roundtable participants agreed, resides with the regulators – the Federal Trade Commission and the Justice Department's Antitrust Division.

Since their introduction nearly three decades ago, the digital platforms and marketplaces provided by companies like Apple, Amazon, Meta, and Google – along with the various data analysis, marketing, advertising, and sales tools they provide – have helped spawn, nurture, and support thousands of new and small businesses. The Covid-19 pandemic has only heightened the importance of digital platforms and tools. Forced by Covid-related restrictions to limit foot traffic in stores or to close physical locations entirely, businesses have increasingly turned to online platforms like Amazon, Google, Facebook, Ebay, and Shopify to open digital storefronts, social media sites like Instagram, Twitter, and LinkedIn to communicate with and market to customers, video conferencing platforms like Zoom and Microsoft Teams to interact with suppliers and investors, and digital payment tools like PayPal, Venmo, and Square to facilitate sales.

According to a recent analysis by consulting firm McKinsey & Co, the Covid pandemic has accelerated the transition to technology-powered commerce by at least a decade. As a result, America's post-Covid economic recovery depends in large part on new and small businesses operating, selling, growing, and thriving online.

Most experts regard the change as permanent. Speaking at a European Central Bank forum last November, Federal Reserve Board Chairman Jerome Powell said: "We're not going back to the same economy. We're recovering, but to a different economy – one that is more leveraged to technology…You'll probably see an acceleration of automation. All of that was in the process of happening, but you're going to see much more of it."

The businesses launched by the entrepreneurs who participated in our recent roundtable represent a wide variety of industry sectors and, while all still young, are at various stages of their growth and development. Participants were provided with background material on the various antitrust bills introduced into Congress from a number of public sources prior to the discussion.

The major insights and observations generated by the roundtable discussion included:

- The problem the antitrust bills intend to address has not been clearly defined, and the bills do not reflect an accurate understanding of the operational realities and needs of technology-era new and small businesses. As one participant observed: "The word 'over-reach' keeps coming to mind. I'd really like to know what the 'PITA' is – the pain in the ass – the problem that policymakers are trying to solve here. It seems that not enough thinking has gone into the impact on small businesses or how we do business – especially those of us using technology and operating virtually."
- The major digital platforms and technological tools provided by large technology companies are enormously important – even critical – to the operation and success of new and small businesses today. Indeed, several participants shared that they could not have even launched their business without the analytic, marketing, and sales tools provided by large technology companies. "We've built a profitable company by using AWS for data analysis and Amazon marketplace to sell," another participant explained. "We've only been able to do it because of the scaling opportunities offered by 'big tech.' Some of it is advertising on Google and Facebook, but, for us, without AWS and the Amazon marketplace, forget it."
- Because of the scale of large technology companies – and the integration of a wide range of products and services – the digital tools offered to new and small business are remarkably

affordable. As one participant noted: "For my first company, I had to buy a $10,000 Compaq server to put my technology stack on. For my last two startups, I use the cloud for pennies."

- Participants also agreed that legislation to restrict acquisitions would threaten the startup ecosystem by obstructing the most common positive outcome or "exit" for entrepreneurs and their investors, thereby short-circuiting the process by which value-creating innovation helps fund the next generation of new businesses.

Despite the enormous value of the digital platforms and the various tools they offer, our roundtable participants made clear that problems related to terms of access and certain policies and procedures do occur and can cause significant challenges for new and small businesses. But such issues, most participants agreed, are best addressed by the FTC and the Justice Department's Antitrust Division, which have the authority to act and have been very effective when they do. Indeed, between 2010 and 2020 regulators prevailed in 79 percent of challenges to mergers in federal court, according to the Review of Industrial Organization.

Thriving entrepreneurship is the essential pathway to faster economic growth, job creation, and opportunity expansion the American people need and deserve – particularly in the wake of the Covid-19 pandemic. Legislation that would break-up the major digital platforms, mandate a wholesale restructuring of their business, require the divestiture of critical products and services, and severely restrict a major avenue of exit for entrepreneurs and their investors risks major damage to America's entrepreneurial ecosystem and the post-Covid recovery. Policymakers should heed the input from the participants in our November 18th roundtable – the regulatory agencies are the far more appropriate, nimble, proactive, and effective policy remedy to legitimate antitrust and competition concerns.



Written by:
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John Dearie is the founder and President of the Center for American Entrepreneurship. He is the former Acting CEO of the Financial Services Forum, a financial and economic policy organization comprised of the chief executive officers of the largest financial institutions with operations in the United States.

Center for Progressive Reform | CPR

March 2, 2022

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Rep. Nydia Velázquez, Chair
Rep. Blaine Luetkemeyer, Ranking Member
House Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515

Dear Chair Velázquez, Ranking Member Luetkemeyer, and Members of the Committee:

I'm a Senior Policy Analyst at the Center for Progressive Reform (CPR), a non-profit research and advocacy organization that works to build thriving communities on a resilient planet. I have been studying the federal regulatory system for over 13 years, including with regard to research on the economic impacts of federal regulation.

Consistent with this work, I followed with great interest the Committee's recent hearing on "Competition and the Small Business Landscape: Fair Competition and a Level Playing Field," which was held on March 1. I noticed that testimony from the minority made reference to the false claim that small businesses suffer disproportionate burdens due to regulations. In support of this false claim, the witness's testimony cites "[a] series of studies conducted for the Small Business Administration's Office of Advocacy."

With this letter, I hope to set the record straight for the Committee regarding the flaws of these Office of Advocacy studies, as well as make the Committee aware of the extent to which these studies' have been repudiated following their publication. As the Committee will see, these studies are so flawed that they can serve no legitimate purpose in a serious discussion regarding how best to help small businesses compete fairly in the economy. As such, I urge the Committee to disregard these studies as it carries out its important work in this area.

The Significant Methodological Flaws of the Office of Advocacy Studies

As a preliminary matter, it is important to underscore that the Office of Advocacy did not conduct these studies on its own in-house. Rather, it contracted to have them performed. The fact a government entity was not

responsible for these studies, combined with the fact that the Office of Advocacy employed derisible contracting oversight (as noted below), explains how such significantly flawed studies were ever able to be published with the apparent imprimatur of the Office of Advocacy.

The most notable flaw of the Office of Advocacy studies is that they fail to put their cost estimates into perspective by providing an accounting of the benefits of regulation in general, and for small businesses in particular. A discussion of regulation is inherently incomplete — and distorted — if it focuses on costs without also considering benefits. If one only looks at the cost side of the ledger, then any economic transaction — from purchasing a loaf of bread to constructing a new factor — will look like a drain of scarce resources. In perpetrating this flaw, the Office of Advocacy studies confirm they're not serious economic analyses, but rather anti-regulatory propaganda.

The 2010 version of the Office of Advocacy study departed from earlier versions by creating a category of regulations it styles as "economic" in nature. This category is significant for two reasons. First, it accounts for 70 percent of the total regulatory costs that the study purports to find. Second, the methodology for calculating this category of regulatory costs relies on a very peculiar source: public opinion polling. Specifically, the authors of the Office of Advocacy study rely on polling performed by the World Bank – and this despite the fact that the World Bank researchers explicitly warned against attempting to extrapolate from their data in such a manner. Nevertheless, the Office of Advocacy study authors disregarded these warnings and sought to manufacture out of whole cloth an exotic model that purported to describe a relationship between a country's regulatory stringency and its Gross Domestic Product (GDP). The upshot of this model was that excessive regulation in the United States was allegedly costing the economy in terms of economic growth.

To make matters worse, the authors of the 2010 Office of Advocacy study made it impossible for a more detailed critique of their model because they refused to release all the underlying data and assumptions necessary for recreating it independently. They rebuffed my organization's repeated requests to share this information; likewise, they never provided this information to the Office of Advocacy as part of the contract under which they performed the study. Needless to say, such opacity is contrary to prevailing academic and government norms.

Attached to this letter, I have included a report I co-authored that explains in greater detail the flaws of the model used by the 2010 Office of Advocacy study. This report also explains how the 2010 Office of Advocacy study and its predecessors used dubious methods to generate exaggerated estimates for the other regulatory costs categories, including environmental regulations and occupational safety and health and homeland security regulations. Bizarrely, those studies also count "tax compliance" as a regulatory cost category. All of these methodological choices are noteworthy for sharing the same effect: the systematic overstatement of regulatory costs.

Finally, the peer review process of the 2010 Office of Advocacy study was essentially a farce that fell below federal guidelines for federally sponsored research. Only two people examined the study. The study's authors ignored a significant criticism raised by one of the two reviewers concerning their estimate of economic regulatory costs. As for the second reviewer, the entire

review consisted of the following comments: "I looked it over and it's terrific, nothing to add. Congrats[.]"

The Backlash Against the Office of Advocacy Studies

The Office of Advocacy studies on regulation attracted controversy, but this was especially the case for the 2010 version. All of these studies were known for their topline finding – the total annual cost of federal regulation. Thanks to its inclusion of an "economic" regulations category, the 2010 study's topline funding was significantly higher than previous version, pegging this value at the outlandish amount of $1.75 trillion. Many opponents of federal safeguards – including lawmakers and industry lobbyists – cited this finding repeatedly to justify their attacks on the regulatory system.

As the citations 2010 study's topline finding grew more frequent, there was increased attention to the study's methodology itself, including the report I co-authored. Several members of Congress spoke out against the studies and criticized officials from the Office of Advocacy for sponsoring it without adequate supervision. Eventually, the then-Administrator of the White House Office of Information and Regulatory Affairs (OIRA) Cass Sunstein also publicly denounced the studies, referring to them as an "urban legend."

The Congressional Research Service (CRS) conducted its own review of the 2010 study. It raised criticisms that largely tracked with the ones identified in my organization's report. I have attached a copy of that CRS review to this letter.

The criticism reached a point that even the Office of Advocacy was forced to formally disavow the study. In October 2013, the Office of Advocacy posted a disclaimer on its website explaining that, with regard to the 2010 study, "the findings of the study have been taken out of context and certain theoretical estimates of costs have been presented publicly as verifiable facts."[1]

Finally, the Government Accountability Office (GAO) weighed in on this episode as part of a larger, scathing audit of the Office of Advocacy, which was published in July of 2014. I have attached a copy of the GAO audit report to this letter. With respect to the Office of Advocacy's program for sponsoring research, the GAO audit identified the following shortcomings:

- The Office of Advocacy has no policies defining how its staff should select peer reviewers for the research projects it sponsors. The lack of such policies gives rise to the appearance that SBA Office of Advocacy staff are free to choose peer reviewers who are unqualified or who would be unduly biased in favor of the project undergoing review. This appeared to be the case for the 2010 study where both of the peer reviewers were individuals who were widely known for their anti-regulatory views.
- The GAO reviewed 20 different research projects that the Office of Advocacy had sponsored, and, of those, 16 lacked any documentation demonstrating that they had been subject to any peer review process, even though such documentation is required by both Office of Advocacy internal guidelines and federal internal control standards. Without such documentation, it is impossible to confirm whether these research projects

[1] Off. of Advocacy, U.S. Small Bus. Admin, The Impact of Regulatory Costs on Small Firms, https://www.sba.gov/advocacy/impact-regulatory-costs-small-firms (last visited Mar. 1, 2022).

underwent any peer review at all. This appeared to be the case for the 2010 study, as well. While the Office of Advocacy had records of the peer reviewers reviews (such as they were), there was no documentation or evidence of the 2010 study's authors responses to those reviews, if, indeed, they had any responses.

- The Office of Advocacy lacks any policies or procedures for ensuring that research projects are properly revised to reflect substantive comments from peer reviewers prior to being published. Of 10 research projects that the GAO reviewed, only 1 "included evidence that the peer reviewer comments were incorporated into the final report." This was relevant to the 2010 study where, as noted above, one of the reviewers raised a core criticism one of the key methodologies used for the study. The study nonetheless retained that methodology, and there was no evidence that the study's authors attempted to address or defend that the methodology against the reviewer's criticism.
- The Office of Advocacy did not retain any of the "original data or underlying computer codes" for three studies on regulatory costs—including the 2010 version—even though this step is required by both Office of Management and Budget (OMB) data quality guidelines and by the SBA's internal data quality guidelines. By failing to retain these data and codes, it is impossible for the general public to independently verify the quality of these studies.
- The Office of Advocacy attempted to provide the GAO with a feeble excuse for not retaining the data and computer codes for those three studies, which the GAO easily dismantled. The Office of Advocacy attempted to claim that retaining the data and codes would have been prohibitively expensive. Performing its own calculations, however, the GAO concluded that the "cost would not have been prohibitive."
- The Office of Advocacy failed to take any additional steps—in lieu of retaining the underlying data and computer codes—to attempt to substantiate the quality of the information contained in two of the studies on total regulatory costs (including the 2010 study), even though such steps are required by OMB data quality guidelines. When pressed on the matter by the GAO, the Office of Advocacy could offer no explanation for this failure, but instead sought to direct the GAO's investigators to the authors of the two studies who also declined to cooperate.
- The GAO determined that the Office of Advocacy had taken actions that would lead the public to conclude that it agreed with the findings contained in the two major studies on total regulatory costs (including the 2010 study). These actions include maintaining the studies on their website and citing one of the studies in their comment letters. As noted above, the Office of Advocacy eventually sought to distance itself from these studies, but the GAO found that these efforts have been insufficient.

Conclusion

As the forgoing amply demonstrates, the Office of Advocacy studies on federal regulations – and especially the 2010 version – are simply not credible, given the faulty methodologies on which they are based and the appalling supervision by the Office of Advocacy of the contracts under which the studies were performed. As such, I urge this committee to disregard any citations of this study, both for the purposes of this hearing and in the future. Further, I urge this committee to conduct vigorous oversight of the Office of Advocacy's activities, including their

involvement in individual rulemaking as well as their sponsorship of studies related to regulatory policy.

I appreciate your attention to this letter. I look forward to continuing work with the committee on the important issue of how regulations impact America's small business community.

Sincerely,

James Goodwin
Senior Policy Analyst
Center for Progressive Reform

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Setting the Record Straight:

The Crain and Crain Report on Regulatory Costs

by CPR Member Scholar Sidney A. Shapiro (University Distinguished Chair in Law, Wake Forest University School of Law),
Ruth Ruttenberg (Professor, National Labor College),
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©Center for Progressive Reform White Paper #1103
February 2011

Setting the Record Straight: The Crain and Crain Report on Regulatory Costs

Introduction

Critics of health, safety, and environment regulation have sought to buttress the case against regulation by citing a 2010 report by economists Nicole Crain and Mark Crain called *The Impact of Regulatory Costs on Small Firms*[1] ("the Crain and Crain report"). The Crain and Crain report is the fourth in a series of reports that have been produced under contract for the Small Business Administration's (SBA) Office of Advocacy since 1995, each of which has attempted to calculate the total "burden" of federal regulations, and to demonstrate that small businesses in all economic sectors bear a disproportionate share of that burden.[2]

Among the Crain and Crain report's findings is one that has become a centerpiece of regulatory opponents' rhetoric: the "annual cost of federal regulations in the United States increased to more than $1.75 trillion in 2008."[3] This figure is several orders of magnitude larger than the estimate generated by the Office of Management and Budget (OMB)—the official estimate of the aggregate costs and benefits of federal regulations prepared annually for Congress. The 2009 OMB report found that in 2008 annual regulatory *costs* ranged from $62 billion to $73 billion.[4] The authors of the Crain and Crain report attribute this massive difference to the fact that their report considers many more rules than do the annual OMB reports, including rules with estimated costs less than $100 million, rules that were put on the books more than 10 years ago, and rules issued by independent regulatory agencies.[5]

As this report demonstrates, however, much more is at work than that. In areas where the OMB and Crain and Crain calculations overlap, Crain and Crain use the same cost data as OMB, but, unlike OMB, which presents regulatory costs as a range, Crain and Crain always adopt the upper end of the range for inclusion in their calculations, a departure that is not justified as we explain in this report. Further, Crain and Crain's calculations for the regulations not covered by OMB's report appear to be based largely on a decidedly unusual data source for economists—public opinion polling, the results of which Crain and Crain massage into a massive, but unsupported estimate of the costs of "economic" regulations. Because Crain and Crain have refused to make their underlying data or calculations public—apparently even withholding them from the SBA office that contracted for the study—it is difficult to know precisely how they arrived at the result that economic regulation has a cost of $1.2 trillion dollars, comprising more than 70 percent of the total costs in their report. Nevertheless, even based on what Crain and Crain reveal, their calculation of the cost of economic regulations is deeply flawed, as we also explain.

In addition, the OMB report accounts for an equally relevant figure that the Crain and Crain's $1.75 trillion figure simply omits: the economic benefits of regulation. OMB's 2009 recent report found that in 2008 annual *benefits* of regulation ranged from $153 billion to $806 billion.[6] And, as a series of CPR reports have explained, the OMB reports likely overestimate regulatory costs and underestimate regulatory benefits, including omitting from its calculations altogether significant benefits that happen to defy monetization.[7] In contrast, the Crain and Crain report makes no effort to account for regulatory benefits. If, for example, a regulation imposes $100 in

costs on a business, but provides twice that in benefits, the Crain and Crain report would still tally that as $100 cost to society, even though it provides substantial net benefits.

It's easy to see why the anti-regulatory critics have seized on the Crain and Crain report and its findings.[8] The $1.75 trillion figure is a gaudy number that was sure to catch the ear of the media and the general public. Upon examination, however, it turns out that the $1.75 trillion estimate is the result of transparently unreliable methodology and is presented in a fashion calculated to mislead.

This report points out the severe flaws with the effort by Crain and Crain to estimate total regulatory costs. These flaws include:

- **Omitted benefits of regulation**. A discussion of regulation is inherently incomplete—and distorted—if it focuses on costs without also considering benefits. Simply put, OMB's calculations demonstrate that regulation has a positive net effect on the economy, and not by a little. The Crain and Crain report simply ignores the benefits of regulation, focusing solely on one half of the equation. But, claiming to present a compilation of regulatory costs, without also presenting a compilation of regulatory benefits, is fundamentally misleading. Indeed, using Crain and Crain's methodology, practically any economic transaction—from the purchase of a loaf of bread to the construction of a manufacturing plant—would be counted as a drain on the economy, because they only include the costs not the benefits.* The Crain and Crain report's failure to include an accounting of regulatory benefits is particularly puzzling, since virtually every source the authors rely on for estimates of costs also provide estimates of benefits as well.
- **Questionable assumptions and flimsy data**. The report's estimate of "economic regulatory" costs—financial regulations, for example—which account for 70 percent of the total regulatory costs, is not based on actual cost estimates. Instead, this estimate is based on the results of public opinion polling concerning the business climate of countries that has been collected in a World Bank report. The authors of the World Bank report warn that its results should not be used for exactly the type of extrapolations made by Crain and Crain, because their underlying data are too crude. Crain and Crain nevertheless enter the World Bank data into a formula, which they appear to have created out of whole cloth, that purports to describe a relationship between a country's regulatory stringency and its Gross Domestic Product (GDP). OMB has repeatedly warned against

* While comparing costs and benefits is beyond the scope of this paper, it is notable that the 2009 OMB report found that total regulatory benefits are far larger than total regulatory costs. *See infra* endnote 4 and *supra* accompanying text. This finding refers to total aggregate net benefits, which means that some individual regulations may not have benefits that exceed costs. But, this result usually arises from the difficulty of monetizing regulatory benefits, rather than the lack of actual benefits. *See* comments cited *infra* endnote 7; *see also* Rena Steinzor et al., *A Return to Common Sense: Protecting Health, Safety, and the Environment Through "Pragmatic Regulatory Impact Analysis"* (Ctr. for Progressive Reform, White Paper 909, 2009), *available at* http://www.progressivereform.org/articles/PRIA_909.pdf; John Applegate et al., *Reinvigorating Protection of Health, Safety, and the Environment: The Choices Facing Cass Sunstein* (Ctr. for Progressive Reform, White Paper 901, 2009), *available at* http://www.progressivereform.org/articles/SunsteinOIRA901.pdf; Frank Ackerman et al., *Applying Cost Benefit Analysis to Past Decisions: Was Protecting the Environment* Ever *a Good Idea?* (Ctr. for Progressive Reform, White Paper 401, 2004), *available at* http://www.progressivereform.org/articles/Wrong_401.pdf.

trying to reduce the complex relationship between these two concepts to such simplistic terms, yet this is precisely what Crain and Crain do.

- **Opaque calculations**. Contrary to academic and government norms, Crain and Crain do not reveal their data or show the calculations they used to arrive at their cost estimates. Neither is the information available from the SBA Office of Advocacy. Moreover, Crain and Crain declined to furnish their data to CPR despite several requests. As a result, it is impossible to replicate their results, a flaw so significant it would prevent the publication of their paper in any respectable academic journal.
- **Slanted methodology**. The Crain and Crain report suffers from several methodological problems, all of which tilt the results towards an overstatement of regulatory costs. These problems are itemized and explained further below.
- **Overstated costs**. To estimate the cost of non-economic regulation, Crain and Crain almost always used the agency estimates of such costs that were submitted to OMB. Although OMB presents these costs as a range, Crain and Crain always used the upper bound estimate, effectively eliminating the agencies' careful efforts to draw attention to the uncertainties in these calculations. Moreover, cost estimates are typically based on industry data, and regulated entities have a strong incentive to overstate costs in this circumstance. As discussed below, empirical studies have shown that such estimates are usually too high.
- **Peer review rendered meaningless.** The peer review process used by the SBA Office of Advocacy does not support the reliability of the report. Only two people examined the document. The authors ignored a significant criticism raised by one of the two reviewers concerning their estimate of economic regulatory costs. As for the second person, the entire review consisted of the following comments: "I looked it over and it's terrific, nothing to add. Congrats[.]"[9]

For the reasons that follow, we conclude that the Crain and Crain report is sufficiently flawed that it does not come close to justifying regulatory reform efforts, such as the REINS Act,[†] which seek to limit protection of people and the environment. If Crain and Crain had used a more straightforward and generally accepted methodology, they likely would have reached a figure that was several orders of magnitude smaller. And, if Crain and Crain had properly considered regulatory benefits, they likely would have found that regulation is a net economic plus for society. Such findings, however, would not comport with the political agenda of the SBA's Office of Advocacy or of the opponents of regulation in general.

[†] Regulations from the Executive in Need of Scrutiny (REINS) Act, H.R. 10, 112th Cong. (2011). Under this bill, no new "economically significant" regulations would take effect unless Congress affirmatively approved the regulation within 90 days of receiving it, by means of a joint congressional resolution of approval, signed by the President. For more information on the REINS Act, see Sidney Shapiro, *The REINS Act: The Conservative Push to Undercut Regulatory Protections for Health, Safety, and the Environment* (Ctr. for Progressive Reform, Backgrounder, 2011), *available at* http://www.progressivereform.org/articles/CPR_Reins_Act_Backgrounder_2011.pdf.

The Crain and Crain Report's Methodology

The Crain and Crain report purports to provide a complete accounting of all regulatory costs. It divides the regulatory universe into four categories: economic regulations; environmental regulations; tax compliance regulations; and occupational health and safety and homeland security regulations. Notably, the report never provides a clear definition of the term "regulation," nor does it provide clear definitions of each of the four regulatory categories. Next, the authors employ different methodologies to calculate the total costs of regulation in each category. Finally, they add up the costs of regulation for each category to derive a total cost of federal regulations.

The report provides only a part of the data, equations, assumptions, extrapolations, and calculations that would be necessary for replicating the report's results. The authors of this white paper made several attempts to obtain the missing additional materials from the authors of the Crain and Crain report, as well as from the SBA Office of Advocacy, which funded the report, so that we could fully understand and verify the methodologies, data, and assumptions that were employed. The authors of the Crain and Crain report provided us with only very general responses and have given no indication that they would furnish us with the missing information.

Remarkably, a staff member at the SBA Office of Advocacy explained that his office did not have access to any of the additional materials, since it had only contracted to receive the final report from the authors.[10] Thus, the SBA Office of Advocacy entered into an agreement with Crain and Crain to spend taxpayer money on a report whose findings it could not then have verified in any significant way—not even checking the arithmetic.[‡]

Because this underlying information is unavailable, the Crain and Crain report is a political document, rather than an academic study. No academic author would submit such a study for publication without revealing the data and calculations on which the scholar relied. No academic publication would accept such a study unless such information was released. Academic reports also acknowledge and discuss potential weaknesses in their calculations, a modesty that is absent from the Crain and Crain report.

Methodological Problems

Economic Regulation Costs

To calculate the total cost of economic regulations, Crain and Crain employ a regression analysis that purports to establish a correlation between a country's score on the World Bank's "Regulatory Quality Index" (RQI) and the size of the country's economic activity, as measured by GDP per capita.[11] According to the World Bank report, the RQI seeks to measure public "perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development."[12] Crain and Crain have

[‡] If the SBA Office of Advocacy contracts to have similar reports performed in the future, we strongly urge it to obtain all the data, equations, assumptions, extrapolations, and calculations as part of the contract, and to make these materials readily available in a useable format on its website.

interpreted the RQI as measuring how friendly a country is to business interests.[13] The World Bank researchers did not intend for the RQI to be used as a proxy measure for regulatory burden or as a tool for critiquing a particular country's regulatory stringency.[14] Nevertheless, Crain and Crain use the RQI in precisely this fashion.

As the World Bank report explains, the RQI is based on public opinion polling, not quantitative data. It is derived from a composite of 35 opinion surveys that asked questions about the regulatory climate of approximately 200 countries.[15] Given its subjective origins, the World Bank researchers responsible for the RQI designed it with a few limited applications in mind—namely, to make meaningful cross-country comparisons as well as to monitor a single country's progress over time. At the same time, these researchers strongly caution against using the RQI for developing specific policy prescriptions in particular countries.[16]

Crain and Crain provide no justification defending their use of the RQI to estimate regulatory costs, nor do they ever acknowledge the myriad theoretical or empirical problems with calculating such costs based on public opinion polling. Significantly, one of the peer reviewers of the Crain and Crain report raised this objection, stating "I am concerned that the index may not measure what the authors say it measures, and even if it does, it may overstate the costs of regulation when used in conjunction with the other measures."[17] The authors do not appear to have revised the report in response to this comment.

As noted above, the Crain and Crain report uses the RQI, which the authors have converted into a proxy measure for a country's regulatory stringency, as the main variable in their formula for calculating the cost of a country's economic regulations—that is, the supposed reduction in that country's GDP caused by the regulations. The authors do not explain how they devised this formula, nor do they provide any of the underlying data, calculations, and assumptions that they used to devise it. Consequently, no one can verify whether or not the formula provides a reasonable model of reality, nor can anyone verify their calculations.

Using this formula, Crain and Crain calculate the loss in GDP the United States suffers because of economic regulation. It is unclear whether Crain and Crain calculate the loss in GDP as compared to the country with the highest RQI score or whether they calculate the loss in GDP attributed to all regulation. The latter baseline would reflect the GDP in a hypothetical United States that had no economic regulations. Whichever baseline they use, Crain and Crain thus conclude that the cost of economic regulations in the United States in 2008 was $1.236 trillion, "as reflected in lost GDP."[18]

Crain and Crain do not clearly define the category of "economic regulations," other than to note it is broadly inclusive.[§] The lack of a clear definition opens up the possibility that the category of "economic regulations" also includes the other categories of regulations identified by Crain and Crain. If, for example, this category includes some environmental regulation costs, those costs are also the subject of a separate calculation in the report. This would mean that some of

[§] The report indicates that the category of economic regulations is broad enough to include "a wide range of restrictions and incentives that affect the way businesses operate—what products and services they produce, how and where they produce them, and how products and services are priced and marketed to consumers." CRAIN & CRAIN, *infra* endnote 1, at 17.

these regulation costs would be counted twice (once as an economic regulation and once as an environmental regulation), leading to an exaggeration of total regulation costs. Some of the polling data used by the authors of the World Bank study in the calculation of the RQI asks questions of environmental and safety regulations, although the majority of the questions are about tax and price control regulations, trade barriers, access to capital, and regulatory barriers to starting a new business.**

One other significant problem in this category of costs is that the regression analysis used in the report assumes an overly simplistic relationship between regulatory stringency and GDP. As noted above, the Crain and Crain report's formula implies that increases in regulatory stringency *cause* a reduction in a country's economic activity, which are reflected in a decreased GDP. The actual relationship between regulatory stringency and a country's economic activity is not so clear-cut, however, because measurements of GDP do not include regulatory benefits. On this subject, the 2009 OMB report to Congress notes:

> The relationship between regulation and indicators of economic activity raises a number of complex questions, conceptual, empirical, and normative. A key issue involves identification of the appropriate measures. For example, is GDP the appropriate measure? As we have seen, many regulations have favorable net benefits, and by hypothesis, such regulations are desirable on standard economic grounds. Of course it would be useful to understand the effects on GDP of particular regulations and of classes of regulations. But while important, GDP is hardly a complete measure of relevant values, and some of the benefits of regulation, such as environmental protection, are not adequately captured by changes in GDP.[19]

Finally, the report's use of the RQI is misleading because it gives the false impression that the U.S. regulatory burden is especially high. In fact, the United States has one of the highest RQI scores, ranking eleventh out of more than 200 countries.[20] The United States ranks higher than many of its competitive trading partners, including China, Germany, Japan, Mexico, South Korea, and Taiwan, and its RQI score has remained fairly constant since 1996, when these scores were first developed.[21] But Crain and Crain's use of the RQI, and the SBA's use of the Crain and Crain report, imply that the U.S. is inferior to these other countries as an excellent place to do business.

Environmental Regulation Costs

To calculate the costs of environmental regulations, the Crain and Crain report adds up the estimated costs of environmental regulations found in each of OMB's annual reports to Congress on cost-benefit analysis since 2001.[22] These estimates in turn are based on aggregation of the

** The World Bank study relied on 35 different sources of global or regional surveys, produced by 33 different organizations. Only 16 of the sources had any measure of regulation at all. Only one specifically mentioned environmental regulations (the World Economic Forum Global Competitiveness Survey). Only 2 of the 35 sources mentioned labor market policy: the African Development Bank (not relevant to the US) and the Institute for Management Development World Competitiveness Yearbook. Neither of these two said which labor market issues they measured, and there was no mention of safety and health by them. *See* Kaufmann et al., *infra* endnote 11, at 29 (Table 1), 39-71 (App. A).

cost-benefit analyses that EPA produced when developing the regulations. Based on this data, Crain and Crain find that the total cost of environmental regulations in 2008 was $281 billion,[23] which is 16 percent of the total regulatory costs according to their estimate of total costs.

To generate cost estimates for its cost-benefit analyses, EPA primarily relies on surveys of representative companies that the regulation will likely affect. Because companies know the purpose of the surveys, they have a strong incentive to overstate costs in order to skew the final cost-benefit analysis toward weaker regulatory standards.[24] Agencies must also fill in any data gaps they encounter by making various assumptions. Due to fear of litigation over the regulation, they tend to adopt conservative assumptions about regulatory costs, such that the cost assessment ends up reflecting the maximum possible cost, rather than the mean.[25]

Industry cost estimates—and therefore the cost estimates that EPA develops-- do not account for technological innovations that reduce the cost of compliance and produce non-regulatory co-benefits, such as increased productivity. When companies are asked to predict which technology they will employ to comply with a particular environmental regulation, they often will point to the most expensive existing "off-the-shelf" technology available. Once the regulation actually goes into effect, however, companies have a strong incentive to invent or purchase less costly technologies to come into regulatory compliance. As a result, compliance costs tend to be less, and often much less, than the predicted costs. Moreover, the technological innovations tend to produce co-benefits unrelated to the regulation—such as increased productivity and efficiency—that the company strives to achieve in any event. Given these co-benefits, only a portion of the innovative technology's costs can fairly be counted as compliance costs.[26]

As the following chart indicates, retrospective studies of regulatory costs find that the initial cost estimates are often too high.

Retrospective Studies of Regulatory Costs

Study	Subject of Cost Estimates	Results
PHB, 1980[27]	Sector level capital expenditures for pollution controls	– EPA overestimated capital costs more than it underestimated them, with forecasts ranging 26 to 126% above reported expenditures
OTA, 1995[28]	Total, annual, or capital expenditures for occupational safety & health regulations	– OSHA overestimated costs for 4 of 5 health regulations, with forecasts ranging from $5.4 million to $722 million above reported expenditures
Goodstein & Hedges, 1997[29]	Various measures of cost for pollution prevention	– Agency and industry overestimated costs for 24 of 24 OSHA & EPA regulations, by at least 30% and generally by more than 100%
Resources for the Future, 1999[30]	Various measures of cost for environmental regulations	– Agency overestimated costs for 12 of 25 rules, and underestimated costs for 2 rules

Finally, unlike the OMB reports, which present regulatory costs as a range, Crain and Crain always adopt the upper end of the range for inclusion in their calculations.[31] The authors justify this move by claiming that agencies allegedly have a strong incentive to underestimate regulatory costs, although they provide no empirical evidence to support this claim. In fact, as just explained, it is likely that regulatory costs are overstated. In any case, the choice by Crain and Crain to always take the higher bound estimate, rather than presenting their results as a range of costs, as OMB does, is a misleading use of the OMB data.

Agencies were not required by Executive Order to provide OMB with estimates of regulatory costs and benefits prior to 1988. For this reason, OMB had to rely on non-government estimates in order to estimate regulatory benefits and costs prior to 2000. For environmental regulations issued before 1988, the 2001 OMB report relied on a 1991 study of regulatory costs undertaken by economists Robert Hahn and John Hird.[32]

Hahn and Hird performed no new calculations of regulatory costs, but instead they generated an estimate by synthesizing a set of earlier studies of regulatory costs conducted by a small circle of conservative economists.[33] These estimates are subject to the same limitations as agency-produced cost analyses, including relying on industry-estimates of compliance costs and failing to account for innovation.[††] An additional problem is that the Hahn and Hird study is nearly 20 years old, and many of the earlier studies and data it relies upon are more than 30 years old. The data and assumptions reflected in the Hahn and Hird study cannot be reasonably extrapolated to modern social and economic reality.[‡‡]

Occupational Safety and Health and Homeland Security Regulation Costs

The Crain and Crain report concludes that the total cost of occupational safety and health and homeland security regulations in 2008 was $75 billion,[34] which is four percent of their total costs. Occupational safety and health regulations accounted for $65 billion of the total.

Occupational Safety and Health Regulation Costs

To calculate the occupational safety and health regulations, the Crain and Crain report relies on two sources. The first source, a 2005 study by Joseph Johnson, provides the total costs of all occupational safety and health regulations issued before 2001.[35] The second source, the 2009

[††] In addition, many of these earlier studies assume a regulatory baseline of zero for their comparisons of regulatory costs. In other words, these studies assume that in the absence of the regulations under examination, companies would have taken no environmentally protective actions. This assumption has no basis in a reality where other existing regulations (federal, state, and local), fear of tort liability, and simple market forces induce companies to take some minimal level of environmentally protective action all the time. This minimal level of actions represents the proper baseline against which regulatory costs should be measured. To the extent that these earlier studies assume a zero baseline, they grossly overestimate regulatory costs. McGarity & Ruttenberg, *infra* endnote 24, at 2047.

[‡‡] In the intervening years, the U.S. economy and society have drastically changed. For example, scientific knowledge regarding the harmful public health and environmental effects of pollution has greatly improved, the U.S. has shifted from an industrial sector-based economy to a service sector-based one, and even industry has become characterized by more automation and less human labor. *See* Ian D. Wyatt & Daniel E. Hecker, *Occupational Changes During the 20th Century*, MONTHLY LABOR REV., March 2006.

OMB report to Congress, provides the total cost of all occupational safety and health regulation issued since 2001.

The cost estimate from the 2009 OMB report to Congress is based on a simple aggregation of the cost-benefit analyses that OSHA produced when developing these regulations.[36] As discussed above, the cost assessments generated as part of these cost-benefit analyses greatly overstate the costs of regulations, since the agencies that produce them rely on industry for estimates of compliance costs, adopt conservative assumptions to fill in data gaps, and fail to account for innovation.

The Johnson study likewise suffers from several flaws, leading it to overestimate these regulatory costs. The study begins by aggregating the agency-produced cost-benefit analyses for all of OSHA rules issued before 2001.[37] As just noted, these costs estimates are overstated. Nevertheless, the Johnson study then inflates OSHA's cost estimates by multiplying the total of all of the estimates by 5.5. According to Johnson, using the multiplier is necessary to account for the costs of all of OSHA's non-major regulations—since OSHA does not perform cost-benefit analyses for these regulations—and for *fines* levied for violations of any OSHA standards.[38] In other words, the Johnson study assumes that for every dollar industry spends on compliance with OSHA's major rules, it spends $5.50 on compliance with non-major regulations and on fines for violations of existing OSHA standards.

We see no justification for counting the fines that companies pay for violating regulatory standards as regulatory costs. Instead, these are the costs of *choosing* to break the law. That is, the fines would never have occurred if the firms had not chosen to disobey the law. Under this logic, mass lawbreaking raises regulatory costs, enabling regulatory opponents to argue that we need to reduce regulation because of these high regulatory costs.

The Johnson study took the multiplier of 5.5 from a 1996 study by Harvey James.[39] The James study uses an unpublished and otherwise unavailable 1974 estimate prepared by the National Association of Manufacturers (NAM) of the per-firm cost of compliance with OSHA regulations.[40] Because the report is unavailable, it cannot be checked for accuracy. As we related earlier, industry estimates of regulatory costs are suspect because of the political incentive to inflate such costs. Nevertheless, the Crain and Crain report incorporate the Johnson study without any discussion of this significant limitation in the data.

Homeland Security Regulation Costs

To calculate the cost of all homeland security regulations, the Crain and Crain report again relies on the 2009 OMB report to Congress,[41] which is based on the cost-benefit analyses that the Department of Homeland Security produced when developing its regulations.[42] The cost assessments provided in these cost-benefit analyses are overstated for all the reasons stated above: industry-supplied estimates of compliance estimates; conservative assumptions to fill in data gaps; and failure to account for innovation.

Tax Compliance Regulation Costs

To calculate the cost of tax compliance regulations, the Crain and Crain report starts with estimates of the time that businesses, non-profit organizations, and individuals spend each year completing tax-related forms and filings, and multiplies it by an estimate of the hourly cost of filling out the forms. Using this methodology, the Crain and Crain report concludes that the total cost of tax compliance regulations in 2008 was $160 billion,[43] which is about nine percent of their total costs.

The report says it derives its estimates of the time it takes to fill out tax forms from the Internal Revenue Service and the Tax Foundation, a conservative-leaning non-profit organization.[44] However, they do not explain which data they use or how those data contribute to their estimate. To the extent that data from the Tax Foundation are used, the report's estimate of the amount time spent on tax compliance should be viewed with caution since the Tax Foundation tends to be "anti-tax" in orientation.

The authors calculate tax compliance costs for businesses separately from individuals and non-profit organizations, using the reasonable assumption that businesses spend more money per hour complying with tax regulations. Crain and Crain assume that all businesses rely on "Human Resources professionals" to prepare their taxes, but they provide no evidence to justify this assumption. They nevertheless multiply estimates of the amount of time it takes to fill out the tax forms by $49.77 per hour ("the hourly compensation rate for Human Resources professionals") on tax compliance.[45] The report then appears to assume that all individuals and non-profit organizations have their taxes prepared by accountants or auditors, and it estimates that these entities spend $31.53 per hour ("the average hourly wage rate for accountant and auditors") on tax compliance.[46] With respect to individuals, this assumption seems particularly unfounded given that millions of American households prepare their own taxes.

Conclusion

The Crain and Crain study is rife with flawed methodologies and questionable data and assumptions. Of even greater importance, each of the problems with the Crain and Crain report's methodologies, data, and assumptions lead to an overstatement of regulatory costs. Because of these problems with the Crain and Crain report's reliability, we believe policymakers should disregard its misleading conclusions as they consider matters of regulatory policy.

Endnotes

[1] NICOLE V. CRAIN & W. MARK CRAIN, THE IMPACT OF REGULATORY COSTS ON SMALL FIRMS (2010) (This report was developed under a contract with the Small Business Administration's Office of Advocacy), *available at* http://www.sba.gov/sites/default/files/rs371tot.pdf.

[2] For the three earlier reports, see W. MARK CRAIN, THE IMPACT OF REGULATORY COSTS ON SMALL FIRMS (2005) (This report was developed under a contract with the Small Business Administration's Office of Advocacy), *available at* http://archive.sba.gov/advo/research/rs264tot.pdf; W. MARK CRAIN & THOMAS D. HOPKINS, THE IMPACT OF REGULATORY COSTS ON SMALL FIRMS (2001), *available at* http://archive.sba.gov/advo/research/rs207tot.pdf; THOMAS D. HOPKINS, PROFILES OF REGULATORY COSTS (1995), *available at* http://archive.sba.gov/advo/research/rs1995hoptot.pdf.

[3] CRAIN & CRAIN, *supra* endnote 1, at 6 (2009 dollars).

[4] OFFICE OF MGMT & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, 2009 REPORT TO CONGRESS ON THE BENEFITS AND COSTS OF FEDERAL REGULATIONS AND UNFUNDED MANDATES ON STATE, LOCAL, AND TRIBAL ENTITIES 3 (converted from 2001 to 2009 dollars), *available at* http://www.whitehouse.gov/sites/default/files/omb/assets/legislative_reports/2009_final_BC_Report_01272010.pdf [hereinafter 2009 OMB Report]. The Regulatory Right-to-Know Act requires OMB to produce a report every year that, among other things, calculates the annual cost of major regulations. Treasury and General Government Appropriations Act of 2001 §624, Pub. L. 106-554, 31 U.S.C. §1105 note.

[5] CRAIN & CRAIN, *supra* endnote 1, at 3-5.

[6] 2009 OMB Report, *supra* endnote 4, at 3 (converted from 2001 to 2009 dollars).

[7] *See, e.g.*, Sidney Shapiro et al., *CPR Comments on Draft 2010 Report to Congress on the Benefits and Costs of Federal Regulations* 16-19 (App. A, Pt. C.) (2010), *available at* http://www.progressivereform.org/articles/2010_CPR_Comments_OMB_Report.pdf; Rena Steinzor et al., *CPR Comments on Draft 2009 Report to Congress on the Benefits and Costs of Federal Regulations* 16-19 (App. A, Pt. C.) (2009), *available at* http://www.progressivereform.org/articles/2009_CPR_Comments_OMB_Report.pdf; Amy Sinden & James Goodwin, *CPR Comments on Draft 2008 Report to Congress on the Benefits and Costs of Federal Regulations* 5-8 (2008), *available at* http://www.progressivereform.org/articles/2008_Comments_OMB_Report.pdf. For all of the comments on OMB's annual reports to Congress on the benefits and cost of federal regulation produced by CPR Member Scholars and staff, see Ctr. for Progressive Reform, *OMB Reports on the Costs and Benefits of Regulation*, http://www.progressivereform.org/OMBCongress.cfm (last visited Feb. 5, 2011).

[8] For examples of instances in which anti-regulatory critics have cited the Crain and Crain report and its conclusions, see, e.g., James L. Gattuso, Diane Katz, & Stephen A. Keen, *Red Tape Rising: Obama's Torrent of New Regulation* (Heritage Foundation, Backgrounder No. 2048, 2010) ("According to a report recently released by the Small Business Administration, total regulatory costs amount to about $1.75 trillion annually . . . ."), *available at* http://thf_media.s3.amazonaws.com/2010/pdf/bg2482.pdf; Sen. Mark R. Warner, Op-Ed, *To Revive the Economy, Pull Back the Red Tape*, WASH. POST, Dec. 13, 2010 ("According to the U.S. Small Business Administration, the estimated annual cost of federal regulations in 2008 exceeded $1.75 trillion."), *available at* http://www.washingtonpost.com/wp-dyn/content/article/2010/12/12/AR2010121202639.html?hpid=opinionsbox1; Press Release, U.S. Chamber of Commerce, U.S. Chamber Calls on Federal and State Lawmakers to Stem the Growing Tide of Excessive Regulation (Oct. 7, 2010) ("Donohue cited statistics from the Small Business Administration's Office of Advocacy estimating the total cost of federal regulations at $1.75 trillion."), http://www.uschamber.com/press/releases/2010/october/us-chamber-calls-federal-and-state-lawmakers-stem-growing-tide-excessive (last visited Feb. 1, 2011).

[9] OFFICE OF ADVOCACY, SMALL BUSINESS ADMINISTRATION, INFORMATION QUALITY PEER REVIEW REPORT FOR THE IMPACT OF FEDERAL REGULATORY COSTS ON SMALL FIRMS 4 (2010) (Bob Litan's peer review), *available at* http://www.sba.gov/sites/default/files/files/TheImpactofFederalRegulatoryCostsonSmallFirmsPRFY2010.pdf.

[10] Telephone Interview with Radwan Saade, Regulatory Analyst, Small Business Administration, Office of Advocacy, Office of Economic Research (Jan. 11, 2011).

[11] CRAIN & CRAIN, *supra* endnote 1, at 18-25. The RQI was developed as part of the World Bank's Worldwide Governance Indicators project, which seeks to establish a variety of indexes for measuring countries' governance and institutional quality. *See* Daniel Kaufmann et al., *Governance Matters VIII: Aggregate and Individual Governance Indicators 1996–2008* at 2 (The World Bank, Development Research Group, Macroeconomics and

Growth Team, Policy Research Working Paper No. 4978, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1424591## (follow "One-Click Download" hyperlink at the top of the page).

[12] Kaufmann et al., *supra* endnote 11, at 6.

[13] *See* CRAIN & CRAIN, *supra* endnote 1, at 21 (explaining that increases in the RQI correspond to "reductions in regulatory burden.").

[14] *See id.*

[15] Kaufmann et al., *supra* endnote 11, at 4.

[16] *Id.* at 5 (describing the RQI as "too blunt a tool to be useful in formulating specific governance reforms in particular country contexts. Such reforms, and evaluation of their progress, need to be informed by much more detailed and country-specific diagnostic data . . . .").

[17] OFFICE OF ADVOCACY, *supra* endnote 9, at 2 (Richard Williams' peer review), *available at* http://www.sba.gov/sites/default/files/files/TheImpactofFederalRegulatoryCostsonSmallFirmsPRFY2010.pdf. Richard Williams is a conservative economist who currently works as the Director of Policy Research at the Mercatus Center, an anti-regulatory think tank. *See* Mercatus Ctr., *Richard Williams Biography*, http://mercatus.org/richard-williams (last visited February 4, 2011).

[18] CRAIN & CRAIN, *supra* endnote 1, at 24 (2009 dollars).

[19] 2009 OMB Report, *supra* endnote 4, at 29.

[20] *See* Kaufmann et al., *supra* endnote 11, at 89-91 (Table C4). The RQI is designed so that possible scores range from -2.5 (*i.e.*, the greatest regulatory burden, however defined) to 2.5 (*i.e.*, the lowest regulatory burden, however defined). In 2008, the RQI score for the United States was 1.579. CRAIN & CRAIN, *supra* endnote 1, at 24.

[21] *See* Kaufmann et al., *supra* endnote 11, at 89-91 (Table C4).

[22] CRAIN & CRAIN, *supra* endnote 1, at 25- 27.

[23] *Id.* at 31 (Table 6) (2009 dollars).

[24] Thomas O. McGarity & Ruth Ruttenberg, *Counting the Cost of Health, Safety, and Environmental Regulation*, 80 TEX. L. REV. 1997, 2011, 2044-45 (2002).

[25] *Id.* at 2046.

[26] *Id.* at 2049-50. Studies of OSHA's vinyl chloride and cotton dust standards concluded that actual compliance costs were much lower than predicted costs in part because of overall productivity gains achieved by regulatees. When company scientists and engineers were forced to concentrate on cost-effective compliance techniques, they also identified ways to improve the overall productivity of an industrial process, or even an entire industry. *See* OCCUPATIONAL SAFETY AND HEALTH ADMINISTRATION, OFFICE OF PROGRAM EVALUATION, REGULATORY REVIEW OF OSHA'S COTTON DUST STANDARD (2000) (identifying extensive technological improvements and increased productivity in the textile industry spurred by OSHA's cotton dust standard); RUTH RUTTENBERG, REGULATION IS THE MOTHER OF INVENTION 42, 44-45 (Working Papers for a New Society, May/June 1981), (identifying six regulation-induced changes in the vinyl chloride industry that resulted in increased productivity).

[27] Winston Harrington, Richard D. Morgenstern, & Peter Nelson, *On the Accuracy of Regulatory Cost Estimates* 6 (Resources for the Future, Discussion Paper 99-18, 1999) (citing PUTNAM, HAYES, & BARTLETT, INC., COMPARISONS OF ESTIMATED AND ACTUAL POLLUTION CONTROL CAPITAL EXPENDITURES FOR SELECTED INDUSTRIES (Report prepared for the Office of Planning & Evaluation, U.S. Envtl. Protection Agency, 1980)), *available at* http://www.rff.org/documents/RFF-DP-99-18.pdf.

[28] OFFICE OF TECHNOLOGY ASSESSMENT, GAUGING CONTROL TECHNOLOGY AND REGULATORY IMPACTS IN OCCUPATIONAL SAFETY AND HEALTH: AN APPRAISAL OF OSHA'S ANALYTICAL APPROACH 58 (1995).

[29] Eban Goodstein & Hart Hodges, *Polluted Data: Overestimating Environmental Costs*, 8 AM. PROSPECT 64 (Nov./Dec. 1997).

[30] Harrington, Morgenstern, & Nelson, *supra* endnote 27. The Resources for the Future study notes that actual compliance costs can also be less than an agency estimates because there can be less regulatory compliance than the agency anticipates. If an agency overestimates the extent of pollution reduction, or some similar benefit, then the regulation may cost less than the agency estimates. In such cases, the original agency estimate might have been accurate, but it turns out to be wrong because the regulatory industry does not obey the regulation to the extent that the agency predicted. *Id.* at 14-15.

[31] CRAIN & CRAIN, *supra* endnote 1, at 27.

[32] *Id.* at 25.

[33] Robert W. Hahn & John A. Hird, *The Costs and Benefits of Regulation: Review and Synthesis*, 8 YALE J. ON REG. 233, 248-54 (1991).

[34] CRAIN & CRAIN, *supra* endnote 1, at 31 (2009 dollars).
[35] *Id.*
[36] 2009 OMB Report, *supra* endnote 4, at 11 (Table 1-2).
[37] Joseph M. Johnson, *A Review and Synthesis of the Cost of Workplace Regulations*, *in* CROSS-BORDER HUMAN RESOURCES, LABOR, AND EMPLOYMENT ISSUES 433, 453-54, 466 (Table 10) (Andrew P. Morriss & Samuel Estreicher eds., 2005).
[38] *Id.* at 455.
[39] HARVEY S. JAMES, JR., ESTIMATING OSHA COMPLIANCE COSTS 10-13 (Ctr. for the Study of Am. Bus., Policy Study No. 135, 1996).
[40] *Id.* James compared the NAM estimate to cost-benefit estimates produced by OSHA. Since the NAM estimate was approximately 5.5 times greater than the aggregate value of OSHA's cost-benefit analyses, he assumes he was justified using a 5.5 multiplier. *Id.* James did not cite an original source for the numbers that he derived from the NAM estimate. He merely cited a book by Robert S. Smith in which the NAM estimate was featured in a table. *Id.* at 4. There is no indication in James' report that he read or made any independent attempt to evaluate the accuracy of the NAM report.
[41] CRAIN & CRAIN, *supra* endnote 1, at 31.
[42] 2009 OMB Report, *supra* endnote 4, at 17-18.
[43] CRAIN & CRAIN, *supra* endnote 1, at 29 (2009 dollars).
[44] *Id.* at 28.
[45] *Id.* at 29.
[46] *Id.* at 29.

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Founded in 2002, the Center for Progressive Reform is a 501(c)(3) nonprofit research and educational organization comprising a network of scholars across the nation dedicated to protecting health, safety, and the environment through analysis and commentary. CPR believes sensible safeguards in these areas serve important shared values, including doing the best we can to prevent harm to people and the environment, distributing environmental harms and benefits fairly, and protecting the earth for future generations. CPR rejects the view that the economic efficiency of private markets should be the only value used to guide government action. Rather, CPR supports thoughtful government action and reform to advance the well-being of human life and the environment. Additionally, CPR believes people play a crucial role in ensuring both private and public sector decisions that result in improved protection of consumers, public health and safety, and the environment. Accordingly, CPR supports ready public access to the courts, enhanced public participation, and improved public access to information. The Center for Progressive Reform is grateful to the Public Welfare Foundation for its generous support of CPR's work on regulatory issues in general.

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Analysis of an Estimate of the Total Costs of Federal Regulations

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April 6, 2011

Congressional Research Service
7-5700
www.crs.gov
R41763

CRS Report for Congress
Prepared for Members and Committees of Congress

Summary

Some policy makers have expressed an interest in measuring total regulatory costs and benefits (e.g., the Congressional Office of Regulatory Analysis Creation and Sunset and Review Act of 2011, H.R. 214, 112th Congress), and estimates of total regulatory costs have been cited in support of regulatory reform legislation (e.g., H.R. 10, the Regulations from the Executive In Need of Scrutiny (REINS) Act, H.R. 10, 112th Congress). However, measuring total costs and benefits is inherently difficult. This report examines one such study to illustrate the complexities of this type of analysis.

A September 2010 report prepared by Nicole V. Crain and W. Mark Crain for the Office of Advocacy within the Small Business Administration (SBA) stated that the annual cost of federal regulations was about $1.75 trillion in 2008. This cost estimate was developed by adding together the estimated costs of four categories or types of regulation: economic regulations (estimated at $1.236 trillion); environmental regulations ($281 billion); tax compliance ($160 billion); and regulations involving occupational safety and health, and homeland security ($75 billion). Some commenters have raised questions about the validity and reliability of this estimate.

For example, Crain and Crain's estimate for economic regulations (which comprises more than 70% of the $1.75 trillion estimate) was developed by using an index of "regulatory quality." One of the authors of the regulatory quality index said that Crain and Crain misinterpreted and misused the index, resulting in an erroneous and overstated cost estimate. Other commenters have also raised concerns about using the index to estimate regulatory costs, and about the regression analysis that the authors used to produce the cost estimate. Crain and Crain said that they believe they interpreted and used the regulatory quality index correctly.

Crain and Crain's estimates for environmental, occupational safety and health, and homeland security regulations were developed by blending together academic studies (some of which are now more than 30 years old) with agencies' estimates of regulatory costs that were developed before the rules were issued (some of which are now 20 years old). Although the agency estimates were typically presented as low-to-high ranges, Crain and Crain used only the highest cost estimates in their report. The Office of Management and Budget has said that estimates of the costs and benefits of regulations issued more than 10 years earlier are of "questionable relevance."

Crain and Crain's estimate for the cost of tax paperwork was based on data from the Internal Revenue Service and the Tax Foundation, but OMB data indicate that the number of hours of tax paperwork may be much higher than Crain and Crain's estimate. On the other hand, the authors' assumptions regarding the cost of completing the paperwork may be too high. A threshold question, however, is whether tax paperwork should be considered in the same category as regulatory costs. OMB does not include tax paperwork in its annual reports to Congress.

Crain and Crain said they did not provide estimates of the benefits of regulations, even when the information was readily available, because the SBA Office of Advocacy did not ask them to do so. OMB's reports to Congress have generally indicated that regulatory benefits exceed costs. Crain and Crain said their report was not meant to be a decision-making tool for lawmakers or federal regulatory agencies to use in choosing the "right" level of regulation. This report will not be updated.

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Introduction

Regulation, like taxing and spending, is a basic function of government. Each year, federal agencies issue between 3,000 and 4,000 final rules on topics ranging from the timing of bridge openings to the permissible levels of arsenic and other contaminants in drinking water. Unlike taxing and spending, however, the costs that nonfederal entities pay to comply with federal regulations are not accounted for in the federal budget process. Some policy makers have expressed an interest in measuring total regulatory costs and benefits. For example, the Congressional Office of Regulatory Analysis Creation and Sunset and Review Act of 2011 (H.R. 214, 112th Congress) would require the newly created office to issue "an annual report including estimates of the total costs and benefits of all existing Federal regulations." As discussed later in this report, for nearly 14 years, Congress has required the Office of Management and Budget (OMB) to prepare a report each year on the aggregate costs and benefits of federal rules.[1]

However, measuring total regulatory costs and benefits is inherently difficult. For example, researchers must determine the baseline for measurement (i.e., what effects would have occurred in the absence of the regulation) and aggregating the results of studies conducted years earlier with different methodologies and quality can be highly problematic. Some observers, including OMB, currently doubt whether an accurate measure of total regulatory costs and benefits is possible.

The Crain and Crain Report

In September 2010, the Office of Advocacy within the Small Business Administration (SBA) released a report prepared for the office by Nicole V. Crain and W. Mark Crain entitled "The Impact of Regulatory Costs on Small Firms."[2] Among other things, the report stated that the annual cost of federal regulations in 2008 was about $1.75 trillion. The September 2010 report was the fourth such report prepared for the SBA Office of Advocacy in the previous 15 years:

- In 1995, Thomas D. Hopkins estimated annual federal regulatory costs that year to be between $416 billion and $668 billion.[3]
- In 2001, W. Mark Crain and Hopkins estimated the annual cost of regulations in the year 2000 at $843 billion.[4]

[1] The current requirement is in Section 624 of the Treasury and General Government Appropriations Act, 2001, (31 U.S.C. § 1105 note), sometimes referred to as the "Regulatory Right-to-Know Act."

[2] See http://www.sba.gov/sites/default/files/rs371tot.pdf to view a copy of this report. Hereafter, this report is referred to as "Crain and Crain." In addition to estimating the annual cost of federal regulations, the report also provided information indicating that regulatory costs fall particularly hard on small businesses. The report was developed under a contract with the SBA Office of Advocacy (contract number SBAHQ-08-M0466). Although the report cover states that it "contains information and analysis that was reviewed and edited by officials of the Office of Advocacy," it also says that the "final conclusions of the report do not necessarily reflect the views of the Office of Advocacy."

[3] Thomas D. Hopkins, "Profiles in Regulatory Costs," available at http://www.sba.gov/sites/default/files/files/rs1995hoptot.pdf.

[4] W. Mark Crain and Thomas D. Hopkins, "The Impact of Regulatory Costs on Small Firms," available at http://www.sba.gov/sites/default/files/files/rs207tot.pdf. For an analysis of this estimate, see CRS Report RL32339, *Federal Regulations: Efforts to Estimate Total Costs and Benefits of Rules*, by Curtis W. Copeland.

- In 2005, W. Mark Crain estimated annual regulatory costs in 2004 at about $1.1 trillion.[5]

The $1.75 trillion estimate of regulatory costs has been widely quoted in the press,[6] by witnesses at congressional hearings,[7] and by Members of Congress,[8] and it has been cited as evidence of the need for regulatory reform legislation and congressional oversight actions.[9] Other observers, however, have criticized the estimate, saying that it overstates the total cost of federal regulations.[10]

This report examines how Crain and Crain developed the $1.75 trillion estimate of federal regulatory costs in 2008. It also compares the $1.75 trillion estimate for 2008 with the $1.1 trillion estimate for 2004, and with OMB's estimates of regulatory costs in 2008.

How Crain and Crain Developed the $1.75 Trillion Estimate of Regulatory Costs

Crain and Crain developed their $1.75 trillion estimate of total regulatory costs by adding together cost estimates for each of four categories or types of regulation: economic regulations ($1.236 trillion); environmental regulations ($281 billion); tax compliance ($160 billion); and

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[5] W. Mark Crain, "The Impact of Regulatory Costs on Small Firms," available at http://www.sba.gov/sites/default/files/files/rs264tot.pdf.

[6] See, for example, Chad Moutrey, "To cure the economy, fix the business environment," *Washington Post*, January 10, 2011, available at http://www.washingtonpost.com/wp-dyn/content/article/2011/01/07/AR2011010705681.html; "Obama's reformer disguise; Accountability is the solution to government red tape," *Washington Times*, January 26, 2011, p. B2; and Mark Tapscott, "Washington is the Reason the Economy Is Not Growing," *The Examiner*, December 2, 2010, p. 39.

[7] See, for example, testimony of Thomas M. Sullivan, before the House Committee on Education and Workforce, Subcommittee on Workforce Protections, February 15, 2011, available at http://edworkforce.house.gov/UploadedFiles/02.15.11_sullivan.pdf; and testimony of Karen Harned, before the House Committee on the Judiciary, Subcommittee on Courts, Commercial and Administrative Law, February 10, 2011, available at http://judiciary.house.gov/hearings/pdf/Harned02102011.pdf.

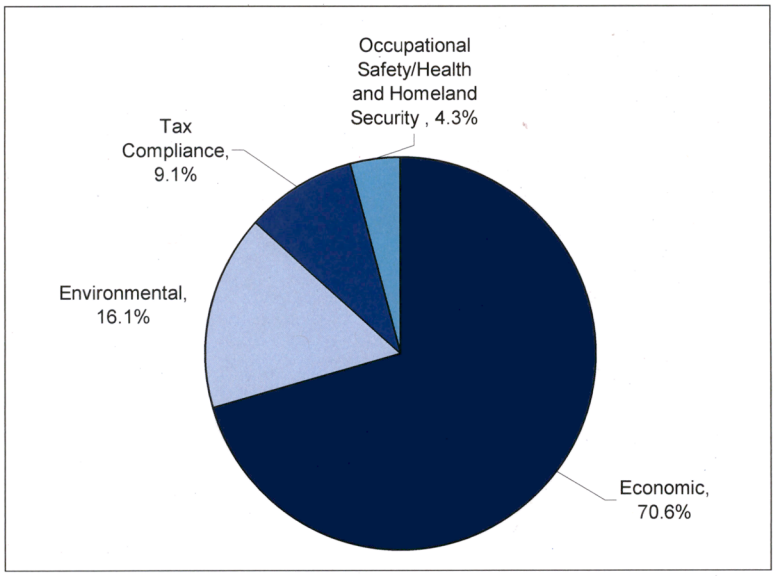
[8] See, for example, Senator Dan Coats, "Coats Says Excessive Regulation is Hindering Private Sector Job Growth," Press Statement in support of S. 358, February 16, 2011, available at http://coats.senate.gov/newsroom/press/release/?id=F6E06668-FE12-460E-9D04-4ED611EAB111; Opening statement of Representative Sam Graves, Chairman, House Committee on Small Business, February 16, 2011, available at http://smbiz.house.gov/UploadedFiles/2011.02.16_State_of_SmBiz_Opening.pdf; and a letter to President Barack Obama by four House committee chairmen, available at http://geoffdavis.house.gov/UploadedFiles/POTUS_Letter_031011.pdf.

[9] See, for example, http://www.geoffdavis.house.gov/Legislation/reins.htm, and http://www.geoffdavis.house.gov/News/DocumentSingle.aspx?DocumentID=208463, in support of the "Regulations from the Executive In Need of Scrutiny (REINS) Act," H.R. 10 in the 112th Congress; http://snowe.senate.gov/public/index.cfm/pressreleases?ContentRecord_id=49fe01bb-b475-4ff1-b9e1-7ea6eda50b7e&ContentType_id=ae7a6475-a01f-4da5-aa94-0a98973de620&Group_id=2643ccf9-0d03-4d09-9082-3807031cb84a&MonthDisplay=3&YearDisplay=2011, in support of the Small Business Regulatory Freedom Act of 2011, S. 474 in the 112th Congress; and H.Rept. 112-6, "Directing Certain Standing Committees to Inventory and Review Existing, Pending, and Proposed Regulations and Orders from Agencies of the Federal Government, Particularly With Respect to Their Effect on Jobs and Economic Growth," Report to accompany H.Res. 72, February 8, 2011.

[10] Carl Bialik, "The Numbers Guy: Small Business Regulatory 'Burden' Is Tough to Quantify," *Wall Street Journal*, January 29, 2011, p. A2; and Sidney A. Shapiro, Ruth Ruttenberg, and James Goodwin, "Setting the Record Straight: The Crain and Crain Report on Regulatory Costs," Center for Progressive Reform White Paper #1103, February 2011, available at http://www.progressivereform.org/articles/SBA_Regulatory_Costs_Analysis_1103.pdf ("CPR report").

regulations involving occupational safety and health, and homeland security ($75 billion). As **Figure 1** below illustrates, the estimated cost of economic regulations was more than 70% of the authors' estimate of total regulatory costs.

Figure 1. Economic Regulations Were More Than 70% of Crain and Crain's Estimate of Total Regulatory Costs



Source: CRS, based on data from Crain and Crain, September 2010.

Note: Due to rounding, the individual segments total 100.1%.

Economic Regulations

According to the Crain and Crain report, "[e]conomic regulations include a wide range of restrictions and incentives that affect the way businesses operate—what products and services they produce, how and when they produce them, and how products and services are priced and marketed to consumers."[11] They said such regulations affect both domestic and international business operations, and include quotas and tariffs on foreign imports that "limit competition from outside the United States, restrict production and employment, raise prices, and generally curtail U.S. economic activities."[12] To develop an estimate of the cost of economic regulations, Crain and Crain used a Worldwide Governance Index (WGI) of "regulatory quality" that was developed by Aart Kraay and Massimo Mastruzzi of the World Bank, and Daniel Kaufmann of

[11] Crain and Crain, p. 17.

[12] Ibid.

the Brookings Institution.[13] According to Crain and Crain, the WGI regulatory quality index "measures perceptions of the ability of governments to formulate and implement sound policies and regulations that permit and promote private sector development."[14] Crain and Crain said the index was calibrated to range between -2.5 and +2.5, and that +2.5 represented "the minimal amount of regulation."[15] In 2008, the WGI regulatory quality index score for the United States was +1.579.

Crain and Crain used regression analysis[16] in an effort to determine the impact of changes in the regulatory quality index on real Gross Domestic Product (GDP) per capita, holding constant four other variables that they said the literature suggests explain differences in economic development across countries and over time: country population, primary education as a share of the eligible population, foreign trade as a share of GDP, and fixed broadband subscribers per 100 people. Using this approach, Crain and Crain concluded that a one-unit change in the WGI regulatory quality index (e.g., a change from +1.5 to +2.5 on the scale) represented a 9.4% change in real GDP per capita. Because the regulatory quality index for the United States in 2008 was +1.579, Crain and Crain said that the 0.921 difference between that value and the +2.5 maximum represented an 8.7% reduction in GDP (0.094 times 0.921) because of economic regulations. Because GDP in the United States was about $14.2 trillion in 2008, Crain and Crain concluded that the types of economic regulations included in the regulatory quality index reduced real GDP per capita in the United States by about $1.236 trillion ($14.2 trillion times 0.087).[17]

Composition of the Regulatory Quality Index

According to Kaufmann, Kraay, and Mastruzzi, the WGI index of regulatory quality for the United States in 2008 was determined by aggregating six expert-based measures and two surveys, each of which was scored on a 0 to 1 scale.[18] The six expert-based measures, their scores, and the particular factors considered in each measure were as follows:

- Economist Intelligence Unit (scored at 0.70), a commercial business information provider headquartered in London, England. The score is based on its experts' judgment of 16 factors, including "protectionism in the country negatively affects the conduct of business," "access to capital markets (foreign and domestic) is easily available," "real corporate taxes are non distortionary," "labor regulations hinder business activities," and "easy to start a business."

[13] In addition to "regulatory quality," the WGI indices include five other governance indicators: "voice and accountability," "political stability and absence of violence," "government effectiveness," "rule of law," and "control of corruption." The WGI methodology is described in Kaufmann, Kraay and Mastruzzi (2010). "The Worldwide Governance Indicators: Methodology and Analytical Issues" World Bank Policy Research Working Paper No. 5430, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1682130.

[14] Crain and Crain, p. 19.

[15] Ibid., p. 24.

[16] Regression analysis is used to understand how the value of a dependent variable (e.g., real GDP per capita) changes when one of the independent variables is varied (e.g., the index of regulatory quality), while the other independent variables (e.g., country population) are held fixed.

[17] Here, and elsewhere in the Crain and Crain report, cost estimates are provided for 2008 in 2009 dollars. It is unclear why Crain and Crain used 2009 dollars to present cost estimates for 2008.

[18] See http://info.worldbank.org/governance/wgi/pdf/rq.pdf. Documentation for each individual source is available at http://info.worldbank.org/governance/wgi/sources.htm.

- Global Insight Business Conditions and Risk Indicators (scored at 0.94). Global Insight is a commercial business information provider headquartered in Boston, Massachusetts. The score is based on its experts' assessment of two factors: (1) "tax effectiveness," defined as "how efficient the country's tax collection system is"; and (2) "legislation," defined as "whether the necessary business laws are in place, and whether there any outstanding gaps."
- Global Insight Global Risk Service (scored at 0.95). Global Risk Service is a commercial business information provider headquartered in Boston, Massachusetts. The score is based on its experts' judgment of five factors: (1) "export regulation," (2) "import regulation," (3) "other business regulation," (4) "nonresident business ownership restrictions," and (5) "nonresident equity ownership restrictions."
- Heritage Foundation Index of Economic Freedom (scored at 0.73). The Heritage Foundation is described by the WGI index as a "nongovernmental research and educational institute headquartered in Washington, United States, advocating conservative public policies." The index score is based on its experts' judgment of two factors: (1) "foreign investment" and "banking/finance."
- Institutional Profiles Database (scored at 0.89), which is provided by the French government's Ministry of the Economy. The score is based on its experts' judgment of four factors: (1) "ease of starting a business," (2) "administered prices and market prices," (3) "competition: productive sector: ease of market entry for new firms," and (4) "competition between businesses: competition regulation arrangements."
- Political Risk Services International Country Risk Guide (scored at 1.00). Political Risk Services is a commercial business information provider headquartered in Syracuse, New York. The score is based on their experts' judgment of one factor entitled "investment profile," summarizing the investment environment.

The two surveys used to develop the regulatory quality index, their values, and the particular factors considered in each survey were as follows:

- Institute for Management and Development World Competitiveness Yearbook (scored at 0.50). The Institute for Management Development is an educational and research organization headquartered in Lausanne, Switzerland. The score is based on a survey of business people working in the United States, who are asked to comment on the same 16 factors used by the Economist Intelligence Unit mentioned above (e.g., "protectionism in the country negatively affects the conduct of business," "access to capital markets (foreign and domestic) is easily available," "real corporate taxes are non distortionary," "labor regulations hinder business activities," and "easy to start a business").
- World Economic Forum Global Competitiveness Report (scored at 0.62). The World Economic Forum is an international organization based in Switzerland. Its survey asked domestic and foreign-owned firms their views regarding seven statements: (1) "administrative regulations are burdensome," (2) "tax system is distortionary," (3) "import barriers/cost of tariffs as obstacle to growth," (4) "competition in local market is limited," (5) "it is easy to start company," (6)

> "anti-monopoly policy is lax and ineffective," and (7) "environmental regulations hurt competitiveness."

Some observers have questioned whether WGI indices, such as the regulatory quality index, "measure what they purport to measure,"[19] and the authors of the WGI have responded to those concerns.[20] Crain and Crain noted in their report that the World Bank Development Research Group published a detailed description of how the WGI indices were developed,[21] and noted that the WGI indices were correlated with an index of economic regulations developed by the Organization for Economic Cooperation and Development (OECD) that Crain had used in his 2005 study of federal regulatory costs.[22] Crain and Crain said they used the WGI regulatory quality index in their 2010 study because it covered more countries for a longer period of time than the OECD index, and because it used a variety of sources and dimensions.

In a "Frequently Asked Questions" page on the World Bank's website, the WGI authors indicated that indices such as the regulatory quality index are "useful as a first tool for broad cross-country comparisons and for evaluating broad trends over time," but cautioned that they are "often too blunt a tool to be useful in formulating specific governance reforms in particular country contexts." They went on to say that such reforms "need to be informed by much more detailed and country-specific diagnostic data that can identify the relevant constraints on governance in particular country circumstances."[23]

Comments Regarding the Estimate of the Cost of Economic Regulations

The validity and accuracy of Crain and Crain's estimate of the cost of economic regulations depends on at least two factors: (1) whether the WGI index of "regulatory quality" can be used as part of a formula to measure the cost of economic regulations, and (2) whether the authors interpreted the regulatory quality index in the way it was intended. Several commenters on the Crain and Crain study have addressed one or both of these issues.

Comments from Aart Kraay of the World Bank

On January 27, 2011, Aart Kraay, a lead economist in the Development and Research Group at the World Bank, and one of the authors of the WGI regulatory quality index, contacted Crain and Crain by e-mail and provided his views on their use of the index in their September 2010 report on regulatory costs.[24] Kraay said that although "in principle an exercise like this could make

[19] See, for example, M.A. Thomas, "What Do the Worldwide Governance Indicators Measure? *European Journal of Development Research*, vol. 22 (2010), pp. 31-54.

[20] Daniel Kauffman, Aart Kraay, and Massimo Mastruzzi, "Response to 'What Do the Worldwide Governance Indicators Measure?'" *European Journal of Development Research*, vol. 22 (2010), pp. 55-58.

[21] Daniel Kaufman, Aart Kraay, and Massimo Mastruzzi, "Governance Matters VIII: Aggregate and Individual Governance Indicators 1996 – 2008," World Bank Development Research Group, Macroeconomics and Growth Team, Policy Research Working Paper 4978, June 2009.

[22] See G. Nicoletti, Scarpetta, and O. Boylaud, "Summary Indicators of Product Market Regulation and Employment Protection Legislation for the Purpose of International Comparisons," OECD Economics Department Working Paper No. 226 (2000).

[23] World Bank, "World Governance Indicators: Frequently Asked Questions," available at http://info.worldbank.org/governance/wgi/faq.htm.

[24] Kraay provided CRS with a copy of his January 27, 2011, e-mail to Crain and Crain on March 4, 2011.

sense," he said that he believed there were two "basic problems with how you use our data." First, he said that although Crain and Crain interpreted higher values of regulatory quality as "less stringent regulations," "[t]his isn't a good characterization of what the [regulatory quality, or RQ] index measures—rather RQ seeks to measure perceptions of the overall quality of the regulatory environment, which is very different from simply measuring whether it is 'stringent' or not." Kraay noted that the United States came in at about the 90th percentile of all countries in the world, and that countries like Finland and Sweden rank ahead of the United States on regulatory quality. "So by this standard," he said, "it is hard to say that the RQ measure 'rewards' deregulation." He also said that he and the other WGI authors had "indicated throughout that the WGI indicators are not literally true and have non-trivial margins of error, indicating that there is of course imprecision in how countries are ranked."[25]

The second major issue that Kraay noted was that Crain and Crain "may be misinterpreting the units of the WGI" by comparing the United States' score of +1.579 to +2.5—what the authors referred to in the report as "the minimal amount of regulation,"[26] and what Nicole V. Crain had referred to in a *Wall Street Journal* article as a "conceptual regulatory environment."[27] In his e-mail to the authors, Kraay said the following:

> You claim that 2.5 is the "best possible" score on the WGI. But this isn't really correct as the WGI are measured in units which don't have a fixed upper or lower boundary (technically the units are those of a standard normal random variable). It would make a lot more sense for you to compare the US score on RQ with that of a country whose regulatory environment you prefer, and then use that difference in score to calibrate the costs of regulations. So for example the highest numbers we see on WGI-RQ in 2009 are around 1.8 for countries like Singapore, followed closely by Denmark (!). The US comes in at around 1.4. So a more relevant comparison would be between the US and Denmark, rather than between the US and 2.5. This of course would mean that your estimated costs of regulation would be a lot smaller, since the distance between the US and Denmark is much smaller than the distance between the US and 2.5.[28]

(Kraay told CRS that the WGI authors periodically make minor revisions to WGI data for previous years, thus explaining the difference between the +1.579 regulatory quality index that Crain and Crain cited, and the "around 1.4" value that he noted in his e-mail to Crain and Crain.)[29] Using the same 2008 data that Crain and Crain used in their study, the nation with the highest regulatory quality index was Ireland, with a value of +1.915.[30] Subtracting the United States' regulatory index value from that of Ireland yields a difference of 0.336 (1.915 minus 1.579). As noted earlier, Crain and Crain used regression analysis to conclude that a one-unit change in the regulatory quality index represented a 9.4% change in real GDP per capita. If this

[25] In his comments to Crain and Crain, Kraay continued by saying that "one should not make a big deal of the fact that Sweden and Finland come in a bit ahead of the US, as the difference is not statistically significant (the margins of error overlap). But this does give you a good indication that WGI-RQ is not just measuring 'less regulation' as you seem to interpret it."

[26] Crain and Crain, p. 24.

[27] Carl Bialik, "The Numbers Guy: Small Business Regulatory 'Burden' Is Tough to Quantify," *Wall Street Journal*, January 29, 2011, p. A2.

[28] E-mail from Aart Kraay to Crain and Crain, January 27, 2011.

[29] E-mail to the author from Aart Kraay, World Bank, March 4, 2011.

[30] To view the data, see http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2009/06/29/000158349_20090629095443/Rendered/PDF/WPS4978.pdf. Two other jurisdictions had higher scores than Ireland in 2008, but they are technically not countries (Hong Kong, at 1.998, and Singapore, at 1.918).

measure is correct, the 0.336 difference between the Ireland and United States regulatory quality indices suggests a 3.16% reduction in GDP (0.094 times 0.336 equals 0.0316) in the United States compared with Ireland, the country with the least "stringent" regulatory climate. Therefore, the monetary "cost" of this GDP reduction would be about $448 billion (0.0316 times $14.2 trillion GDP in 2008), or about $788 billion less than the $1.236 trillion that Crain and Crain calculated. However, all of the above calculations assume that higher values on the regulatory quality index reflect "less stringent regulations," which Kraay indicated it does not.

Kraay also told CRS that he had concerns about the quality of Crain and Crain's regression analysis. He said "The problem is simply that high scores on regulatory quality are correlated with a lot of other good policies and institutions which also matter for GDP per capita. And so it is hard to sort out how much of the correlation between RQ and GDP per capita is due to the regulatory environment per se, and how much is due to other stuff."[31] He also said that "unless one can perfectly control for all these other factors (which is nearly impossible), the econometric estimates [that Crain and Crain] provide will reflect not just the effects of regulation on output, but also of all those other policies that are correlated with regulation."

When contacted by CRS for comment, Crain and Crain said that they understood Kraay's conceptual argument that the regulatory quality index might not reflect changes in the "stringency" of regulation, but they said that "the empirical evidence indicates that it does in practice." They said the index captures the extent of regulation from a variety of stakeholders' perceptions, and noted the nature of the questions used to construct the index (e.g., "How problematic are labor regulations for the growth of your business?" and "How problematic are customs and trade regulations for the growth of your business?"). Crain and Crain also said they did not compare the United States to another country (e.g., Denmark) because to estimate the cost of regulations to small and large businesses (what they contracted with SBA to do), they needed to estimate the total cost of all regulations. They also said they do not believe that they misinterpreted the WGI measure because the documentation provided by the WGI authors indicates that the index values range from about -2.5 to +2.5, and they selected +2.5 as the "best approximation of the regulatory environment that we were trying to capture in our estimate."[32]

Other Commenters

Before publishing the Crain and Crain report, the SBA Office of Advocacy had the study peer reviewed by two economists—Bob Litan of the Kauffman Foundation,[33] and Richard Williams of the Mercatus Center[34] at George Mason University.[35] Litan's complete comments were "I looked it over and it's terrific. Nothing to add." Williams's comments were more extensive. Overall, he said that the study was a "great project," and he hoped his comments would make it stronger. In relation to the estimate of the costs of economic regulations, he said the use of the index of

[31] E-mail to the author from Aart Kraay, World Bank, March 4, 2011.

[32] E-mail to the author from Nicole V. Crain and W. Mark Crain, March 7, 2011.

[33] The Ewing Marion Kauffman Foundation is described on its website as one of the largest foundations devoted to entrepreneurship. See http://www.kauffman.org/.

[34] The Mercatus Center is described on its website as the world's premier university source for market-oriented ideas. See http://mercatus.org/.

[35] According to a March 7, 2011, e-mail to the author from Radwan Saade of SBA's Office of Advocacy, the study was sent to the two peer reviewers "that identified as credible researchers and contributors to the discussion on regulatory costs." He said other researchers were contacted but were unavailable to serve as peer reviewers.

regulatory quality was an "innovative idea," but said he was "concerned that the index may not measure what the authors say it measures, and even if it does, it may overstate the costs of regulation when used in conjunction with the other measures."[36] Among other things, he said that the study "might over-estimate the total costs of regulation because the effect of the Regulatory Quality Index on GDP may also capture some or all of the effects of environmental, workplace, security, and tax regulations." On the other hand, Williams also said that "there are reasons to believe that [the index] may underestimate costs."[37] He said some of the problems "could perhaps be solved simply with a better and more careful explanation of what the Regulatory Quality Index really measures. To guard against over-estimating costs, however, the authors would either need to control for the effects of other types of regulation on GDP, or refrain from adding some or all of the costs that are estimated via other methods."

In February 2011, the Center for Progressive Reform (CPR) issued a report criticizing the Crain and Crain study, and has requested that SBA's Office of Advocacy withdraw its sponsorship of the report.[38] In relation to the estimate of economic regulatory costs, CPR said (among other things) that (1) the WGI authors did not intend the regulatory quality index to be a proxy measure for regulatory burden, or as a tool for critiquing a particular country's regulatory stringency; (2) the lack of a clear definition of "economic regulations" raises the possibility that it includes other types of regulatory costs, which could lead to double counting; (3) the regression analysis used in the report assumes a simplistic relationship between regulatory "stringency" and GDP; and (4) the report gives the false impression that the index of regulatory quality in the United States is low, even though the United States ranked 11th out of more than 200 countries.[39]

CRS Analysis of Crain and Crain's Linear Regression[40]

The Crain and Crain report analyzed data for 25 OECD countries in order to assess the effect of economic regulation on GDP per capita, a common measure of the standard of living.[41]

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[36] Comments of Richard Williams, Mercatus Center, George Mason University, available at http://www.sba.gov/sites/default/files/files/TheImpactofFederalRegulatoryCostsonSmallFirmsPRFY2010.pdf.

[37] Williams said "You can start with the fundamental idea of opportunity costs. Resources that are devoted to complying with regulations are not used to produce GDP that responds to normal market forces (demand). Both activities, complying with regulations and normal market activities add to GDP. What has been estimated here is the difference between the two, GDP with resources that would have been devoted to normal market forces minus GDP with resources devoted to complying with regulation. That difference is, I think, one component of the cost of regulation. However, that may leave, (if I am thinking about this correctly) the cost of complying with regulation that is picked up by GDP. That is, a person can produce 10 widgets that comply with regulation and 15 widgets if employed normally by the market, and this model would estimate the costs of the regulation at 5 widgets (the difference in GDP). But that doesn't count the original 10 widgets of expenditure that adds to GDP and is also a cost and must be weighed against the benefits."

[38] Sidney A. Shapiro, Ruth Ruttenberg, and James Goodwin, "Setting the Record Straight: The Crain and Crain Report on Regulatory Costs," February 2011, available at http://www.progressivereform.org/articles/SBA_Regulatory_Costs_Analysis_1103.pdf. See http://www.progressivereform.org/articles/SBA_Letter_020811.pdf for a copy of the letter requesting that SBA's Office of Advocacy withdraw its sponsorship of the Crain and Crain report. In a March 11, 2011, letter to CPR, the Chief Counsel of SBA's Office of Advocacy said that he disagreed with CPR's assessment, and stood behind the findings of the Crain and Crain report.

[39] Ibid., pp. 4-6.

[40] This section of the report was written by D. Andrew Austin, Analyst in Economic Policy, Congressional Research Service.

[41] The OECD has 34 member states. Chile, Slovenia, and Israel joined in 2010, and Estonia is in the final stages of formal accession. Some historical data for those new entrants is unavailable. See OECD website (http://www.oecd.org) for details.

Economists generally believe that a country's standard of living is affected by a variety of factors, including the availability of (1) land and natural resources, (2) labor and human capital, (3) capital and infrastructure, (4) the level of technology and sophistication of business practices, and (5) opportunities to trade with other countries.[42] Most economists also believe that government interventions in the economy (e.g., through taxes, spending, and regulation) can affect a country's standard of living.[43]

As noted previously in this report, Crain and Crain used linear regression analysis to examine the relationship between GDP per capita and the regulatory quality index, controlling for the effects of four other independent variables: country population; foreign trade as a share of GDP; primary education as a share of the eligible population; and fixed broadband subscribers per 100 people.[44] These four control variables may not capture all of the factors that affect GDP per capita, and other measures of those factors may be more appropriate. For example, "fixed broadband subscribers per 100 people" may or may not capture all aspects of capital investment, and may also partially reflect other factors (e.g., the state of information technology investment, population density, and per capita income levels).[45] The Crain and Crain report did not discuss how the authors selected the control variables used in their analysis.

Crain and Crain also used an estimation strategy that appears non-standard. Like many researchers, Crain and Crain analyze data for several countries over multiple years, known as a cross-country panel data set. Linear regressions on panel data often include country-specific control variables (fixed effects) to take into account national idiosyncrasies that do not vary over time and year-specific control variables to account for shocks that affected all countries in the sample in a given year.[46] Crain and Crain, however, reported that year-specific control variables that were estimated to be statistically insignificant in an unreported first-stage regression were then omitted from the reported second-stage regression results.[47] The statistical properties of this two-stage estimation strategy, which appears to be novel, has apparently not been explored in peer-reviewed journals.

CRS asked Crain and Crain to provide us with a copy of the data that they used in their study, but the authors did not do so. In an effort to assess the sensitivity of their results, CRS ran a linear regression using similar, but somewhat different, data and methods.[48] The results indicated that the regulatory quality index had no discernable independent effect on GDP per capita, suggesting

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[42] Rudiger Dornbusch, Stanley Fischer, and Richard Startz, *Macroeconomics* (10th ed.), (New York: McGraw-Hill, 2008), ch. 1 and 2.

[43] Randall G. Holcombe, *Public Finance*, (Minneapolis: West, 1996).

[44] For details on the linear regression model and its statistical properties, see Peter Kennedy, *A Guide to Econometrics* (4th Edition), (Cambridge, Massachusetts: MIT Press, 1998), ch. 3, "The Classical Linear Regression Model."

[45] In another study, Crain and Crain used a measure of equipment investment in an article that example determinants of GDP per capita for a sample of 99 countries. See Nicole V. Crain and W. Mark Crain, "Terrorized Economies," *Public Choice*, vol. 128, pp.317-349.

[46] Badi Baltagi, *Econometric Analysis of Panel Data* (4th ed.), (New York: Wiley, 2008). If certain technical conditions hold, this approach can generate estimates with desirable statistical properties. See William H. Greene, *Econometric Analysis* (New York: Prentice Hall, 2003), ch. 13, "Models for Panel Data."

[47] See notes to Table 2 in Crain and Crain (2010).

[48] The primary education variable was replaced with two demographic variables: the proportion of the population under age 14, and the proportion of the population over age 65. The data were for 30 OECD countries for the same time period as the Crain and Crain study (2002 – 2008). The analysis used a standard fixed-effects panel estimator with year dummy variables.

that the analysis is highly sensitive to the choice of control variables and measures. **Appendix** of this report discusses this sensitivity analysis and the results in greater detail.

While most economists believe that economic regulation, like other forms of government intervention, can affect a country's standard of living, those effects may be too subtle for a seven-year cross-country panel to pick up. A country's regulatory environment may evolve slowly, and may interact with social and political conditions, other instruments of public policy such as taxation. Understanding the relationship between a measure of regulatory quality and GDP per capita (or other measures of economic well being) may require more focused empirical tools.

Environmental Regulations

Crain and Crain said they developed their cost estimates for environmental regulations by following the same basic approach as used by OMB in its annual reports to Congress. For environmental regulations issued through the first quarter of the year 2000, the authors used OMB's estimate of environmental costs from its 2001 report to Congress[49] (which was drawn in part from a study by Robert W. Hahn and John A. Hird),[50] which the authors converted into 2001 dollars.[51] For environmental regulations issued from April 1999 through September 2001, Crain and Crain used the estimate of the cost of major environmental rules from OMB's 2002 report.[52] For each subsequent fiscal year (October through September), the authors used estimates of the cost of major environmental rules from the subsequent OMB report. By adding together all of these cost estimates and converting the estimates from 2001 dollars to 2009 dollars, the authors concluded that environmental regulations cost between $175 billion and $280 billion in 2009. However, to develop the cumulative cost of all regulations, Crain and Crain used only the $280 billion estimate. The authors said their use of only the upper-end estimate "reflects a judgment that cost estimates are absent for important environmental regulations and that government agencies tend to be conservative in estimating regulatory costs."[53]

The data that Crain and Crain used to estimate the costs of environmental rules represent a mix of academic estimates of the cost of all rules prior to 1988, agency estimates of the costs of all rules issued between 1987 and the first quarter of 2000, and agency estimates of the costs of major rules (e.g., those with a $100 million or more annual impact on the economy) issued from April

[49] See http://www.whitehouse.gov/sites/default/files/omb/assets/omb/inforeg/costbenefitreport.pdf for OMB's 2001 report.

[50] Robert W. Hahn and John A. Hird, "The Costs and Benefits of Regulation: Review and Synthesis," *Yale Journal of Regulation,* vol. 8 (1991), pp. 233-278. Hahn and Hird provided estimates for all rules issued prior to 1988. The estimate for rules issued from 1987 through the first quarter of 2000 were from agencies' estimates of all rules.

[51] In its 2001 report, OMB estimated environmental costs as of the first quarter of 2000 at between $96 billion and $170 billion, in 1996 dollars. In 2001 dollars, Crain and Crain said the costs were between $108.359 billion and $191.887 billion.

[52] See http://www.whitehouse.gov/sites/default/files/omb/assets/omb/inforeg/2002_report_to_congress.pdf for OMB's 2002 report. In this and all subsequent reports, OMB's estimates were in 2001 dollars. As used in this report, the term "major rule" includes all rules meeting the definition in the Congressional Review Act (5 U.S.C. § 804(2) (e.g., an annual effect on the economy of $100 million or more). For a discussion of "major rules," see CRS Report R41651, *REINS Act: Number and Types of "Major Rules" in Recent Years*, by Curtis W. Copeland and Maeve P. Carey.

[53] Crain and Crain, p. 27. In a March 7, 2011, e-mail to the author, Crain and Crain noted that the OMB data do not include regulations whose costs are expected to be below $100 million, or costs that are not monetized. Therefore, they said, using the upper bound is an attempt to correct for this omission in a systemic and reasonable way. They also said that agency cost estimates are unlikely to include costs associated with negotiated enforcement.

1999 through September 2008. Therefore, the unit of analysis is not the same for all of the years (i.e., all rules prior to the year 2000 versus major rules starting in April 1999), and the methodologies differ (i.e., academic studies prior to 1988, and agencies' ex ante estimates of regulatory costs after 1988). In its 2000 report to Congress, OMB said that summarizing the total costs and benefits of regulations by adding together diverse sets of individual studies was an "inherently flawed approach" because the studies vary in quality and methodology, use differing assumptions, and seldom analyze the interaction effects among tens of thousands of regulations.[54]

Also, the time periods covered by the cost estimates that Crain and Crain used overlap in some years, raising the possibility of double counting. For example, both the Hahn and Hird estimate and the agency estimates cover rules that were issued in calendar year 1987. In addition, the baseline estimates of rules issued through the first quarter of 2000 overlap with the estimates for the period April 1, 1999, to September 30, 2001 (i.e., both cover the period April 1, 1999, through March 31, 2000).

In two of the one-year periods covered by the Crain and Crain analysis, the authors appear to have incorrectly recorded the information on environmental regulatory costs from the OMB reports:

- For the period October 2002 through September 2003, the authors said that OMB's estimate was $335 million (in 2001 dollars). Actually, OMB reported those costs as $360 million (in 2001 dollars).[55]
- For the period October 2003 through September 2004, the authors said that OMB's estimate was $3,840 million to $4,073 million (in 2001 dollars). Actually, OMB reported those costs as $3,060 million to $3,211 million (in 2001 dollars).[56]

Also, Crain and Crain did not report any of OMB's estimates of the benefits of environmental regulations. As discussed later in this report, the authors indicated that regulatory benefits were not included because they researched the topic as required by the Office of Advocacy.[57] **Table 1** below shows both the estimated costs and estimated benefits of environmental rules from OMB's reports. Overall and in eight of the nine time periods covered by the table, the average estimated benefits were higher than the average estimated costs. In six of the nine time periods covered by the table, the lowest estimated benefits were higher than the highest estimated costs. The highest estimated benefits were lower than the lowest estimated costs in only one of the time periods (October 1, 2002, to September 30, 2003).

[54] See http://www.whitehouse.gov/sites/default/files/omb/assets/omb/inforeg/2000fedreg-report.pdf, p. 15.

[55] See http://www.whitehouse.gov/sites/default/files/omb/assets/omb/inforeg/2004_cb_final.pdf, p. 7, Table 1.

[56] See http://www.whitehouse.gov/sites/default/files/omb/assets/omb/inforeg/2005_cb/final_2005_cb_report.pdf, Table 1-3. The $3,840 million to $4,073 million cost estimate in this report is for rules issued by the Departments of Health and Human Services and Transportation, and the Environmental Protection Agency.

[57] E-mail to the author from Nicole V. Crain and W. Mark Crain, March 7, 2011.

Table 1. Estimates of Costs and Benefits of Environmental Rules in OMB Reports to Congress

Years Rules Were Issued	Estimated Costs (millions of 2001$)	Estimated Benefits (millions of 2001$)	Source
Through 03/31/2000	$108,359 to $191,887	$109,490 to $1,817,280	OMB, 2001, Table 2
04/01/1999 to 09/30/2001	$11,380 to $12,812	$25,338 to $56,141	OMB, 2002, Table 7
10/01/2001 to 09/30/2002	$192	$1,250 to $4,818	OMB, 2003, Table 1
10/01/2002 to 09/30/2003	$360	$204 to $355	OMB, 2004, Table 1
10/01/2003 to 09/30/2004	$3,060 to $3,211	$10,935 to $100,703	OMB, 2005, Table 1-3
10/01/2004 to 09/30/2005	$2,609 to $3,373	$14,512 to $161,708	OMB, 2006, Table 1-3
10/01/2005 to 09/30/2006	$2,720 to $2,965	$5,113 to $42,109	OMB, 2007, Table 1-3
10/01/2006 to 09/30/2007	$7,475 to $7,584	$21,143 to $170,391	OMB, 2008, Table 1-3
10/01/2007 to 09/30/2008	$7,591 to $8,780	$7,475 to $37,810	OMB, 2008, Table 1-3
Total	$143,746 to $228,274	$195,460 to $2,391,315	OMB, 2001 to 2008

Source: OMB's annual reports on the costs and benefits of regulations, available at http://www.whitehouse.gov/omb/inforeg_regpol_reports_congress/.

Notes: The estimates of rules issued "Through 03/31/2000" includes all rules. All of the other time periods include only major rules.

Comments Regarding the Estimate of the Cost of Environmental Regulations

Crain and Crain said their report "assumes that OMB's coverage of environmental regulations has been relatively complete."[58] Peer reviewer Richard Williams's only comment about the estimate of environmental regulatory cost was that this statement should be noted as an assumption.

As noted earlier, Crain and Crain said they used only OMB's upper estimate of environmental costs because they believed cost estimates were absent for some important environmental regulations, and "government agencies tend to be conservative in estimating regulatory costs."[59] The authors stated in a footnote that several regulatory experts have drawn a similar conclusion about OMB environmental cost estimates, but also noted that "considerable debate continues."[60] Crain and Crain cited studies indicating that government agencies systematically overestimate benefits and underestimate costs, but also cited one study by Winston Harrington and others that reportedly concluded that overestimation of unit costs occurs about as often as underestimation.[61]

[58] Crain and Crain, p. 25.

[59] Crain and Crain, p. 27.

[60] Ibid.

[61] Ibid, footnote 27. Actually, the Harrington study concluded that agencies' estimates of direct costs appeared to be too (continued...)

In its analysis of the Crain and Crain report, the Center for Progressive Reform said that agencies' estimates of environmental costs tend to be too high, reflecting estimates provided to them by industry, whom CPR said have an incentive to overstate costs. CPR also said that industry cost estimates (and therefore the agency estimates) do not take into account technological innovations that reduce the cost of compliance. To support its position on this issue, CPR cited four studies indicating that agencies' initial cost estimates tended to be too high.[62] CPR also questioned Crain and Crain's use of the Hahn and Hird study to estimate the cost of environmental regulations prior to 1988, noting that the study was more than 20 years old, synthesized other estimates developed by a small group of economists, and some of those studies used data that are now more than 30 years old.

In responding to comments on one of its reports to Congress on the costs and benefits of regulations, OMB noted the "theory that agency estimates, upon which many but not all of our estimates are based, systematically understate costs and overstate benefits because agency self-interest lies in regulation." OMB went on to say the following:

> Although this view of agency behavior enjoys widespread support among academics as a theoretical matter, there is little documentation available to support it—perhaps because there are several potentially offsetting factors. For example, much of the data that agencies use to make their estimates of costs comes from the regulated entities who generally have the opposite incentives—namely, they will likely overstate costs to help convince decision makers not to issue the regulation. Also, as noted in our report, competitive firms over time frequently find more cost-effective ways, including new technologies, to comply with regulations than had been envisioned ex ante. Some commenters pointed to a set of case studies that is about to be published to support this contention. On the other hand, there is a large body of literature that shows that agencies tend to overestimate the benefits of their programs because, over time, technological progress—in communications to energy exploration to infectious disease—has reduced the long run expected benefits of earlier regulations.[63]

Tax Compliance

To estimate the costs associated with complying with federal tax paperwork, Crain and Crain said they compiled data from the Internal Revenue Service (IRS), and in some cases the Tax Foundation,[64] on the amount of time required to complete each type of tax form, and the number of filings per form. The authors concluded that businesses, individuals, and nonprofits devoted about 4.3 billion burden hours to completing tax paperwork in 2008 (about 2.28 billion burden hours for business and about 2.02 billion burden hours for individuals and nonprofits). To

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(...continued)

high in 12 rules, and too low in 6 rules. The authors' conclusions regarding per-unit abatement costs only applied to EPA and OSHA regulations. See Winston Harrington, et al., "On the Accuracy of Regulatory Cost Estimates," available at http://www.rff.org/documents/RFF-DP-99-18.pdf.

[62] Sidney A. Shapiro, Ruth Ruttenberg, and James Goodwin, "Setting the Record Straight: The Crain and Crain Report on Regulatory Costs," p. 7.

[63] Office of Management and Budget, "Appendix: Summary of Public Comments," available at http://www.whitehouse.gov/omb/inforeg_appendix.

[64] The Tax Foundation is a nonpartisan tax research group based in Washington, D.C. For more information, see http://www.taxfoundation.org/about/. Crain and Crain said they used information from the Tax Foundation's 2005 report, but did not provide a citation for that report.

monetize that burden, Crain and Crain estimated the cost of completing business paperwork at $49.77 per hour for businesses (which they said was the average hourly rate for "human resources professionals" in 2009 from the Bureau of Labor Statistics website) and $31.53 per hour for individuals and nonprofits (which they said was the average hourly rate for "accountants and auditors" in 2009), for a total cost of about $159.6 billion.

Crain and Crain did not indicate in their report how they "compiled" data from the IRS website and the Tax Foundation to arrive at the estimated 4.3 billion hours of tax paperwork in 2008. According to the Information Collection Budget that OMB develops annually, the government-wide paperwork burden in FY2008 was about 9.71 billion burden hours, of which the Department of the Treasury accounted for about 7.78 billion burden hours.[65] Although the Information Collection Budget did not separately identify the number of burden hours for the IRS, in May 2009, the IRS represented about 77.8% of the government-wide estimate, and about 99.5% of the Treasury estimate.[66] If those same ratios applied in 2008, IRS paperwork would have been about 7.5 billion burden hours—about 3.2 billion hours higher than in the Crain and Crain report.

Certain aspects of how Crain and Crain monetized IRS burden hours are also unclear. For example, it is unclear why the authors assumed that "human resources professionals" would be completing all business tax paperwork, that all individuals and nonprofits would have their returns prepared by "accountants and auditors," or where on the "Bureau of Labor Statistics website" the hourly rates for human resources professionals ($49.77 per hour) and accountants and auditors ($31.53) were derived. According to the Bureau of Labor Statistics' Occupational Employment Statistics, in May 2009, tax preparers received an average salary of $17.34 per hour (median salary was $14.45 per hour).[67] Even if one assumed that total compensation (including benefits and overhead) was one-third higher, the average compensation for tax preparers would still be just over $23 per hour ($17.34 times 1.33). Using this figure for all tax compliance may balance out those businesses and individuals who prepare their returns themselves and those who use more expensive preparers.[68] Therefore, multiplying 7.5 billion burden hours times $23 per hour yields a total cost of about $172.5 billion—about $12.9 billion higher than the Crain and Crain estimate.

A threshold issue, however, is whether tax paperwork should be included in estimates of regulatory costs at all. OMB does not include tax paperwork in its annual reports to Congress on the costs and benefits of federal regulations. In one of the first of those reports, OMB said that "filling out tax forms is not the result of 'regulations' but rather of the tax code itself, with most regulations merely providing interpretations and clarifications of tax law."[69] Also, in testimony before the House Committee on Government Reform in July 2003, John D. Graham, administrator of the Office of Information and Regulatory Affairs (OIRA) within OMB, said the following:

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[65] Office of Management and Budget, *Information Collection Budget: 2009* (reporting on FY2008), available at http://www.whitehouse.gov/sites/default/files/omb/assets/inforeg/icb_2009.pdf.

[66] See CRS Report R40636, *Paperwork Reduction Act (PRA): OMB and Agency Responsibilities and Burden Estimates*, by Curtis W. Copeland and Vanessa K. Burrows.

[67] See http://www.bls.gov/oes/current/oes132082.htm for these data.

[68] For example, BLS data indicated that accountants and auditors were paid an average of $32.42 per hour in May 2009. See http://www.bls.gov/oes/current/oes132011.htm.

[69] Office of Management and Budget, *Report to Congress on the Costs and Benefits of Federal Regulations*, September 30, 1997, available at http://www.whitehouse.gov/omb/inforeg_rcongress/.

> To a greater extent than for other agencies and programs, IRS paperwork burden is driven by a statute (the Tax Code), and in particular the complexities of the Code. To ensure taxpayer compliance with our tax laws, IRS must collect a tremendous amount of information. This task is complicated by a massive, complex Tax Code that is subject to continuous revision. In the 15 years following the 1986 overhaul of the Code, Congress passed 84 tax laws. These laws required IRS to create and/or revise reporting and recordkeeping requirements, which in turn increased taxpayer burden. The Internal Revenue Service also had to make several changes to the 1040 schedules to implement the Economic Growth and Tax Relief Reconciliation Act of 2001. These statutorily driven revisions increased the burden on taxpayers by 47 million hours. Moreover, there are other factors totally outside the control of IRS—most notably increases in the number of tax filings due to economic and population growth over the years—that increase the aggregate IRS burden hours but not—and this is important—the average burden on individual taxpayers.[70]

Occupational Safety and Health and Homeland Security Regulations

Because the "economic regulations" category included many types of workplace regulations, Crain and Crain said that their final category of regulatory costs included only workplace regulations that deal with safety and health, primarily those issued by the Occupational Safety and Health Administration (OSHA) within the Department of Labor, as well as regulations related to homeland security. To estimate the cost of occupational safety and health regulations prior to 2001 (estimated at more than $64.3 billion in 2009 dollars), the authors used information from a 2005 study by Joseph M. Johnson that reportedly synthesized and evaluated other studies of workplace regulations.[71] Crain and Crain said they then added data from OMB's 2009 report to Congress on regulatory costs and benefits on (1) 2001 to 2008 occupational safety and health regulatory costs (estimated at $471 million in 2009 dollars), and (2) all homeland security costs through 2008 (estimated at about $10.4 billion in 2009 dollars). Adding these elements together, the authors concluded that the total cost for occupational safety and health and homeland security regulations in 2008 was about $75.2 billion.

Crain and Crain said they obtained the estimate for occupational safety and health regulatory costs between 2001 and 2008 from Table 1-2 in OMB's 2009 report to Congress. That table reports the estimated costs and benefits of major federal rules within selected programs from October 1, 1998, through September 30, 2008. One of the programs was labeled "Occupational Safety and Health Administration," with the costs associated with four rules estimated at between $362 million and $389 million (in 2001 dollars). Several of those years (October 1998 through December 2000) appear to overlap with estimates provided in Johnson's study of costs prior to 2001, raising the issue of possible double counting.[72] Also, converting the OMB estimate to 2009 dollars yields a range of $440 million to $471 million. Therefore, although the authors did not explicitly say so, it appears that Crain and Crain only used the upper-end of OMB's estimated cost range for these regulations (as they did for environmental regulations).

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[70] See http://www.whitehouse.gov/omb/legislative_testimony_graham_030722_graham/ for a copy of this testimony.

[71] Cited by Crain and Crain as Joseph M. Johnson, "A Review and Synthesis of the Cost of Workplace Regulations, in *Cross-Border Human Resources*, Labor International: Netherlands, 2005, pp. 433-467.

[72] Although Crain and Crain said (in Table 5 on p. 30 of their report) that they only used rules issued between 2001 and 2008, the 2009 OMB report does not identify when the four Occupational Safety and Health Administration rules were issued. Also, conversion of OMB's upper-end estimate for all four rules ($389 million in 2001 dollars) into 2009 dollars yields an estimate of $471 million—the same figure used in Crain and Crain's report.

Crain and Crain said they obtained their estimate for homeland security costs from page 18 of OMB's 2009 report. There, OMB reported that since the Department of Homeland Security was created, "agencies have finalized 17 major homeland security regulations that impose a total annual cost on the economy of between $4.2 billion to $8.6 billion. Converting these estimated costs in 2001 dollars to 2009 dollars yields a range of $5.1 billion to $10.4 billion. Therefore, although they did not say so in their report, it appears that Crain and Crain again only used OMB's upper-end of the estimated cost range. As noted earlier in this report, the authors said that their use of the upper-end of OMB's estimates for environmental rules reflected a judgment that cost estimates were absent for important regulations and that government agencies tend to be conservative in estimating regulatory costs.[73] On the other hand, OMB has said that there is little evidence that agencies' cost estimates are too conservative.[74]

The Center for Progressive Reform's analysis of the Crain and Crain report stated that the cost estimates that the authors used for occupational safety and health costs (both the Joseph M. Johnson study and the agency estimates of costs before the rules are published) likely overstate true compliance costs because they are based on information provided by regulated industries. CPR also said that the Johnson study inflates OSHA's original cost estimates by multiplying them by 5.5, which was reportedly done to take into account non-major rules for which costs were not estimated, and for fines imposed for violations of OSHA standards. CPR said it saw no justification for counting such fines as "regulatory costs." "Under this logic," CPR said, "mass lawbreaking raises regulatory costs, enabling regulatory opponents to argue that we need to reduce regulations because of these regulatory costs."[75]

Comparison of Crain and Crain's 2008 Estimate to Crain's 2004 Estimate

As noted previously and as shown below in **Table 2**, in 2005, W. Mark Crain estimated total federal regulatory costs in 2004 at about $1.11 trillion. In 2010, Crain and Crain estimated those costs in 2008 at about $1.75 trillion—an increase of about $639 billion (57.4%) in four years. Some of this increase is due to inflation,[76] but the authors said that the main reason for the increase was a change in the methodology used in developing their estimate of the cost of economic regulations.[77] As **Table 2** below indicates, were it not for the increase in the cost

[73] Crain and Crain, p. 27. In a March 7, 2011, e-mail to the author, Crain and Crain noted that the OMB data do not include regulations whose costs are expected to be below $100 million, or costs that are not monetized. Therefore, they said, using the upper bound is an attempt to correct for this omission in a systemic and reasonable way. They also said that agency cost estimates are unlikely to include costs associated with negotiated enforcement.

[74] Office of Management and Budget, "Appendix: Summary of Public Comments," available at http://www.whitehouse.gov/omb/inforeg_appendix.

[75] CPR, p. 9.

[76] Crain and Crain said that the $1.1 trillion estimate of regulatory costs in 2004 would be $1.26 trillion in 2009 dollars.

[77] Crain and Crain, p. 20. The authors said that the 2005 study used an index of economic regulations developed by the Organization for Economic Cooperation and Development (OECD), supplemented by information from the International Trade Commission and other sources. Crain and Crain said they used the World Bank index of regulatory quality because it was a more comprehensive index of economic regulations. Had the 2005 study used the methodology used in the 2010 study, the authors said that the total cost would have been $1.7 trillion, an increase of $43 billion between 2004 and 2008 after adjusting for inflation.

estimate for economic regulations, the total estimated cost of the three other types of regulations would have decreased by about $6 billion between 2004 and 2008.

Table 2. Changes in Estimates of the Costs of Federal Regulations: 2004 to 2008

Type of Regulation	2004	2008	Increase/Decrease (%)
Economic	$591 billion	$1,236 billion	$645 billion increase (+109.1%)
Environmental	$221 billion	$281 billion	$60 billion increase (+27.1%)
Workplace	$106 billion	$75 billion	$31 billion decrease (-29.2%)
Tax Compliance	$195 billion	$160 billion	$35 billion decrease (-17.9%)
Total	$1,113 billion	$1,752 billion	$639 billion increase (+57.4%)

Source: The 2004 data are from Crain (2005), and the 2008 data are from Crain and Crain (2010).

Notes: In Crain and Crain's 2010 report, "workplace" regulations were termed "occupational safety and health, and homeland security" regulations.

Comparison of Crain and Crain's 2008 Estimate to OMB's Estimates

For nearly 15 years, Congress has required OMB to submit annual reports on the costs and benefits of federal regulations. The first such requirement was in Section 645 of the Treasury, Postal Service and General Government Appropriations Act, 1997 (P.L. 104-208), which required the director of OMB to submit a report by September 30, 1997, that provided (among other things) "estimates of the total annual costs and benefits of federal regulatory programs, including quantitative and nonquantitative measures of regulatory costs and benefits." Similar requirements were contained in other appropriations bills in subsequent years.

In 2001, Section 624 of the Treasury and General Government Appropriations Act, 2001, (31 U.S.C. § 1105 note), sometimes known as the "Regulatory Right-to-Know Act," put in place a permanent requirement for an OMB report on regulatory costs and benefits. Specifically, it requires OMB to prepare and submit with the President's budget an "accounting statement and associated report" containing an estimate of the total costs and benefits (including quantifiable and nonquantifiable effects) of federal rules and paperwork, to the extent feasible, (1) in the aggregate, (2) by agency and agency program, and (3) by major rule. The accounting statement is also required to contain an analysis of the impacts of federal regulation on state, local, and tribal governments, small businesses, wages, and economic growth.

OMB's Early Estimates of Total Regulatory Costs and Benefits

For the first several years, OMB provided estimates of total regulatory costs and benefits, and those estimates (particularly the benefits estimates) varied substantially from year to year.

- In its 1997 report, OMB estimated total federal regulatory costs in 1997 at $279 billion, and estimated the benefits of federal regulations at $298 billion.[78]
- In its 1998 report, OMB estimated federal regulatory costs at between $170 billion and $230 billion (in 1996 dollars as of 1998), and estimated regulatory benefits at between $260 billion and $3.5 trillion.[79] The dramatic increase in the benefits estimate (by a factor of 12) was almost entirely due to the inclusion of an Environmental Protection Agency (EPA) estimate of the benefits associated with the Clean Air Act. Many observers had serious questions regarding the use of this EPA estimate, and EPA itself said it had only a small probability of being correct.
- In its 2000 and 2001 reports, OMB estimated the cost of all social regulations at between $146 billion and $229 billion (in 1996 dollars as of 1999), and estimated benefits at between $254 billion and nearly $1.8 trillion.[80] The nearly 50% drop in the upper-bound benefits estimate (from $3.5 trillion to $1.8 trillion) was primarily caused by a significant drop in the previously mentioned EPA estimate of the benefits of the Clean Air Act (from $3.2 trillion to $1.45 trillion).

Each year, OMB presented its aggregate cost and benefit estimates with strong caveats. For example, in its first report in 1997, OMB said "it is extremely difficult, if not impossible, to estimate the actual total costs and benefits of all existing Federal regulations with any degree of precision."[81] The next year OMB said "there is not yet a professional consensus on methods that would permit a complete, consistent accounting of total costs and benefits of Federal regulation."[82] Some of the methodological problems that OMB pointed out in these and other reports included the following:

- The baseline for measurement is often not clear (i.e., what costs and benefits would have occurred in the absence of the regulation). Regulatory requirements sometimes become standard business practice (e.g., requirements to remove lead from gasoline or to put air bags in automobiles), so cost or benefit reductions would be unlikely to occur if the rules were eliminated entirely.
- It is difficult to attribute costs or benefits to federal regulations as opposed to state or local rules, voluntary standards organizations, insurance requirements, or the tort system.
- Technological change can make previous estimates of benefits and costs extremely inaccurate.
- Aggregating the results of different studies is highly problematic, as the studies vary in the quality, methodology, and types of regulatory impacts they include.[83]

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[78] See http://www.whitehouse.gov/omb/inforeg_rcongress/ for a copy of this report.

[79] See http://www.whitehouse.gov/sites/default/files/omb/assets/omb/inforeg/costbenefitreport1998.pdf, Table 3.

[80] See http://www.whitehouse.gov/sites/default/files/omb/assets/omb/inforeg/costbenefitreport.pdf, Table 2.

[81] See http://www.whitehouse.gov/omb/inforeg_chap2.

[82] See http://www.whitehouse.gov/sites/default/files/omb/assets/omb/inforeg/costbenefitreport1998.pdf, p. 1.

[83] Specifically, in its 1997 report, OMB said "studies that have attempted to tote up the total costs and benefits of Federal regulations have basically added together a diverse set of individual studies. Unfortunately, these individual studies vary in quality, methodology, and type of regulatory costs included. Thus we have an apples and oranges problem, or, more aptly, an apples, oranges, kiwis, grapefruit, etc., problem." See http://www.whitehouse.gov/omb/ (continued...)

- It is unclear which rules should be included in any tabulation of regulatory costs and benefits (e.g., "transfer" regulations such as crop subsidy payments).

In developing its estimates of total regulatory costs, OMB did not include "transfer" rules (which OMB said were about $140 billion in costs and benefits in 1997) because it considered them to be payments that reflect a redistribution of wealth rather than social costs to society as a whole. OMB also excluded the costs associated with filling out tax paperwork (which OMB estimated were about $140 billion in 1997) because it did not consider filling out income tax forms "regulations" in the traditional sense. Neither did it include estimates for rules published after 1987 for which agencies did not conduct cost-benefit analyses (e.g., rules with less than a $100 million impact on the economy).

OMB's Reports Since 2001

OMB's "Regulatory Right-to-Know Act" reports since 2001 have differed from the office's previous reports in that they have not presented cost or benefit estimates for all rules in existence. Instead, OMB has presented information for all regulations that it reviewed within a particular time-frame that (1) had costs or benefits of at least $100 million annually and (2) the costs and benefits had been monetized by either the rulemaking agency or OMB. Specifically:

- OMB's report for 2002 presented information on the costs and benefits of all regulations meeting those criteria that it reviewed for a six-and-one-half year period from April 1, 1995, to September 30, 2001. OMB said the total cost of those rules was about $50 billion to $53 billion (in 2001 dollars), and the benefits ranged from $48 billion to $101 billion.[84]
- In its 2003 report, OMB provided estimates of the costs and benefits of 107 regulations meeting the above criteria that it reviewed during the 10-year period from October 1992 through September 2002. OMB estimated that the total costs of these rules ranged from nearly $37 billion to nearly $43 billion (in 2001 dollars), with benefits ranging from $146 billion to $230 billion. OMB noted that four rules issued by EPA accounted for a substantial fraction of the aggregate benefits for all 107 rules.[85]

Each report since 2003 has provided information for rules meeting the above criteria during the previous 10 years. In its 2002 report, OMB said its decision to present data for only certain rules during a limited time-frame was driven by the inconsistent and increasingly aged nature of many of the studies used to develop aggregate estimates. OMB went on to say that "we do not believe that the estimates of the costs and benefits of regulations issued over ten years ago are reliable or

(...continued)

inforeg_chap2.

[84] Office of Management and Budget, Office of Information and Regulatory Affairs, Stimulating Smarter Regulation: 2002 Report to Congress on the Costs and Benefits of Regulations and Unfunded Mandates on State, Local, and Tribal Entities, 2002, available at http://www.whitehouse.gov/sites/default/files/omb/assets/omb/inforeg/2002_report_to_congress.pdf.

[85] Office of Management and Budget, Office of Information and Regulatory Affairs, Informing Regulatory Decisions: 2003 Report to Congress on the Costs and Benefits of Federal Regulations and Unfunded Mandates on State, Local, and Tribal Entities, 2003, available at http://www.whitehouse.gov/sites/default/files/omb/assets/omb/inforeg/2003_cost-ben_final_rpt.pdf.

very useful for informing current policy decisions."[86] Therefore, OMB said that "in keeping with the spirit of OMB's new information-quality guidelines, we have decided not to reproduce the aggregate estimates that were contained in Appendix C of the draft report."[87] The report went on to say that the total costs and benefits of all federal rules then in effect "could easily be a factor of ten or more larger." In its 2003 report, OMB said that estimates prepared for rules adopted prior to the 10-year period "are of questionable relevance now."[88]

This point was elaborated by John D. Graham, former administrator of OIRA, in testimony before the House Committee on Government Reform in July 2003:

> The fact that attempts to estimate the aggregate costs of regulations have been made in the past, such as the Crain and Hopkins estimate of $843 billion…, is not an indication that such estimates are appropriate or accurate enough for regulatory accounting. Although the Crain and Hopkins estimate is the best available for its purpose, it is a rough indicator of regulatory activity, best viewed as an overall measure of the magnitude of the overall impact of regulatory activity on the macro economy. The estimate, which was produced in 2001 under contract for the Office of Advocacy of the Small Business Administration, is based on a previous estimate by Hopkins done in 1995, which itself was based on summary estimates done in 1991 and earlier, as far back as the 1970s. The underlying studies were mainly done by academics using a variety of techniques, some peer reviewed and some not. Most importantly, they were based on data collected ten, twenty, and even thirty years ago. Much has changed in those years and those estimates may no longer be sufficiently accurate or appropriate for an official accounting statement. Moreover, the cost estimates used in these aggregate estimates combine diverse types of regulations, including financial, communications, and environmental, some of which impose real costs and others that cause mainly transfers of income from one group to another. Information by agency and by program is spotty and benefit information is nonexistent. These estimates might not pass OMB's information quality guidelines. In particular, many of the studies they relied upon for these aggregate estimates are not sufficiently transparent about the data and methods to facilitate the reproducibility of the information by qualified third parties. That is why we have opted in the most recent Reports to Congress to report just the costs and benefits of major regulations prepared by agencies and reviewed by OMB over the last ten years.[89]

Later that year, testifying on the Paperwork and Regulatory Improvements Act of 2004 (H.R. 2432, 108th Congress), Graham said that requiring agencies to submit annual estimates of the cost and benefits of all their rules, and mandating preparation of a complete inventory of the costs and benefits of all federal rules and paperwork requirements, was "not workable."[90]

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[86] See http://www.whitehouse.gov/sites/default/files/omb/assets/omb/inforeg/2002_report_to_congress.pdf, p. 40.

[87] Ibid., p. 41. Section 515 of the Treasury and General Government Appropriations Act for Fiscal Year 2001, generally known as the "Data Quality Act" or the "Information Quality Act," amended the Paperwork Reduction Act and directed OMB to issue government-wide guidelines that "provide policy and procedural guidance to Federal agencies for ensuring and maximizing the quality, objectivity, utility, and integrity of information (including statistical information) disseminated by Federal agencies."

[88] See http://www.whitehouse.gov/sites/default/files/omb/assets/omb/inforeg/2003_cost-ben_final_rpt.pdf, p. 7. In its 2010 report to Congress, OMB continues to say that estimates that are more than 10 years old are of "questionable relevance." See http://www.whitehouse.gov/sites/default/files/omb/legislative/reports/2010_Benefit_Cost_Report.pdf, p. 11.

[89] Testimony of John D. Graham before the House Committee on Government Reform, July 22, 2003, available at http://www.whitehouse.gov/omb/legislative_testimony_graham_030722_graham.

[90] "Chief of OMB Regulatory Review Opposes Ose Bill on Regulatory Accounting, Budgeting," *BNA Daily Report for Executives*, July 23, 2003, p. A-43.

OMB's 2009 Report to Congress

OMB's 2009 report to Congress provided estimates of the total annual benefits and costs of 98 regulations reviewed by OMB during the 10-year period from October 1, 1998, to September 30, 2008. The 98 rules were those that (1) were estimated to generate benefits or costs of approximately $100 million in any one year; and (2) a substantial portion of the benefits and costs were quantified and monetized by the agency or, in some cases, monetized by OMB. As **Table 3** below shows, OMB said that the estimated costs of these rules ranged from nearly $51 billion to nearly $60 billion, and the benefits were estimated to be between about $126 billion and about $663 billion (in 2001 dollars). Because the estimates were provided for only 98 rules meeting the above criteria, and because not all benefits and costs for even those rules could be assessed, OMB noted that the estimates were "not a complete accounting of all of the benefits and costs of all regulations issued during this period."[91]

Table 3. Estimates of the Total Benefits and Costs of Major Rules by Agency: October 1, 1998 – September 30, 2008

(in millions of 2001 dollars)

Agency	Number of Rules	Benefits	Costs
Department of Agriculture	6	$906 – $1,315	$1,014 – $1,353
Department of Education	1	633 – 786	349 - 589
Department of Energy	6	4,954 – 5,391	3,067 – 3,118
Department of Health and Human Services	18	20,522 – 32,426	3,879 – 4,387
Department of Homeland Security	1	20 – 29	13 – 99
Department of Housing and Urban Development	1	190	150
Department of Justice	1	275	108 – 118
Department of Labor	6	481 – 1605	320 347
Department of Transportation	18	11,256 – 19,098	5,218 – 8,968
Environmental Protection Agency	40	87,042 – 601,469	36,853 – 40,851
Total	98	126,277 – 662,584	50,973 – 59,978

Source: OMB's 2009 Report to Congress, Table 1-1.

As in its previous reports, OMB said it presented information only for a 10-year period because "pre-regulation estimates prepared for rules adopted more than ten years ago are of questionable relevance today."[92] OMB also said the following:

[91] OMB's 2009 report to Congress, p. 9.

[92] Ibid.

> Aggregating benefit and cost estimates of individual regulations—to the extent they can be combined—provides significant insight about the effects of regulations. But the resulting estimates are neither precise nor complete. Individual regulatory impact analyses vary in rigor and rely on different assumptions, including baseline scenarios, methods, and data. Summing across estimates involves the aggregation of analytical results that are not strictly comparable. [93]

How OMB's and Crain and Crain's Estimates Differ

It is difficult to compare OMB's estimates of regulatory costs and Crain and Crain's estimates because they were constructed in very different ways, and because the presentation categories were different (e.g., by agency in OMB's study, and by type of regulation in the Crain and Crain study). For several reasons, Crain and Crain's estimates of annual regulatory costs in 2008 were much larger than the estimates provided by OMB.

- Crain and Crain included estimates of costs associated with all rules for certain periods, and major rules for other periods. Their estimates attempt to measure the cumulative costs of all rules. OMB's estimates included only major rules that met certain criteria that had been issued during a 10-year period.
- Crain and Crain included estimates of the cost of "economic regulations," whereas OMB's estimate did not include economic regulations.[94]
- Crain and Crain included costs associated with tax paperwork, whereas OMB's estimate did not include tax paperwork.

Concluding Observations

Although accurate measures of the costs and benefits of all federal rules would be useful, decision makers using studies of aggregate regulatory costs and benefits to guide public policy need to be aware of those studies' conceptual and methodological underpinnings. The validity and reliability of Crain and Crain's $1.75 trillion estimate of total federal regulatory costs in 2008 depends on the validity and reliability of its individual elements. More than 70% of the overall estimate ($1.236 trillion) is based on the WGI index of regulatory quality for the United States, with the authors determining the extent to which economic regulations reflected in that index reduces per capita real GDP in the United States. However, one of the authors of the regulatory quality index has said that Crain and Crain misinterpreted the index, and that higher values on the index cannot be interpreted as "less stringent regulations." Even if it could, he said that the index for the United States should be compared to a country with a preferable index, not to an idealized "best possible" score on the index. Comparing the United States' regulatory quality index in 2008 to the country with the highest index that year (Ireland) would have reduced Crain and Crain's estimate of the cost of economic regulations by nearly two-thirds. Other commenters (including one of the peer reviewers of the Crain and Crain study) raised similar concerns about whether the

[93] Ibid., p. 8.

[94] OMB's report did, however, provide some information on rules issued by certain independent regulatory agencies (e.g., the Board of Governors of the Federal Reserve System and the Securities and Exchange Commission) as provided to OMB by the Government Accountability Office. The agencies typically did not provide information on costs and benefits.

regulatory quality index could be used to measure the cost of economic regulations, and about the regression analysis used to produce the cost estimate. Responding to these criticisms, Crain and Crain said that they continue to believe that the regulatory quality index indicates the stringency of a country's economic regulations, and believe that it was appropriate for them to compare the index for the United States to a "conceptual regulatory environment" represented by a 2.5 score rather than to another country with a somewhat higher index score. The World Bank indicates on its website that measures like the regulatory quality index are "often too blunt a tool to be useful in formulating specific governance reforms in particular country contexts."

Crain and Crain's estimates for environmental, occupational safety and health, and homeland security regulations were developed by mixing together academic studies (some of which were more than 30 years old) with agencies' estimates of regulatory costs that were developed before the rules were issued (some of which are now 20 years old). OMB has said that adding together diverse sets of individual studies to develop a summary measure of regulatory costs is an "inherently flawed" approach. The agency estimates that Crain and Crain used were drawn from OMB reports to Congress on the estimated costs and benefits of regulations, which were typically presented as low-to-high ranges. However, Crain and Crain used only the highest cost estimates from these reports, stating that they did so because the OMB estimates did not cover all regulations, and because they believe "government agencies tend to be conservative in estimating regulatory costs." OMB has said that there is little documentation to support this view, and empirical studies of agencies' regulatory cost estimates have not resolved the issue. Also, OMB has concluded that estimates of the costs and benefits of regulations issued more than 10 years earlier are of "questionable relevance." Since 2003, OMB's annual "Regulatory Right-to-Know Act" reports to Congress have only included information on the costs and benefits of major rules issued during the previous 10 years. Although OMB has recognized that this approach understates total regulatory costs and benefits, OMB has said it does not believe older estimates are reliable or useful in informing policy decisions.

In one of its first reports to Congress on this issue, OMB also said that the incremental costs of regulations (i.e., over and above what businesses and individuals would have done in the absence of regulations) tend to decrease over time, as companies' business practices and consumers' expectations change.

> Thus, although the National Highway Traffic Safety Administration has significantly increased the safety of automobiles, it is not likely that if the agency's regulations were eliminated the automobile companies would discontinue the safety features that had been mandated. Consumers demand safer cars than they used to and automobile companies are concerned about product liability. This same phenomenon exists with the environment, although probably to a lesser extent. Environmentally responsible behavior has become good for the bottom line.... Over time, this "rising baseline" phenomenon reduces the true costs and benefits of health, safety, and environmental regulations. Estimates of the aggregate costs and benefits of regulation that include unadjusted estimates from aging studies are thus likely to be over estimates of the current costs and benefits of those regulations.[95]

[95] Office of Management and Budget, *Report to Congress on the Costs and Benefits of Federal Regulations*, September 30, 1997, available at http://www.whitehouse.gov/omb/inforeg_rcongress/.

OMB went on to say that "it does not seem implausible that, for environmental and other social regulations over ten years old, no more than half of compliance costs would likely be saved if these Federal regulations magically disappeared over night."[96]

Crain and Crain's estimate for the cost of tax paperwork was reportedly based on data from the IRS and the Tax Foundation, but data in OMB's annual Information Collection Budget suggests that the number of hours of tax paperwork may be much higher than the authors used in their report. On the other hand, Crain and Crain's assumptions regarding the per hour cost of completing the paperwork may be too high (e.g., the assumption that "human resources professionals" paid at nearly $50 per hour would be completing all business paperwork). However, a threshold question is whether tax paperwork should be considered in the same category as regulatory costs. OMB does not include tax paperwork in its annual reports to Congress on regulatory costs and benefits.

Regulatory Benefits

Although Crain and Crain attempted to determine all of the costs associated with federal regulations, their report did not discuss the benefits of those regulations—even when information on regulatory benefits was readily available in the OMB reports that they used to determine regulatory costs. In their report, the authors said that it "does not address the benefits of regulation, an important challenge that would be a logical next step toward achieving a rational regulatory system."[97] Crain and Crain told CRS that they did not include regulatory benefits in their study "because we researched the topic as required by the Office of Advocacy."[98] The SBA Office of Advocacy confirmed that Crain and Crain "were not asked to look at benefits, as the task for this last iteration was to update the previous study, which also looked at costs and the disproportionality between small and large businesses."[99]

Executive Order 12866 requires covered agencies to "assess both the costs and the benefits of the intended regulation and, recognizing that some costs and benefits are difficult to quantify, propose or adopt a regulation only upon a reasoned determination that the benefits of the intended regulation justify its costs."[100] It also says that agencies should generally select regulatory approaches that "maximize net benefits." OMB's reports to Congress on the aggregate costs and benefits of federal regulations have generally indicated that the estimated benefits exceed the estimated costs. For example, see the following:

- In the report for 2010 covering major rules reviewed by OMB from October 1999 through September 2009 for which benefits and costs were monetized, the aggregate costs were estimated to be between $43 billion and $55 billion, and the aggregate benefits were estimated to be between $128 billion and $616 billion. Of the 16 major rules issued during FY2009 for which benefits and costs were

[96] Ibid.

[97] Crain and Crain, p. 10.

[98] E-mail to the author from Nicole V. Crain and W. Mark Crain, March 7, 2011.

[99] E-mail to the author from Radwan Saade, SBA Office of Advocacy, March 7, 2011. See https://www.fbo.gov/?s=opportunity&mode=form&tab=core&id=8ffd890376c03038eb0e7f3fa657f7c1&_cview=1 to view the solicitation for this study.

[100] Executive Order 12866, "Regulatory Planning and Review," 58 *Federal Register* 51735, Oct. 4, 1993.

monetized, the costs were estimated at between $3.7 billion and $9.5 billion, and the benefits were estimated at between $8.6 billion and $28.9 billion.[101]

- In the draft report for 2011 covering major rules reviewed by OMB from October 2000 through September 2010 for which benefits and costs were monetized, the aggregate costs were estimated to be between $44 billion and $62 billion, and the aggregate benefits were estimated to be between $136 billion and $651 billion. Of the 18 major rules issued during FY2010 for which benefits and costs were monetized, the costs were estimated at between $6.5 billion and $12.5 billion, and the benefits were estimated at between $23.3 billion and $82.3 billion.[102]

Each year, however, there were a number of rules in which the agencies only quantified or monetized benefits or costs, but not both. Most commonly, the agencies quantified or monetized only costs.

Policymaking and the Crain and Crain Estimate

As noted at the beginning of this report, Crain and Crain's estimate that federal regulations cost $1.75 trillion in 2008 has been cited as evidence of the need for regulatory reform legislation. However, Crain and Crain told CRS that their report was "not meant to be a decision-making tool for lawmakers or federal regulatory agencies to use in choosing the 'right' level of regulation. In no place in any of the reports do we imply that our reports should be used for this purpose. (How could we recommend this use when we make no attempt to estimate the benefits?)"[103]

As Crain and Crain suggest, information on regulatory costs alone, whether for individual rules or for all rules in the aggregate, provides only one piece of information that Congress and other policymakers can use in determining how to proceed. For example, even if all federal regulations did cost $1.75 trillion in 2008 (which at least some commenters believe may not be correct), if the monetized benefits of those regulations were determined to be greater than those costs, then policymakers may conclude that those costs were (in the words of Executive Order 12866) "justified." On the other hand, if the monetized benefits of federal regulations were estimated to be less than the estimated costs, policymakers may reach another conclusion, or may decide to examine any non-monetized costs and benefits of those rules. But a valid, reasoned policy decision can only be made after considering information on both costs and benefits.

[101] See http://www.whitehouse.gov/sites/default/files/omb/legislative/reports/2010_Benefit_Cost_Report.pdf for a copy of this report.

[102] See http://www.whitehouse.gov/sites/default/files/omb/legislative/reports/Draft_2011_CBA_Report_AllSections.pdf for a copy of this report.

[103] E-mail to the author from Nicole V. Crain and W. Mark Crain, March 7, 2011.

Appendix. CRS Sensitivity Analysis

In an effort to assess the sensitivity of Crain and Crain's results, CRS ran a linear regression using similar, but somewhat different, data and methods.[104] Specifically, CRS compiled a dataset for 30 OECD countries over the period 2002-2008 using the same dependent variable (GDP per capita in constant 2000 dollars) and four of the five independent variables that were used by Crain and Crain. The four identical independent variables were (1) the World Governance Indicators regulatory quality index, (2) broadband penetration rates, (3) country population, and (4) foreign trade as a percentage of GDP. Data for these four variables were obtained from the OECD website (http://www.oecd.org).

Crain and Crain also included one other variable in their analysis: primary school enrollment as a share of the eligible population. In their analysis, the associated coefficient had an unexpected negative sign (indicating that as primary school enrollment went up, GDP per capita went down). Crain and Crain told CRS that the negative coefficient could be due to "aging pyramid" demographic effects. In the CRS analysis, two variables were added to account for such demographic effects: the proportion of the population under 14 and the proportion of the population over 65. These variables were calculated from data obtained from the U.S. Census Bureau international population statistics.[105] These demographic measures may capture "aging pyramid" effects more directly than the primary education variable.

CRS ran a cross-country fixed effects panel estimator with year indicator variables. Natural logarithms of all variables except the regulatory quality index were used in the regression. Estimation results using Stata 11 xtreg procedure, using robust (White) standard errors that are used by most empirical researchers. Estimation results run with conventional standard errors, which are very similar, are available upon request.

The estimation output is shown in **Table A-1** below. The estimated coefficient on the World Governance Indicators regulatory quality index is very small and is not significantly different from zero. The coefficient on population is also statistically insignificant, although other estimated coefficients have expected signs and are statistically significant at conventional levels of confidence.

[104] This appendix was written by D. Andrew Austin, Analyst in Economic Policy, Congressional Research Service.

[105] The U.S. Census Bureau International Population Data Base is available at http://www.census.gov/ipc/www/idb/informationGateway.php. The regulatory quality index was taken from the World Bank's World Governance Indicators website, available at http://info.worldbank.org/governance/wgi/index.asp. The OECD data were taken from data portal available at http://www.oecd.org.

Table A-1. CRS Regression Analysis

Estimated determinants of log real GDP per capita

Independent Variables	Estimated Marginal Contribution	Robust Standard Error	t-statistic	P>|t|	95% Confidence Interval	
Regulatory Quality Index	.0001609	.0217325	0.01	0.994	-.0442871	.0446089
Population (log)	.2132556	.2595086	0.82	0.418	-.317499	.7440102
Broadband Penetration Rate (log)	.0233723	.0035276	6.63	0.000	.0161575	.0305872
Percent Population Under 14 (log)	-1.449251	.1967557	-7.37	0.000	-1.851661	-1.04684
Percent Population Over 65 (log)	-.3208979	.1686001	-1.90	0.067	-.6657239	.0239281
Foreign Trade as % of GDP (log)	.1051034	.0493794	2.13	0.042	.0041111	.2060957
sigma_u	.6039017	sigma_e .0206743				
Rho	.99882937	(fraction of variance due to u_i)				

Source: CRS.

Notes: Estimated using fixed-effects ordinary least squares regression with year dummies. Huber/White robust standard errors are reported.

Number of observations = 210. Number of groups = 30. Observations per group: 7. F(12,29) = 86.57.

R-square: within = 0.9003; between = 0.0521; overall = 0.0409. Corr(u_i, Xb) = -0.7610.

The point estimate of the coefficient regulatory quality index (.0001609) can be used to estimate the economic effect of shifting the United States from the 2008 regulatory quality index value (1.508) to the 2008 level of Ireland (1.856). According to that calculation which presumes that the regression specification reflects the true structure of the economy, that shift would result in an increase of $2.14 in per capita GDP (measured in year 2000 dollars). Because the point estimate of the effect of the regulatory quality index is so imprecise, however, the calculated effect of a hypothetical shift of U.S. regulatory quality to the Irish level is also imprecise.

One test statistic (rho, a measure of intercountry correlation) indicates that 99.9% of the variance in the model results from differences among countries, rather than time-series variation within countries. This could suggest that estimating the effects of variables that generally change slowly over time, such as the regulatory environment in economically advanced countries, may be challenging using panel estimation methods the employ highly aggregated country-level data. Other econometric approaches that focus on more specific changes in regulatory environment may provide a better path for understanding the effects of regulation on economic activity.

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United States Government Accountability Office



Report to the Chairman, Subcommittee on Financial Services and General Government, Committee on Appropriations, United States Senate

July 2014

SMALL BUSINESS ADMINISTRATION

Office of Advocacy Needs to Improve Controls over Research, Regulatory, and Workforce Planning Activities

GAO-14-525

GAO Highlights

Highlights of GAO-14-525, a report to the Chairman, Subcommittee on Financial Services and General Government, Committee on Appropriations, United States Senate

Why GAO Did This Study

Congress created Advocacy within SBA in 1976 as an independent voice for small businesses. Questions have recently been raised about Advocacy's efforts to represent small businesses in regulatory activities and some of its research on small business issues. In light of these questions, GAO was asked to review Advocacy's activities.

This report examines Advocacy's (1) research, (2) regulatory activities, and (3) workforce planning efforts. GAO analyzed Advocacy's research, comment letters, and other regulatory information for fiscal years 2008-2013; assessed Advocacy's policies and procedures against federal standards for internal control and information quality; and interviewed agency officials, and small business and industry representatives. GAO also analyzed the applicability of the Federal Advisory Committee Act to Advocacy roundtables.

What GAO Recommends

GAO makes several recommendations to improve the Office of Advocacy's controls over the quality of its research, the documentation of its regulatory activities, and workforce planning. In commenting on a draft of this report, Advocacy agreed with our recommendations and noted some steps it will take to address them.

View GAO-14-525. For more information, contact Cindy Brown Barnes at (202) 512-8678 or brownbarnesc@gao.gov.

July 2014

SMALL BUSINESS ADMINISTRATION

Office of Advocacy Needs to Improve Controls over Research, Regulatory, and Workforce Planning Activities

What GAO Found

The Office of Advocacy (Advocacy) within the Small Business Administration (SBA) fulfills its mission by researching small business issues and providing input into federal rulemaking and related regulatory activities. However, GAO identified key areas in Advocacy's system of internal control that could be improved.

- *Research.* GAO found that Advocacy did not ensure that its staff monitored the quality of the information the office disseminated, as required. GAO reviewed 20 selected research products and found that in 16 cases a required quality review had not been documented. Advocacy recently established a review policy for its research, but it does not include procedures for selecting the reviewers or documenting that a review occurred and how reviewer comments are addressed. GAO also found that Advocacy staff had not followed federal information quality guidelines to retain data and could not substantiate the quality of information in two cost-estimation reports—a research product it has contracted for every 5 years. Without better controls over its quality review process and efforts to substantiate the information it disseminates, Advocacy cannot ensure the validity of one of its core activities—research in support of small businesses.
- *Regulatory activities.* Advocacy recently updated procedures for its regulatory activities, but these could be strengthened. GAO found the extent to which individual staff maintained records varied, in part, because the procedures lacked policies for documentation. For instance, the procedures state that when staff decide to intervene in the rulemaking process, they must follow up as appropriate with the interested groups to ensure that Advocacy has sufficient information and data to support its case. However, there is no policy that these interactions be documented. Federal internal control standards state that documentation and records should be maintained. If key procedures are not being documented, managers do not have an institutional record that agency goals and objectives in this area are being met. GAO also found that the Federal Advisory Committee Act's transparency and other requirements do not apply to Advocacy's meetings with stakeholders to get input on regulations (roundtables).
- *Workforce planning.* Advocacy's workforce efforts include training and mentoring for new staff, but do not include succession planning, which is recommended by the Office of Personnel Management. According to federal internal control standards, effective management of a workforce is essential to achieving program results. Officials told GAO that Advocacy was a small office and that additional staff were hired on an as-needed basis. However, some key staff have been with Advocacy for many years and their experience will be difficult to replace. If Advocacy does not incorporate succession planning strategies into its workforce planning efforts, it is at risk of not having the skills and expertise to meet its mission when key staff leave or retire.

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Abbreviations

ADA	Americans with Disabilities Act
AAPS	Association of American Physicians and Surgeons
APA	Administrative Procedure Act
BATF	Bureau of Alcohol, Tobacco, and Firearms
CFPB	Consumer Financial Protection Bureau
EPA	Environmental Protection Agency
FACA	Federal Advisory Committee Act
FOIA	Freedom of Information Act
GSA	General Services Administration
HCAAF	Human Capital Assessment and Accountability Framework
HEW	Department of Health, Education, and Welfare
JAG	Judge Advocate General of the Army
OIRA	Office of Information and Regulatory Affairs
OMB	Office of Management and Budget
OPM	Office of Personnel Management
OSHA	Occupational Safety and Health Administration
OST	Executive Office of the President's Office of Science and Technology
RFA	Regulatory Flexibility Act
SBA	Small Business Administration
SBREFA	Small Business Regulatory Enforcement Fairness Act of 1996

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GAO U.S. GOVERNMENT ACCOUNTABILITY OFFICE
441 G St. N.W.
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July 22, 2014

The Honorable Tom Udall
Chairman
Subcommittee on Financial Services and General Government
Committee on Appropriations
United States Senate

Dear Senator Udall:

Congress created the Office of Advocacy (Advocacy) within the Small Business Administration (SBA) in 1976 as an independent voice for small businesses within the federal government.[1] The Chief Counsel for Advocacy, appointed by the President and confirmed by the U.S. Senate, directs the office and is tasked with representing the views and interests of small businesses to other federal agencies, including during rulemaking and related regulatory activities. Advocacy's mission is to encourage the development and growth of America's small businesses by

- producing research to keep policymakers and other stakeholders informed about the impact of federal regulatory burdens on small businesses, document the role of small businesses in the economy, and explore and explain issues of concern to the small business community;
- intervening early in federal agencies' regulatory development process on proposals that affect small businesses and providing training in complying with the Regulatory Flexibility Act (RFA) to agency policymakers and regulatory development officials; and
- fostering two-way communication between federal agencies and the small business community.

Questions have recently been raised about Advocacy's efforts to represent small businesses. For example, some stakeholders questioned how Advocacy staff gather and use information to develop comment letters on proposed regulations and whether that information actually conveys the views of small businesses. Also, some parties have expressed concerns that Advocacy's information-gathering events ("roundtables") are not fully transparent and open to the public, and

[1]P. L. No. 94-305, §201, 90 Stat. 668 (1976).

others have criticized the methodology of some of the research conducted by contractors hired by Advocacy.

You asked us to review the Office of Advocacy. This report examines Advocacy's (1) research activities; (2) regulatory activities, including the applicability of the Federal Advisory Committee Act's (FACA) transparency and other requirements to Advocacy's roundtables; and (3) workforce planning efforts.

To understand Advocacy's mission, operations, and participation in the rulemaking process, we interviewed Advocacy officials, and reviewed Advocacy documents, including its policies and procedures, budget and strategic planning documents, annual reports to Congress on the RFA, and other publications. To evaluate Advocacy's research activities, we selected a nonprobability sample of 20 of its products and assessed them against Advocacy's review process for its research ("peer review"), the Office of Management and Budget's (OMB) Peer Review guidance, and OMB and SBA's Information Quality Guidelines.[2] Our sample was designed to include a variety of topics and report types and focused on more recent publications in order to maximize the possibility that the research staff involved would be available for interviews. In addition, we evaluated three of Advocacy's most recent external studies on the economic costs of regulation and assessed the studies against OMB and SBA Information Quality Guidelines. We also reviewed peer reviewers' comments and other external reviews on the studies to understand questions that had been raised about the studies. Lastly, we interviewed the Advocacy officials responsible for this research to obtain information on the steps taken to substantiate the quality of these studies.

[2]OMB, *Final Information Quality Bulletin for Peer Review*, December 16, 2004. This Bulletin established government-wide guidance aimed at enhancing the practice of peer review of government science documents. OMB. *Guidelines for Ensuring and Maximizing the Quality, Objectivity, Utility, and Integrity of Information Disseminated by Federal Agencies*. 67 Fed. Reg. 8452 (Feb. 22, 2002). OMB's information quality guidelines implement section 515 of the Treasury and General Government Appropriations Act for Fiscal Year 2001 (P. L. No. 106-554). Section 515 directed OMB to issue government-wide guidelines that "provide policy and procedural guidance to Federal agencies for ensuring and maximizing the quality, objectivity, utility, and integrity of information (including statistical information) disseminated by Federal agencies." Agencies were required to issue their own implementing guidelines by October 1, 2002. For SBA's guidelines, accessed April 24, 2014, see http://www.sba.gov/about-sba/sba_performance/open_government/information_quality/information_quality_guidelines. Advocacy officials told us they follow SBA's information quality guidelines.

To evaluate Advocacy's regulatory activities, we analyzed comment letters and information-gathering events (roundtables) from fiscal years 2009 through 2013 as well as relevant policies and procedures. We interviewed Advocacy staff who were responsible for these activities and reviewed supporting documentation to understand their origins and purposes. In addition, we attended three roundtables. To analyze whether FACA (5 U.S.C. App. II) applies to Advocacy's roundtables, we reviewed relevant statutes, case law, regulations, and guidance. We also considered Advocacy's views on the issue. Lastly, we interviewed officials from the entities that interact with Advocacy in rulemaking—the Environmental Protection Agency (EPA), Occupational Safety and Health Administration (OSHA), Bureau of Consumer Financial Protection, also known as the Consumer Financial Protection Bureau (CFPB), and OMB's Office of Information and Regulatory Affairs (OIRA). Also, we interviewed officials from six industry associations that represent small and large businesses; one large corporation; and two nonprofit organizations whose missions relate to policies or rules under consideration, to understand their perspectives on Advocacy's roundtables and other work. We made our selections to include representatives from a variety of sources, and while the results from our interviews cannot be projected to all entities that interact with Advocacy, the information we gathered provides insights into how the selected groups view Advocacy and its work in representing small businesses to federal policymakers.

To assess Advocacy's workforce planning efforts, we interviewed senior management to discuss any workforce planning efforts that were in place. We evaluated those efforts and any related documents against applicable federal standards for internal control and the Office of Personnel Management's Human Capital Assessment and Accountability Framework (HCAAF).[3]

We conducted this performance audit from August 2013 to July 2014 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that

[3]Human Resources Management in Agencies, HCAAF and HCAAF Systems, Standards, and Metrics, 73 Fed. Reg. 23012 (Apr. 28, 2008).

the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Under legislation that established Advocacy in its current form in 1976, Advocacy' duties are to

- serve as a focal point for small businesses' concerns about the federal government's policies and activities;
- advise small businesses on how to interact with the federal government;
- develop proposals for federal agencies on behalf of small businesses;
- represent the views and interests of small businesses before federal agencies;
- enlist the cooperation and assistance of public and private agencies, businesses, and other organizations in disseminating information about the federal government's programs and services that benefit small businesses.[4]

Since its establishment, a series of laws and executive orders has increased Advocacy's roles and responsibilities. First, in 1980 the White House Conference on Small Business made recommendations that led directly to the passage of the RFA, which requires government agencies to consider the effects of their regulatory actions on small entities and, where possible, mitigate them.[5] Under the RFA, agencies provide a small business impact analysis, known as an initial regulatory flexibility analysis, with every proposed rule published for notice and comment and a final regulatory flexibility analysis with every final rule.[6] The Chief Counsel for Advocacy was charged with monitoring federal agencies' compliance with the act and with submitting an annual report to Congress.

[4]Prior to establishing a separate Office of Advocacy within SBA in 1976, Congress created the position of Chief Counsel for Advocacy within SBA. See Pub. L. No. 93-386, § 10, 88 Stat. 749 (1974).

[5]Under the RFA, the term "small entity" includes small businesses, small governments, and small organizations. 5 U.S.C. § 601(6). For the purposes of this report, we use the term "small businesses" since that is our focus.

[6]When an agency can determine that the rule would not have a "significant economic impact on a substantial number of small entities," the head of the agency may certify to that effect and forego the regulatory flexibility analysis requirements. (5 U.S.C. § 605).

Second, in 1996 the Small Business Regulatory Enforcement Fairness Act (SBREFA) provided for the judicial review of agency compliance with key sections of the RFA. It also established a requirement that EPA and OSHA convene panels whenever these agencies are developing a rule for which an initial regulatory flexibility analysis would be required (SBREFA panels).[7] These panels consist of the agency, OIRA, and Advocacy. The 2010 Dodd-Frank Act added the newly created CFPB to the agencies required to convene SBREFA panels.[8] The SBREFA panels meet with representatives of the affected small businesses to review the agencies' draft proposed rules, identify alternative approaches to the rules, and provide insight on the anticipated impact of the rules on small entities. The panels issue a report, including any recommendations for minimizing the economic impact of the rule on small entities.

Third, Advocacy's responsibilities were further expanded by Executive Order 13272, which was issued in 2002. The order required each agency to establish procedures and policies to promote compliance with the RFA and to publish a response in the Federal Register to any written comment received from Advocacy on rules published.[9] This requirement was codified by the Small Business Jobs Act of 2010.[10] Executive Order 13272 also directs Advocacy to provide training to federal agencies on how to comply with the RFA.

Until 2010, Advocacy's budget was part of SBA's. As of fiscal year 2010, however, Advocacy was given statutory line-item funding in a Treasury account separate from other SBA funding, with Congress setting the amount available for Advocacy's direct costs.[11] In fiscal year 2014, Advocacy's enacted budget was $8.75 million. Its fiscal year 2015 budget request was $8.46 million. Of that amount, $7.75 million (92 percent) is to be used to fund compensation and benefits for Advocacy's professional staff, with the balance of Advocacy's budget split almost equally between

[7]The Small Business Regulatory Enforcement Fairness Act of 1996 (P. L. No. 104-121, title II).

[8]The Dodd-Frank Wall Street Reform and Consumer Protection Act (P. L. No. 111-203).

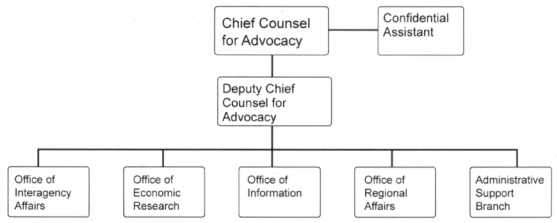
[9]Executive Order 13272, *Proper Consideration of Small Entities in Agency Rulemaking,* 2002.

[10]Pub. L. No. 111-240, § 1601(4), 124 Stat. 2504, 2551 (codified at 5 U.S.C. § 604(a)(3)).

[11]*See* Pub. L. No. 111-240, sec. 1602(b)

external research and all other direct expenses.[12] Advocacy is organized in five offices, as shown in figure 1.

Figure 1: Office of Advocacy Organizational Chart, Fiscal Year 2014



Source: Office of Advocacy. | GAO-14-525

Research Activities

Advocacy's Office of Economic Research produces both internal and external research, which is publicly disseminated, on a variety of small-business issues. More specialized research—requiring proprietary data or econometric analysis—typically is conducted by contractors (external). SBA handles the contracting process for Advocacy. The contracts generally last for 1 year. Advocacy economists act as the official contracting officers' representatives (contracting officer) overseeing and coordinating the work of the contractors. The contracting officers maintain a contract file for each external research product. Each year the Office of Economic Research solicits research topics from Advocacy staff and small business stakeholders, such as associations comprised of small businesses. In addition, Congress requests studies, either formally (by putting the requirement into a law), or informally (through discussions with Advocacy staff). A final list of potential research is presented to the Chief Counsel before the beginning of the fiscal year, and the counsel chooses the topics for the year. In fiscal year 2013, Advocacy produced 22

[12]Under Public Law 111-240, SBA must provide support to Advocacy, including office space and equipment, communication and IT services, and equipment and facilities maintenance. Therefore any costs of those services, as well as centralized indirect expenses shared with other SBA offices, would appear in SBA's budget request, not Advocacy's.

research products on topics that included access to capital, small business exporters, entrepreneurship, and minority- and women-owned businesses. Other Advocacy research addresses the concerns highlighted in Advocacy's authorizing statute, such as examining the role of small business in the American economy, assessing the effectiveness of existing federal subsidies and assistance programs for small businesses, and evaluating efforts to assist small veteran-owned small business concerns.[13]

Advocacy follows a peer review process that was revised and formalized in 2013 and applies to all internal and external research products. Advocacy staff, including the Director of the Office of Economic Research, conduct peer reviews for internal products. For external research products, the peer review is initiated when Advocacy receives the first draft of the product, typically 6 to 8 months after the contract has been awarded, and generally includes external reviewers. In addition to the peer review process, all of Advocacy's research products are required to pass Advocacy's internal clearance process, which involves review by the Director of Economic Research, editors in Advocacy's Office of Information, and individuals in Advocacy's Office of Chief Counsel (Senior Advisor, Deputy Chief Counsel, and Chief Counsel).

Regulatory Activities

Advocacy's Office of Interagency Affairs oversees the office's regulatory activities, which aim to convey the views of small businesses on the impact of federal regulations and related costs. These activities generally fall into three categories—developing and issuing comment letters, convening information roundtables, and providing RFA training.[14] Attorneys in this office ("regulatory attorneys") are expected to become experts in the policy areas they oversee and to establish and maintain broad and effective networks of small business experts (e.g., trade associations) in their policy area. The regulatory attorneys are encouraged to go to trade association and other industry meetings in order to maintain and expand those networks. In addition to maintaining working relationships with industry members and experts, the staff are to

[13]P. L. No. 94-305, §202, 90 Stat. 668 (1976), as amended.

[14]The regulatory attorneys also engage with rulemaking agencies through the interagency review process, which is run by OMB's Office of Information and Regulatory Affairs (OIRA). However, OIRA and its operations are outside the scope of this report.

establish and maintain relationships with the regulatory staff within each agency who write the rules.

One of the primary ways Advocacy provides input to agencies that are issuing rules and regulations of concern to small businesses is through public comment letters. Our review of comment letters from fiscal years 2009 through 2013 found that they covered a wide range of rulemakings on issues such as food labeling, designations for critical habitat, and emission standards. Advocacy made a number of recommendations in its comment letters that included creating an exemption for small businesses or strengthening economic analyses required by the RFA. Advocacy also issued "nonrule" letters that involved the agencies' other activities, such as agencies' scientific research. These letters constitute a small proportion of Advocacy's comment letters. Table 1 below shows the number of comment letters on rulemakings by fiscal year.

Table 1: Advocacy Comment Letters by Policy Area, Fiscal Years 2009-2013

Policy area	Fiscal year 2009	Fiscal year 2010	Fiscal year 2011	Fiscal year 2012	Fiscal year 2013	Total
Environment	11	9	10	6	7	**43**
Natural resources and agriculture	6	4	8	5	3	**26**
Safety and transportation	5	9	6	2	3	**25**
Banking and economic regulation	1	2	7	3	5	**18**
Food, drug, and health	3	4	6	0	3	**16**
Labor and immigration	1	3	6	1	1	**12**
Procurement and small business	1	4	1	3	1	**10**
Rulemaking issues (no specific policy area)	2	1	3	3	0	**9**
Telecommunications and energy	3	2	2	2	0	**9**
Taxes, pensions, and securities	2	0	4	1	1	**8**
Intellectual property	0	1	0	0	2	**3**
Not applicable	0	0	0	2	0	**2**
Total	**35**	**39**	**53**	**28**	**26**	**181**

Source: GAO analysis of Advocacy data. | GAO-14-525

Regulatory attorneys also convene information-gathering roundtables to discuss the regulatory concerns of small businesses. Roundtables are convened on a regular basis in two policy areas—environment and labor safety—while events covering other areas are convened on an ad hoc basis, depending on which regulatory or rulemaking issues might be forthcoming. According to the regulatory attorneys, the most typical reason for convening a roundtable was an upcoming rule or legislation

that would impact small businesses. The regulatory attorneys use the information gathered from the roundtables, together with other information, to inform Advocacy's positions on the issues involved, and to give Advocacy direction on proposed rules' economic impacts and possible regulatory alternatives. The attorneys also told us roundtable discussions help them set priorities, and broaden their knowledge base. The roundtables sometimes resulted in a comment letter, although not always. Table 2 shows the number of roundtables by policy area for fiscal years 2009 through 2013.

Table 2: Number of Roundtables by Policy Area, Fiscal Years 2009-2013

Policy area[a]	Fiscal year 2009	Fiscal year 2010	Fiscal year 2011	Fiscal year 2012	Fiscal year 2013	Total
Safety and transportation	11	9	9	9	8	**46**
Environment	7	10	11	9	7	**44**
Taxes, pensions, and securities	2	7	6	6	2	**23**
Banking and economic regulation	0	1	0	4	1	**6**
Labor and immigration	1	1	3	1	0	**6**
Veteran issues	1	1	3	0	0	**5**
Intellectual property	0	1	1	1	0	**3**
Natural resources	0	1	0	1	1	**3**
Labor safety/environment	0	0	0	2	0	**2**
Rulemaking issues (no specific policy area)	1	0	0	1	0	**2**
Procurement and small business	0	1	0	0	0	**1**
Telecommunications	0	0	1	0	0	**1**
Total	**23**	**32**	**34**	**34**	**19**	**142**

Source: GAO analysis of Advocacy data | GAO-14-525

[a]There are more policy areas for the roundtables since there are instances where Advocacy hosted roundtables in areas that did not have comment letters, such as veteran issues

As discussed previously, Executive Order 13272 requires Advocacy to provide training to the agencies on how to comply with the RFA. According to data provided by Advocacy officials, in 2013, Advocacy staff provided training on the RFA to 159 officials at nine agencies and to 22 congressional staff. In addition to the formal training sessions, regulatory attorneys told us they were encouraged to interact regularly with the relevant rulemaking officials at the agencies as rules were developed in order to communicate the concerns of the small business advocates.

Advocacy's Internal Controls Do Not Ensure the Quality of Its Research and That Required Information Quality Practices Are Followed

Producing research products, both internally and externally, on issues of importance to small businesses is one of Advocacy's primary responsibilities. However, we found that Advocacy's quality review process lacked some key controls to substantiate the quality of the research and did not take steps to ensure that staff were adhering to existing controls.

Advocacy's Peer Review Process Lacks Guidance for Identifying Reviewers

According to Advocacy officials, peer review is the main quality control over the research it disseminates. Advocacy's current Chief Counsel recently directed the office to strengthen its peer review process with the intent to make it more rigorous and consistent. As a result, during the course of our review, Advocacy finalized a written peer review process. We found that the written guidance discussed the various levels of review for internal and external products as well as a process for initiating peer review. However, it did not specify how the economists who managed the research products were to identify peer reviewers. Instead, Advocacy officials told us that they relied on their own expertise and professional contacts to identify appropriate peer reviewers and provide recommendations through the Director of Research and to the Chief Counsel for Advocacy. The officials told us that within a specific subject matter there is often a small group of available peer reviewers, in part because their expertise is specialized and there are not many other alternatives.

OMB's peer review guidance calls on agencies to select peer reviewers with the appropriate knowledge and expertise and to take into account their independence and lack of conflicts of interest.[15] Advocacy managers told us that, in practice, the economists recommend peer reviewers based on knowledge and experience in both subject matter and databases—as discussed in the OMB guidelines. However, they did not provide specific written guidance to the economists on how to identify peer reviewers. Federal internal control standards state that internal control activities help ensure that management's directives are carried out and in implementing

[15] OMB, *Final Information Quality Bulletin for Peer Review*, December 16, 2004

those standards management is responsible for developing the detailed policies, procedures and practices for their agency's operations.[16] With additional guidance, Advocacy would be in a better position to help ensure that the economists fully understand how best to identify qualified peer reviewers and carry out the Chief Counsel's directive to improve the peer review process.

Advocacy Has Not Consistently Documented Peer Reviews

Advocacy does not have consistent documentation showing whether a peer review occurred for all of its research products. Our review of 20 recent research products—10 internal and 10 external—revealed that 16 did not have documented peer reviews in the research files.[17] According to interviews with Advocacy economists who managed the research, all of the 20 products underwent some form of peer review. The economists said that the type of review was commensurate with the methodological complexity of each product, among other factors. However, the Advocacy officials were unable to produce any documentation that peer reviews occurred for these 16 products. According to Advocacy's peer review guidance, the economists who manage the research should document all correspondence pertaining to the peer review and maintain this documentation in the research file. In addition, federal internal control standards require all transactions and significant events be documented and that the documentation be readily available.

Advocacy officials do not have procedures to review the external research files to ensure that the peer reviews were documented. Furthermore, they noted that for some of the less in-depth internal research products—typically 2 to 5 pages—such documentation would be administratively burdensome.[18] However, we note that the documentation could be likewise concise, such as a checklist, or a form that reviewers sign,

[16]GAO, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21 3 1 (Washington, D.C November 1999). These internal control standards, first issued in 1983, present the internal control standards for federal agencies for both program and financial management

[17]Of the 10 external products we reviewed, 6 did not contain documentation on whether a peer review occurred Of the 10 internal products we reviewed, none contained documentation on whether a peer review occurred

[18]According to our analysis, of the 70 internal research products produced from fiscal years 2008 through 2012, approximately 54 percent were shorter products, between 1 to 5 pages

similar to the one currently used by Advocacy for its internal clearance process. Otherwise, absent written documentation, Advocacy managers are limited in their ability to conduct oversight and ensure that this key quality control activity is happening. For example, for one of the internal research products we selected for review, the study author no longer worked at Advocacy, and therefore no one could tell us with any certainty whether the required peer review had occurred, or who had participated in it. Without adequate documentation—a key internal control—of its peer reviews, Advocacy does not have an institutional record of its activities and cannot demonstrate that it is following its own peer review process.

In addition, Advocacy has not consistently documented how peer reviewers' comments were addressed by the authors of its external research products. Of the 10 external research files we reviewed, 4 had documentation that a peer review occurred, and 1 file included evidence that the peer reviewer comments were incorporated into the final report. Advocacy officials told us that the economists who managed external research consolidated the peer reviewers' comments and forwarded to the author those that needed to be addressed, including methodological and data issues and other comments, but not those that might change the scope of the contracted research.[19] They also told us that they did not typically maintain documentation showing which comments had been addressed and why, but included the final report in the research file. However, Advocacy's peer review process states that the economist managing the research will analyze and incorporate, as needed, peer reviewers' suggestions and maintain all related documentation in the research file. However, since the economists are not keeping records and documenting that comments have been considered and addressed, management does not have an institutional record to provide reasonable assurance that its quality control process is being followed.

[19]According to Advocacy officials, it is not permissible to expand the scope of the research or change the nature of the deliverables specified in the contract after an award has been made. Therefore, if the peer reviewer's comments discuss changes that would result in expanding the scope of the research (e.g., analyzing data from additional time periods), those comments could not be accommodated.

Advocacy Has Not Followed Some Required Elements of Information Quality Guidelines

While Advocacy has quality review policies for its peer review process, it does not have policies and procedures that reflect the federal information quality guidelines on retaining data for influential studies or taking other steps to substantiate the quality of information in such studies when they have not retained the data. Advocacy officials told us that they did not retain the original data or underlying computer codes for three external studies on the costs of regulation as required by the information quality guidelines.[20] We focused on external studies on estimating the costs of regulation because it is a key research area for Advocacy, according to its originating statute and the mission statement of its Office of Economic Research. The OMB Information Quality Guidelines require that all agencies producing and disseminating "influential statistical information" help ensure a high degree of transparency about data and methods to facilitate the reproducibility of such information by qualified third parties. The SBA guidelines implement this standard for transparency by requiring that the underlying data be stored and made available for public review for as long as the agency-disseminated information based on the data are valid. The guidelines also state that all formulas, calculations, matrixes, and assumptions used in processing the data should be available. Because Advocacy classified two of the regulatory cost studies as "influential" according to the OMB guidelines, those data should have been maintained.[21]

Advocacy officials said that they did not maintain the data or models for influential external research because there might be a cost associated with obtaining such data, which would raise the costs of the studies, possibly making them prohibitively expensive. However, in the case of two of the studies, the original data were from publicly available sources and involved a relatively small dataset, suggesting the cost would not

[20]Andy Bollman, E. H Pechan & Associates, *Evaluation of Barrier Removal Costs Associated with the 2004 Americans with Disabilities Act (ADA) Accessibility Guidelines*, prepared for SBA Office of Advocacy, under contract SBAHQ-03C0020 (Washington, D.C . 2007), W Marc Crain, *The Impact of Regulatory Costs on Small Firms*, prepared for SBA Office of Advocacy, under contract SBHQ-03-M-0522 (Washington, D C · 2005), and Nicole V Crain and W Mark Crain, *The Impact of Regulatory Costs on Small Firms*, prepared for SBA Office of Advocacy, under contract SBAHQ-08-M-0466 (Washington, D C · 2010). We refer to the latter two studies as "the Crain studies."

[21]The study by Andy Bollman and E H Pechan & Associates was also classified as "influential "

have been prohibitive.[22] The OMB guidelines state that sufficient transparency—achieved in part by storing the relevant data—results in analyses that can be substantially reproduced. Not retaining the underlying information for these influential research papers makes it much more difficult to assess the quality of that work, including its objectivity—a key goal of the information quality guidelines.

We also found that Advocacy staff had not taken additional steps, in the absence of retaining the underlying data, to substantiate the quality of the regulatory cost estimates in two of the studies that it sponsored and disseminated.[23] The OMB guidelines state that when data and methods are not retained and made available to the public because of other compelling interests such as privacy, trade secrets, intellectual property, and other confidentiality protections, the agency shall apply rigorous checks to the analytical results and document what checks were undertaken. Because Advocacy had not retained data on the two cost estimation studies that had been criticized, we interviewed senior Advocacy officials, including the Director of its Office of Economic Research, about the information and methodologies used in the studies. We asked them a set of questions related to criticisms of the methodologies, data, and models used in the studies that were identified in our evaluation and the work of other researchers. Advocacy staff declined to answer many of our questions and instead directed us to the authors, stating that they, not Advocacy economists, were the experts on

[22]In the case of the 2010 Crain study, the original underlying data for the economic regulation cost regression were publicly available from the World Bank and the Organisation for Economic Co-operation and Development, and the study's regressions contained only 118 records and 6 explanatory variables. Furthermore, since the regression models employed in the studies consisted of one equation each, we do not believe there would have been significant costs associated with requiring the Crains to provide Advocacy the data and computer coding written to produce the estimates. While Advocacy did not classify the 2005 Crain study as "influential" according to the OMB and SBA criteria, because the 2005 study used similar methodologies, we examined them together.

[23]We asked Advocacy officials how they substantiated the two Crain studies. We did not ask the Advocacy officials to verify the quality of the third regulatory cost study (*Evaluation of Barrier Removal Costs Associated with the 2004 Americans with Disabilities Act (ADA) Accessibility Guidelines*) because our work did not reveal the same level of methodological weaknesses that we identified in the Crain studies.

the issues covered in the studies.[24] However, the authors would not speak with us, stating that they were no longer contractually obligated to respond to our requests for information.

During our discussions with Advocacy officials, they stated that the purpose of the studies was not to estimate the overall costs of regulations, but rather to estimate the disproportionate share borne by small businesses They also noted that, as with all contract research, the external research reports contain a disclaimer indicating that the views presented did not necessarily represent those of Advocacy. In addition, Advocacy added language to the 2010 report's cover page about the uncertainty of the authors' estimates of the costs of regulation.[25] Advocacy officials noted that the majority of the research it conducts is not classified "influential" according to the OMB and SBA guidelines, and that they have no plans to engage in such work in the near future. However, given Advocacy's mission, it may do influential research in the future as it has in the past even if on a limited basis. We acknowledge that these reports may not necessarily be representative of all Advocacy's research efforts, but not substantiating the quality of the information in even one study could call into question the credibility of Advocacy's research program. Thus, establishing policies and procedures that reflect the federal information quality guidelines on retaining data for influential studies or when such data are not retained because of certain compelling interests, and requiring additional steps to substantiate the quality of the information, would put Advocacy in a better position to provide reasonable assurance about the quality of its research program.

OMB Information Quality Guidelines require that agencies develop policies to ensure that managers be able to substantiate the quality of information they disseminate. The guidelines also discuss narrow

[24]Advocacy officials also provided us with rebuttals the Crains published in response to earlier criticisms by others of the studies However, the rebuttals do not directly address important criticisms

[25]This one-page statement notes, among other things, that "The study is a top-down analysis of regulatory costs that uses certain assumptions to estimate totals, and is not a bottom-up precise accounting of the overall cost of regulations." Also, the statement says. "The overall figure of $1 75 trillion in costs is derived from a number of different assumptions and sources to create an estimate As with almost any academic methodology, it was not intended to be considered a precise finding " For the full statement, see the report, available on Advocacy's website, accessed on April 24, 2014, www sba gov/advocacy/7540/49291.

circumstances under which an agency does not have to substantiate the quality of the information that resulted from a research project of one of its contractors or grantees. In those circumstances, the researcher is to make clear with an appropriate disclaimer that the views expressed in the research are his or her own and do not necessarily reflect those of the agency. However, OMB cautions that "if an agency, as an institution, disseminates information prepared by an outside party in a manner that reasonably suggests that the agency agrees with the information, this appearance of having the information represent agency views makes agency dissemination of the information subject to these guidelines."[26]

As we noted previously, Advocacy placed a disclaimer on the two studies, but its actions indicate its agreement with the information in the studies. First, Advocacy made the two studies available on its website, where they continue to be available. Second, Advocacy's disclaimer that appeared on the 2010 study noted that it contained information and analysis that was reviewed and edited by Advocacy. Advocacy's description of its review role suggests that the agency contributed to the content, if not the conclusions of the study. Finally, several Advocacy comment letters have cited the 2005 study's regulatory cost estimates in support of their arguments.[27] Because Advocacy's actions raise, at the least, an appearance of agreement with the information contained in the studies, we believe that the office was required to substantiate the quality of the estimates of the economic costs contained in the studies.

[26]OMB. *Guidelines for Ensuring and Maximizing the Quality, Objectivity, Utility, and Integrity of Information Disseminated by Federal Agencies* 67 Fed Reg 8452 (Feb 22, 2002)

[27]*See* Advocacy letter to Environmental Protection Agency, dated November 28, 2008, *Re Comments on EPA's Advance Notice of Proposed Rulemaking "Regulating Greenhouse Gas Emissions under the Clean Air Act," Docket ID No EPA-HQ-OAR-2008-0318,* Advocacy letter to Environmental Protection Agency, dated June 23, 2009, *Re: Docket ID No EPA-HQ-OAR-2009-0171, Comments on EPA's "Proposed Endangerment and Cause or Contribute Findings for Greenhouse Gases Under Section 202(a) of the Clean Air Act"*; Advocacy letter to National Marine Fisheries Services, Department of Commerce, dated October 30, 2009, *Re: RIN 0648-AW18 Magnuson-Stevens Fishery Conservation and Management Act Regional Fisheries Management Councils; Operations.*

Documentation of Key Regulatory Activities is Inconsistent and Roundtables Are Not Publicized According to Advocacy's Policies

Advocacy has practices and procedures ("policies") for its regulatory activities—comment letters and roundtables—however, documentation of these key regulatory activities is inconsistent. Furthermore, while we determined that transparency and other requirements in FACA do not apply to Advocacy's roundtables, Advocacy is not following its internal policies meant to ensure its roundtables are as open to the public as they could be. As a result Advocacy cannot demonstrate that it is always fully meeting its mission to foster two-way communication between small businesses and federal policymakers.

Advocacy's Documentation for Key Regulatory Activities Is Inconsistent

Our review of Advocacy's key regulatory activities—developing and issuing comment letters and convening information roundtables—found that Advocacy staff are inconsistently maintaining documentation of key decisions and events. In April 2014, Advocacy provided us with a "practices and procedures guide" for the Office of Interagency Affairs, dated March 2014. The guide covers staff activities related to initiating comment letters and convening roundtables, among other things. Advocacy management told us that they update the guidance periodically, including amending it during the course of our review to make it clear that the decision to issue a public letter or hold a roundtable rests with the Chief Counsel for Advocacy. However, our review found that the updated guide continued to lack policies for documenting key decisions and activities. For example, the guide stated that when regulatory attorneys decide to intervene in the rulemaking process, they must follow up, as appropriate, with the interested associations to ensure that Advocacy has sufficient information and data to make its case for intervening. But there is no policy to document these interactions. The following are other instances where we found a lack of policies to document key activities.

- *Small Business Input into Comment Letters.* Advocacy does not have any policies requiring that the regulatory attorneys retain documentation showing which entities provided input into comment letters, and we found that the attorneys do not consistently do so. Our analysis of Advocacy's comment letters found that about 57 percent of the letters referenced small business input or concerns. But when we interviewed seven regulatory attorneys about how they developed comment letters generally, some told us that they maintained a record of the entities providing input for specific letters, but others said that they did not. Further, when we asked Advocacy staff for documentation on the sources of the small business input referred to

in a nonrepresentative sample of 11 comment letters, they were unable to provide specific emails or notes of conversations.[28]

- *Reasons for Convening Roundtables.* Advocacy's practices and procedures guide states that the Chief Counsel must approve the proposed agenda, speakers, and discussion topics for all proposed roundtables before participants are invited. But the guide contains no policy that this step be documented. We interviewed seven regulatory attorneys responsible for the roundtables and their management and were told that the attorneys set agendas and selected speakers based on their own assessment of the issues and, in some cases, with suggestions from small businesses or interested industry parties. Advocacy officials emphasized that they only held roundtables when there is sufficient interest or need on the part of small businesses.
- *Roundtable Discussions and Participants.* Information gathered from the roundtables is used to inform Advocacy's positions on issues related to small businesses and in comment letters, but Advocacy's guidance contains no policies to document roundtable discussions. Our content analysis of Advocacy's comment letters showed 19 percent of them referred to roundtable discussions. However, staff did not routinely take and maintain notes of the discussions, according to the interviews we conducted with the regulatory attorneys. In addition, not all staff take attendance at the events. In most cases, Advocacy staff keep an "RSVP list" of those who have indicated that they will attend. However, some of the staff noted that the RSVP lists may not include all participants, including those on the phone. As a result it is difficult to determine the extent to which small businesses and related entities were represented at these events.

Advocacy officials told us that they did not have guidance on maintaining documentation on the sources of input to comment letters or on roundtable discussions because they did not feel that setting such standards was required to fulfill their duties under Advocacy's statute. Furthermore, they noted that, in the case of roundtables, keeping records in a manner that identified specific speakers would inhibit discussion and limit their ability to gain valuable input. They also cited logistical challenges in taking accurate attendance at larger events. We acknowledge that specific parties might not want to be publicly named, but federal standards for internal control call for agencies to document

[28]We selected a nonrepresentative sample of recently published comment letters—published from 2011 through 2013—weighting our choices of letters to reflect the distribution of policy areas listed in table 2

significant events. Taking steps to balance the need for privacy so individuals can speak freely, with a commitment to maintain a basic level of documentation of these events—that is, documenting which entities provided input into its comment letters and roundtables—could help Advocacy demonstrate that it is meeting its mission to represent the interests of small businesses.

Advocacy's Policy for Publicizing Information on Roundtable Events Is Not Followed

Key documents for Advocacy's roundtables—agendas and presentation materials—are not made available to the public at-large after the fact. The regulatory attorneys cultivate email lists of relevant stakeholders who are invited to roundtable events, and these lists are continually updated. It is Advocacy's policy to add any interested parties to the invitation list, if asked, and several of the attorneys we interviewed said they did so. They also told us they made agendas and presentations available to any interested parties who requested them after the roundtable. However, the agendas and presentations are not posted to the website or made publically available in any systematic way and if small businesses and other interested parties do not know about the roundtables, they cannot request information from the events.

Advocacy's policies and procedures state that agendas and presentations should be posted on Advocacy's website. Advocacy officials stated they had been unable to post roundtable materials to the website, which SBA maintains, because of difficulties in meeting certain readability and accessibility requirements in the Americans with Disabilities Act.[29] However, a variety of other Advocacy reports and publications are posted on its website that also must meet these requirements, and Advocacy officials did not explain why information on the roundtables could not be likewise included. Making the roundtable materials available on its website would strengthen Advocacy's efforts to inform small businesses and other interested parties about its efforts to represent their interests to federal decision makers.

[29] 42 U S C § 12101 et seq

Federal Advisory Committee Act Requirements Do Not Apply to Advocacy's Roundtables

In addition to evaluating whether Advocacy publicizes and conducts its roundtables in accordance with its internal policies and procedures, we also analyzed whether Advocacy's roundtable groups constitute "advisory committees" subject to the public notice and other transparency requirements of FACA.[30] We found that the roundtables are not advisory committees, and thus Advocacy is not required by law to follow these rules. We first determined that Advocacy is an "agency" covered by FACA. It is an "authority of the Government of the United States, whether or not it is within or subject to review by another agency."[31] In addition, Advocacy possesses the type of "substantial independent authority" required by the courts. While located within SBA, Advocacy is independent of SBA, and it has distinct statutory authorities and responsibilities, a separate statutory charter, and an appropriation account that is separate from the rest of SBA. Furthermore, its duties and authorities under statute and Executive Order are substantial and its recommendations made in furtherance of small entities' concerns must, by law, be given considerable weight by other agencies.

While we found that Advocacy is a FACA "agency," we concluded that its roundtable groups are not "advisory committees" as defined by the statute and interpreted by the courts and implementing regulations. A covered advisory committee is a panel, task force, or similar group created or used by an agency for the purpose of providing advice or recommendations on particular matters. Participants' input must be sought as a group, not as a collection of individuals. The formality and fixed structure of the group also is an important factor in determining coverage under FACA. Advocacy does not seek roundtable participants' input as a group, however; rather, attendees provide their individual perspectives on the agency rule or policy under discussion, do not significantly interact with one another, and no attempt is made to reach a consensus. Advocacy's roundtables also do not have the requisite organized or fixed structure; rather, as noted, Advocacy's policy is to extend roundtable invitations to anyone who expresses a desire to attend. Finally, according to Advocacy, it is the agency itself, not the roundtable participants, that develops policy advice and recommendations, albeit based in part on the data and information provided by roundtable participants (as well as obtained elsewhere). Our detailed legal analysis

[30] 5 U.S.C. App. II.

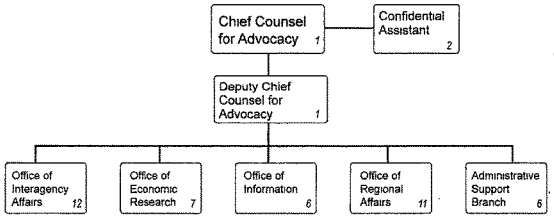
[31] 5 U.S.C. App. II, § 3(3), incorporating 5 U.S.C. § 551(1) (Administrative Procedure Act).

of the applicability of FACA to Advocacy's roundtables is contained in appendix III.

Advocacy's Workforce Planning Efforts Lack Succession Planning

Workforce planning presents some challenges for Advocacy, in part because the office is small and has a large number of positions, which, according to Advocacy officials, typically are replaced with each new administration. While the office currently does some workforce planning, its efforts do not include the long-term strategic plans that would help ensure that it maintains the expertise and skills needed to fulfill its mission. While Advocacy now has responsibility for developing its own budget, goals, and performance measures, our review of its strategic plan and goals did not find goals or objectives that discussed workforce issues such as staff development and succession planning. Advocacy officials told us that they used their organizational chart as the basis for their workforce planning efforts and discussed workforce issues with staff and managers at meetings as needed (see fig. 2). Advocacy officials said that because Advocacy was a small office with only 46 staff, the organizational chart and meetings to discuss staffing issues met their workforce planning needs. Advocacy officials told us that to develop staff they provided training to regulatory attorney and economist staff, had established a mentoring program for newer staff, and were implementing a knowledge-sharing database to help staff develop expertise in specialized policy areas.

Figure 2: Office of Advocacy Organizational Chart, Fiscal Year 2014



Source: Office of Advocacy | GAO-14-525

When we asked Advocacy officials about succession planning and their plans for addressing the departure of senior or experienced staff, the officials told us that most of the turnover in staff occurred during changes

in administration. For example, according to Advocacy officials, the change of administration in 2009 resulted in the turnover of at least 15 of 20 senior officials. Among these were the 10 regional advocates, who are located in each of SBA's regional offices across the country, and make up the Office of Regional Affairs. Turnover tends to be low among the economists and regulatory attorneys, some of whom have been with the office for years. Advocacy officials said that because rulemaking often took so long, they generally had enough time to hire or realign any staff as needed.

According to federal internal control standards, effective management of a workforce is essential to achieving program results. Our body of work on workforce planning has demonstrated the importance of such planning and the need to develop long-term strategies—such as training and succession planning—for acquiring, developing, and retaining staff to achieve programmatic goals.[32] OPM's Human Capital Assessment and Accountability Framework states that agencies and offices with workforce planning are better able to manage their staff by, for example, ensuring that systematic processes are in place for identifying and addressing any gaps between current and future workforce needs. Further, OPM recommends that succession planning is needed to ensure continuity in leadership positions. In addition, workforce planning can help management determine the type of training and other strategies that are needed to address factors such as projected retirements and succession planning. In past work on succession planning, we have found that in addition to focusing on replacing individuals, succession planning strategies can also strengthen current and future organizational capacity.[33]

Given the length of time some attorneys and economists have been with Advocacy, the loss of their expertise through retirement, among other things, could leave significant gaps in needed skills and knowledge, according to Advocacy officials. Yet Advocacy has not incorporated

[32]GAO, *Human Capital: Key Principles for Effective Workforce Planning,* GAO-04-39 (Washington, D C Dec 11, 2003), and *Securities and Exchange Commission: Improving Personnel Managements is Critical for Agency's Effectiveness*, GAO-13-621 (Washington, D C · July 18, 2013)

[33]GAO, *Human Capital· Selected Agencies Have Opportunities to Enhance Existing Succession Planning and Management Efforts,* GAO-05-585 (Washington, D.C.. June 30, 2005)

succession planning into its workforce planning efforts, such as its training and mentoring initiatives. Further, Advocacy officials told us that they discussed future staffing needs and various options for addressing them, including training, but these efforts are not documented in a manner that would ensure consistent implementation. However, ensuring that activities such as staff training are consistently implemented is particularly important when senior management can change significantly every 4 or 8 years. Without incorporating long-term succession planning into its workforce planning efforts, Advocacy is not in the best position to ensure that it has qualified staff to fill leadership and other key positions and a skilled workforce able to meet the demands of its mission on behalf of small businesses.

Conclusions

Effective internal controls are critical for the Office of Advocacy if it is to achieve program outcomes and minimize operational problems. Recognizing this, Advocacy recently has taken action to improve some of its guidance and controls. However, Advocacy's research, regulatory, and workforce planning functions could be improved by strengthening its internal controls as follows:

- *Research activities.* In its research operations, Advocacy has taken some initial steps toward establishing stronger control policies by, for example, formalizing its peer review process for internal and external research products. However, the guidance provided did not include information on how to select appropriate peer reviewers—the experts whom Advocacy relies on to assess the quality of the research that it disseminates. The guidance also lacks policies for documenting that a peer review occurred and how reviewer comments were addressed for its external research products. Such guidance would help ensure that Advocacy research staff fully understand how best to identify the most qualified peer reviewers, and how to document and incorporate reviewer comments. In addition, Advocacy did not follow federal guidelines for information quality for influential studies that set out requirements for retaining data and taking additional steps to substantiate the quality of information it disseminates when it has certain compelling reasons to not retain the data. Improving policies and procedures for its research activities would help support Advocacy's mission to provide quality research on small business issues that decision makers and the public can rely on.
- *Regulatory activities.* Advocacy's lack of documentation and transparency of the regulatory activities we reviewed made it difficult to validate Advocacy's efforts to represent small businesses.

Specifically, weaknesses exist in Advocacy's documentation of both the sources of the small business input in comment letters and the views of small businesses discussed and conveyed at its roundtables. As a result, the extent to which the small businesses' views on regulations were being obtained and communicated is unknown. Improving its guidance to staff on its regulatory activities and emphasizing the importance of documentation would enable Advocacy to more effectively demonstrate to decision makers that it was obtaining and communicating the interests of small businesses. In addition, Advocacy is not following its internal policy to post materials from roundtables on its website. As a result, it is missing an opportunity to reach out more broadly to small businesses and other interested parties and increase the transparency of its activities.

- *Workforce planning activities.* While Advocacy's workforce planning efforts help in managing its current staff, these efforts do not include any strategies to plan for succession, even though several staff have been with the office for many years and will eventually need to be replaced. Without this important element of workforce planning, Advocacy could be in a vulnerable position when critical staff leave the agency or staff face new demands. Although Advocacy is a relatively small office, having a skilled workforce is critical to meeting its mission. Succession planning would help ensure that Advocacy was better prepared to maintain qualified staff to conduct its research and regulatory activities in support of small businesses.

Recommendations for Executive Action

To improve Advocacy's system of internal control, and help to provide reasonable assurance that the office is meeting its mission, we recommend that the Chief Counsel of Advocacy take the following five actions:

- Strengthen the accountability of its research activities by taking the following two actions:
  - Enhance its peer review policies and procedures by including written guidance on selecting peer reviewers and documenting all steps of the peer review process—whether a peer review occurred and how and to what extent peer reviewer comments were addressed.
  - Develop policies and procedures that reflect the federal information quality guidelines on retaining data for influential studies, and when not retaining data, taking additional steps to substantiate the quality of information disseminated.
- Strengthen the accountability of its regulatory activities by developing policies and procedures to ensure that key elements of that work—

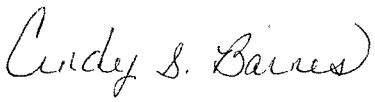
such as sources of input for comment letters and roundtable discussions—are consistently documented.
- Coordinate with SBA officials who oversee website administration to comply with Advocacy's roundtable policy to make information on the events—agendas, presentation materials—publicly available on its website so that its regulatory activities are more transparent to the public.
- Improve its workforce planning efforts to be better prepared to meet its future workforce needs by incorporating succession planning.

Agency Comments

We provided a draft of this report to Office of Advocacy for its review and comment. In its written comments (reproduced in app. II), Advocacy agreed with our recommendations. Advocacy stated that for its research activities, its current effort to further formalize procedures for the peer review process will include steps for additional documentation and that it also plans to develop written guidelines for determining which research products are considered influential, which will clarify when Advocacy needs to take additional information quality steps. Advocacy also said that as it develops how it will disseminate information about its regulatory activities, it will incorporate approaches that are responsive to our recommendations. Finally, Advocacy agreed that workforce planning is important for ensuring that the office maintains the skills and resources needed to fulfill its mission and noted that the office is developing a Leadership Succession Plan in response to our recommendation.

We are sending this report to the Office of Advocacy and interested congressional committees. The report also will be available at no charge on the GAO website at http://www.gao.gov If you or your staff have any questions about this report, please contact Cindy Brown Barnes at (202) 512-8678 or brownbarnesc@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix V.

Sincerely yours,



Cindy Brown Barnes
Acting Director, Financial Markets and
Community Investment

Appendix I: Objectives, Scope, and Methodology

This report examines Advocacy's (1) research activities; (2) regulatory activities, including the applicability of the Federal Advisory Committee Act (FACA) to Advocacy's roundtables; and (3) workforce planning efforts. The scope of our work covered key activities conducted from fiscal year 2008 to fiscal year 2013, although in some cases, we broadened that scope to include fiscal years 2005 through 2008, as noted below.

To understand Advocacy's mission, operations, and participation in the rulemaking process, we reviewed relevant laws and regulations, Advocacy documents, including its annual reports to Congress on the Regulatory Flexibility Act (RFA), budget and strategic planning documents, and other publications.

To assess Advocacy's research activities, we determined: how Advocacy staff chose its research topics; how they conducted the research; and what controls they had in place to ensure quality products. We analyzed Advocacy's research products produced in the 5 most recent fiscal years—2008 through 2012—and interviewed relevant Advocacy officials on the processes by which they assess the quality of its research products.[1] To evaluate Advocacy's research activities, we analyzed a nonprobability sample of research, which included 10 research products authored by Advocacy staff (internal), and 10 products produced by its contractors (external). To select a sample of internal research products that best represented the variety of internal research, we reviewed the 58 research products issued from fiscal years 2008 through 2012, and categorized each as either "routine" (meaning published either quarterly or semi-annually, and relying on the same underlying data set), or as "nonroutine." Within the routine category, we selected the mostly recently published product from each of the following routine publications: (1) *Small Business Profiles of the States and Territories*, (2) *Small Business Quarterly Bulletin*, (3) *Quarterly Lending Bulletin*, (4) *Small Business Lending*, and (5) *The Small Business Economy*. For the nonroutine products, we created five categories, such as "analysis" and "fact sheets." We selected, from each of those five categories, the most recently published report. Then, for each of the 10 selected internal research products, we used a data collection instrument and interviewed the

[1]For the period we conducted our audit, not all the internal research publications for fiscal year 2013 were available in all cases, so we focused on internal research published from fiscal years 2008 through fiscal year 2012

Advocacy staff who wrote the products in order to see to what extent the products adhered to Information Quality Guidelines issued by the Office of Management and Budget (OMB) and the Small Business Administration (SBA) and Advocacy's internal quality review process ("peer review").[2] To assess the quality of the peer review used for Advocacy's external research, we reviewed the contract files for the 10 most recently published external research products, as of year-end 2013, and compared how the work was produced, including Advocacy's peer review process, against the OMB Peer Review Guidance and OMB and SBA information quality guidelines, and applicable federal internal control standards.[3] The results from our reviews cannot be projected to all Advocacy studies, but they provide an indication of how Advocacy staff conducted or oversaw the research and what controls were in place to ensure quality products.

We also assessed Advocacy's contract studies that focused on the economic costs of regulation. We focused on external studies in these areas because they are key research areas for Advocacy, according to its originating statute and the mission statement of its Office of Economic Research. For the economic costs studies, we assessed them against OMB and SBA Information Quality Guidelines, and examined Advocacy's compliance with related data retention policies therein.[4] We also reviewed peer reviewers' comments and other external reviews on the studies as part of our assessment. Lastly, we interviewed Advocacy officials to obtain information on steps they took to substantiate the quality of information for influential studies when data are not retained.

[2]OMB, *Guidelines for Ensuring and Maximizing the Quality, Objectivity, Utility, and Integrity of Information Disseminated by Federal Agencies* (Washington, D C February 2002). 67 Fed Reg 8452 (Feb 22, 2002) Agencies were required to issue their own implementing guidelines by October 1, 2002 For SBA's guidelines, accessed on April 24, 2014, see http //www.sba gov/about-sba/sba_performance/open_government/information_quality/information_quality_guidelines

[3]OMB, *Final Information Quality Bulletin for Peer Review*, December 16, 2004 This Bulletin established government-wide guidance aimed at enhancing the practice of peer review of government science documents.

[4]Advocacy's studies examining total costs of regulation to the U S economy have been conducted approximately every 5 years, according to Advocacy officials. For this reason, we broadened the scope to fiscal year 2005, whereas in other research work, we focused on fiscal years 2008 through 2012

To evaluate Advocacy's regulatory activities, we assessed: how and why Advocacy decides to issue comment letters and convene roundtables; the policies and practices in place that pertain to those activities; how Advocacy staff solicit input from small businesses and other parties. We interviewed relevant staff, as described below; reviewed relevant policies and procedures, and analyzed comment letters produced and roundtables convened from fiscal years 2009 through 2013.[5] Specifically, we performed a content analysis on the 181 comment letters issued during that period, using NVivo software, to analyzed and categorize the content of the letters and the nature and source of the small business input provided.[6] We also interviewed Advocacy staff who are responsible for rulemaking and related activities, weighting our choices of interviewees to reflect the distribution of comment letters by policy area, and reviewed supporting documentation for comment letters to understand how Advocacy staff develop and issue comment letters, and compared this information to federal internal control standards.

Similarly, we reviewed available information on the 142 roundtables convened during the same 5-year period and interviewed the responsible Advocacy staff, weighting our choices of interviewees to reflect the distribution of roundtables by policy area. We reviewed Advocacy's policies for roundtables to understand their origin, purpose, and documentation requirements, and compared this information to federal internal control standards. In order to understand the perspective of those who attended the roundtables, we attended three of the events. In addition, we selected and interviewed a nonprobability sample of past participants from email lists provided by Advocacy's regulatory attorneys. Specifically, we talked to the following representatives: five from industry associations that represent small and large businesses; one from a large corporation; and one nonprofit organization whose mission relates to policies or rules under consideration.[7] We made our selections to include

[5]Similar to our approach in assessing Advocacy's research work, we wanted to focus on the five most recent fiscal years. In the case of the regulatory activities—comment letters and roundtables—information was available through the end of fiscal year 2013.

[6]NVivo is a qualitative data analysis software system that allows organization and analysis of information from a variety of sources including complex nonnumeric or unstructured data.

[7]Separate from interviewing the officials selected from the roundtable invitation lists, we interviewed representatives from an association that represents small businesses and a nonprofit whose mission relates to transparency in government. We discussed roundtables and other Advocacy activities with these parties.

representatives from a variety of sources, and while the results from our interviews cannot be projected to all entities that interact with Advocacy, the information we gathered does provide insights into how the selected groups view Advocacy and its work in representing small businesses to federal policymakers.

We also reviewed Advocacy's training to agency staff in how to comply with the RFA and interactions with agency rulemaking officials In addition, we interviewed officials from the entities that interact with Advocacy in rulemaking—the Environmental Protection Agency (EPA), Occupational Safety and Health Administration (OSHA), Bureau of Consumer Financial Protection, also known as the Consumer Financial Protection Bureau (CFPB), and Office of Management and Budget's (OMB) Office of Information and Regulatory Affairs (OIRA).

To analyze whether FACA (5 U.S.C. App II) applies to Advocacy's roundtables, we reviewed relevant statutes, case law, regulations, and guidance. In addition, we reviewed and considered Advocacy's written views on the issue. See appendix III for more information on the legal analysis we conducted.

Finally, we reviewed Advocacy's workforce efforts. To understand Advocacy's workforce planning, we reviewed Advocacy's strategic goals and other planning and budget documents and interviewed senior management to determine what, if any, policies and procedures were in place related to workforce and succession planning. We assessed any such policies and procedures against applicable federal standards for internal control and the Office of Personnel Management's (OPM) Human Capital Assessment and Accountability Framework (HCAAF).[8] We also reviewed GAO reports on workforce and succession planning to gain insights about key practices and how agencies have used them.

We conducted this performance audit from August 2013 to July 2014 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that

[8]Human Resources Management in Agencies, HCAAF and HCAAF Systems, Standards, and Metrics, 73 Fed Reg 23012 (Apr 28, 2008)

the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Comments from the Office of Advocacy, Small Business Administration

SBA Office of Advocacy
www.sba.gov/advocacy

SBA Office of Advocacy
409 3rd Street, SW
Washington, DC 20416

Advocacy: the voice of small business in government

July 11, 2014

Ms. Cindy Brown Barnes
Acting Director, Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Ms. Barnes:

Thank you for providing the SBA Office of Advocacy with a copy of the Government Accountability Office (GAO) draft report entitled *Office of Advocacy Needs to Improve Controls Over Research, Regulatory, and Workforce Planning Activities.* We have reviewed GAO's recommendations and welcome the opportunity to comment. In addition, Advocacy appreciates the time and effort GAO took to understand how we fulfill the unique mission of our office.

The following statements reference recommendations put forth by GAO:

- **Research Activities**

  Advocacy appreciates GAO's recommendations regarding our research activities. As GAO states, Advocacy is currently working on guidance to further formalize procedures for the peer review process, which will include additional documentation. Advocacy also plans to develop written guidelines for determining what Advocacy research products would be considered "influential," which will further clarify needed information quality checks. Advocacy agrees with GAO that such steps will strengthen our ability to provide robust and quality economic research for small businesses and policymakers.

- **Regulatory Activities**

  Advocacy's use of comment letters and roundtables is central to our mission to advocate for small businesses, and we appreciate GAO's recommendation to improve our documentation of these activities. Advocacy will continue to develop how we disseminate information about our regulatory activities in ways that are both responsive to the GAO recommendations and in furtherance of Advocacy's mission.

- **Advocacy's Workforce Planning Activities**

  GAO recommends that Advocacy improve our workforce planning efforts by incorporating succession planning. Advocacy agrees that workforce planning is an

important part of ensuring that our office maintains the skills and resources needed to fulfill our important mission. As a result of this GAO recommendation, Advocacy is developing a Leadership Succession Plan that will formalize existing and future workforce planning efforts.

Also, GAO agreed with SBA and Advocacy that Federal Advisory Committee Act requirements do not apply to Advocacy's roundtables. Advocacy values the thorough investigation that GAO performed. As mentioned before, our roundtables are an invaluable tool to hear from small businesses and these findings will help our office to continue this important part of our outreach.

The SBA Office of Advocacy is committed to continuing to fulfill our mission as the independent voice for small business by researching small business issues and providing input into federal rulemaking and related regulatory activities.

Sincerely,

Claudia R. Rodgers

Claudia Rayford Rodgers
Deputy Chief Counsel
SBA Office of Advocacy

Appendix III: Legal Analysis of the Applicability of the Federal Advisory Committee Act to the Office of Advocacy's Roundtables

Introduction and Summary of Conclusions

As part of our review of the Small Business Administration Office of Advocacy's (Advocacy) activities in identifying and communicating the concerns of small businesses and other small entities as agencies develop regulations and policies, we analyzed whether the Federal Advisory Committee Act (FACA), 5 U S C. App. II, applies to "roundtable" groups that Advocacy convenes for the purpose of conveying and soliciting information and viewpoints about agency rules and policies. Based on our review of relevant statutes and legislative history, case law, regulations, and guidance, and consideration of Advocacy's views, and for the reasons detailed below, we conclude that these roundtable groups are not "advisory committees" within the meaning of FACA and thus Advocacy is not required to comply with the provisions of that statute.[1]

Background on Advocacy's Duties and Use of Roundtables

Advocacy is an office established by statute within the Small Business Administration (SBA). 15 U.S.C. § 634a. The office has a separate statutory charter[2] and, as of 2010, the President must include a separate line-item appropriation request for Advocacy designated in a separate Treasury account.[3] Advocacy is headed by a Chief Counsel who, among other things, has statutory authority to appear as an official "friend of the court" (amicus curiae) in all court challenges to agency regulations in order to "present his or her views with respect to compliance with [the Regulatory Flexibility Act, discussed below], the adequacy of the rulemaking record with respect to small entities and the effect of the rule on small entities." 5 U.S.C § 612(c). According to recent testimony, Advocacy is not required to obtain clearance of its comment letters, publications, and testimony as are other executive branch agencies.[4]

[1]Our practice when rendering opinions is to contact the relevant agency and obtain its legal views on the subject of the request GAO, *Procedures and Practices for Legal Decisions and Opinions*, GAO-06-1064SP (Washington, D C Sept 2006), available at www gao gov/legal/resouces html We contacted the Chief Counsel for Advocacy who, through Advocacy's Director of Interagency Affairs, provided us with the agency's views Letter from Advocacy to Managing Associate General Counsel, GAO, April 24, 2014 (Advocacy Letter to GAO)

[2]Pub L No 94-305, Title II (1976), codified as amended at 15 U S C §§ 634a *et seq.*

[3]Pub L No 111-240 (2010)

[4]Testimony of Dr Winslow Sargeant, Chief Counsel for Advocacy, U S Small Business Administration, before the Senate Committee on Small Business and Entrepreneurship (Apr. 17, 2013)

Among Advocacy's duties are serving as "a focal point for the receipt of complaints, criticisms, and suggestions" concerning federal policies affecting small businesses, developing proposals for changes in the policies and procedures of federal agencies that further small business interests and communicating those proposals to the appropriate federal agencies; and "represent[ing] the views and interests of small businesses before other Federal agencies whose policies and activities may affect small business." 15 U.S.C. § 634c. Advocacy also has key responsibilities and authorities under the Regulatory Flexibility Act (RFA), 5 U.S.C. §§ 601 et seq., and under Executive Order 13272 which helps implement the RFA. The RFA requires Advocacy to assist regulatory agencies during all stages of the rulemaking process to mitigate the potential adverse impact of the rules on small entities while achieving their regulatory objectives, and the Executive Order requires agencies to notify Advocacy of any proposed rules expected to have a significant economic impact on a substantial number of small entities and to consider any comments Advocacy submits on the rule. The RFA and Executive Order both require agencies to respond to Advocacy comments in their final rules and note any resulting changes. Advocacy plays a similar role with respect to certain designated agencies as a member of what are known as "SBREFA panels." The Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA)[5] amended the RFA to require the Environmental Protection Agency, the Occupational Safety and Health Administration, and the Consumer Financial Protection Bureau to convene panels with officials from Advocacy, the Office of Management and Budget, and the rule-writing agency whenever the agencies develop rules for which an initial regulatory flexibility analysis is required. The panels must develop information solicited from small entity representatives and other sources concerning the potential impacts of the agency proposal; consider alternatives that minimize burdens on small entities; and prepare a report with recommendations to the agency head for consideration in the proposed rule. 5 U.S.C. § 609(b)-(e).

One of the ways that Advocacy fulfills these statutory responsibilities is by convening roundtable meetings for representatives of small businesses and government agencies. Advocacy invites roundtable participants, typically by email, but it is Advocacy's policy to welcome participation by

[5]Pub L No 104-121, title II

any interested party other than the press.[6] According to Advocacy, it hosted 32 roundtables in Fiscal Year 2012 and 21 roundtables in Fiscal Year 2013.[7] The roundtables typically focus on specific proposed agency regulations and stakeholders provide information about the potential economic impacts of the proposal and identify less burdensome alternatives. Advocacy often uses the results of these roundtables (and other information) as the basis of formal comment letters it submits to the proposing agency, for example disagreeing with the agency's impact analysis and urging less burdensome alternatives; it submitted 26 such letters in FY 2013[8] to which agencies must, by statute, respond. 5 U.S.C. § 604(a)(3). In Advocacy's view, the concerns articulated by small business representatives at roundtables are influential; for example, according to Advocacy, after a roundtable regarding the Employee Benefits Security Administration's guidance on brokerage windows, the Administration issued revised guidance addressing the small business concerns. See Report on the Regulatory Flexibility Act, FY 2012, above, at 7. And after attending an Advocacy roundtable that addressed proposed revisions to Occupational Safety and Health Administration ("OSHA") noise standards, OSHA withdrew the rule and pledged to conduct additional stakeholder outreach before proceeding. See Report on the Regulatory Flexibility Act, FY 2011 at 4.

Applicability of the Federal Advisory Committee Act

FACA establishes requirements for "advisory committees" to the federal government, defined as relevant here as "any committee, . . . panel, task force, or other similar group . . . which is established or utilized by one or more agencies, in the interest of obtaining advice or recommendations for . . . one or more agencies or officers of the Federal Government . . .." 5 U.S.C. App. II, § 3(2). Congress enacted FACA in 1972 "to enhance the public accountability of advisory committees and to reduce wasteful expenditures" that "result only in worthless committee meetings and

[6]Advocacy roundtable invitations and agendas state in part: "Roundtable meetings are open to all interested persons, with the exception of the press, in order to facilitate an open and frank discussion about small business-related issues. Agendas and presentations are available to all, including the press. Anyone who would like to receive roundtables agendas or presentations, or be included in the regular distribution, should forward such requests to [Advocacy]."

[7]SBA Office of Advocacy, *Report on the Regulatory Flexibility Act, FY 2012* at 4, *Report on the Regulatory Flexibility Act, FY 2013*, at i.

[8]*Report on the Regulatory Flexibility Act, FY 2013, supra, at i*

biased proposals". Pub. Citizen v. U.S, Dep't of Justice, 491 U.S. 440, 459 (1989). Similarly, FACA's purpose was to "ensure that new advisory committees be established only when essential [;] . . . that their creation, operation, and duration be subject to uniform standards and procedures; that . . . the public remain apprised of their existence, activities, and cost; and that their work be exclusively advisory in nature." Id. at 446.

For advisory committees covered by the act, FACA requires, among other things, that their meetings be open to the public; that timely notice of meetings be published in the Federal Register; that interested parties be allowed to attend, appear before, or file statements with the advisory committee; and that detailed minutes of advisory committee meetings be kept. In addition, for advisory committees established by agency heads, the agency must, as applicable, ensure that committee membership is fairly balanced in terms of points of view represented and functions to be performed and ensure that the recommendations of the committee are not inappropriately influenced by the agency or any special interest but rather reflect the committee's independent judgment. 5 U.S.C. App. II, § 10. Because Advocacy does not apply these FACA requirements to its roundtables, we examined whether the statute applies to these groups and their activities

1. Is Advocacy a FACA "Agency"?

As noted above, whether Advocacy roundtables are advisory committees subject to FACA depends in part on whether they have been "established or utilized by one or more agencies . . .." (emphasis added). Thus as a threshold issue, we examine whether Advocacy is an "agency" for purposes of FACA.

FACA defines "agency" by incorporating the term's general definition in the Administrative Procedure Act (APA). 5 U.S.C. App. II, § 3(3). With exclusions not relevant here, the APA defines "agency" as "each authority of the Government of the United States, whether or not it is within or subject to review by another agency . . .." 5 U.S.C. § 551(1)

Advocacy believes it is an "agency" for purposes of FACA. Citing the foregoing APA definition, Advocacy states that it is an "authority of the Government of the United States" and not covered by any of the exclusions. Advocacy Letter to GAO at 2.

Yet as the courts have recognized, "the law on the simple question of what is an [APA] agency is quite complex." Lee Constr. Co. v. Federal

Reserve Bank, 558 F. Supp. 165, 172 (D. Md. 1982). Likewise, the courts have acknowledged that "[a]ny general definition [of "agency" under the APA] can be of only limited utility . . . [when] confronted with one of the myriad organizational arrangements for getting the business of the government done. . . .The unavoidable fact is that each new arrangement must be examined anew and in its own context." Washington Research Project, Inc. v. HEW, 504 F 2d 238, 245-46 (D.C. Cir.1974), cert. denied, 421 U.S. 963 (1975)(citations omitted).

Courts have taken somewhat different approaches to what constitutes an "agency" under the APA. The seminal case is Soucie v. David, 448 F.2d 1067 (D.C. Cir. 1971), which involved what was then called the Executive Office of the President's Office of Science and Technology (OST). The lawsuit sought the release of an OST document under the Freedom of Information Act (FOIA). Because the FOIA and APA definitions of "agency" were identical at the time of the lawsuit, the court looked to interpretations of the APA in determining whether OST was an "agency" under FOIA. The court found that while the meaning of "agency" under the APA was "not entirely clear," it "apparently confers agency status on any administrative unit with substantial independent authority in the exercise of specific functions." 448 F.2d at 1073 (emphasis added). Because OST evaluated federal science programs previously evaluated by the National Science Foundation, in addition to its non-"independent" responsibilities in advising and assisting the President, the court found OST had "substantial independent authority" and "must be regarded as an agency subject to the APA and [FOIA]." Id. at 1075.

The court in McKinney v. Caldera, 141 F. Supp. 2d 25 (D.D.C. 2001), applied the Soucie test and found that the office of the Judge Advocate General of the Army (JAG) was not an APA "agency" because it lacked "substantial independent authority." Although JAG supervised the Army's military justice system, performed appellate review of court martial trials, and furnished legal services, the court focused on the fact that JAG's duties flowed from the authority of the Secretary of the Army. This rendered JAG insufficiently independent, the court ruled, notwithstanding that the APA contemplates the possibility of an "agency" within an "agency."

Other courts have framed the APA "agency" definition slightly differently, looking to whether an entity can take "final and binding action." This standard is based in part on the Soucie "substantial independent authority" test but also on the APA's legislative history indicating Congress intended covered agencies to have "final and binding" legal

authority. In Dong v. Smithsonian Institution, 125 F.3d 877 (D C. Cir. 1997), cert. denied, 524 U.S. 922 (1998), for example, the court looked to whether the Smithsonian Institution was:

> "a part of government which is generally independent in the exercise of [its] functions and . . by law has authority to take final and binding action affecting the rights and obligations of individuals, particularly by the characteristic procedures of rule-making and adjudication "

Id. at 881 (emphasis added). The court found that the Smithsonian was not an APA "agency" under this standard because while it exercised authority, the authority was not sufficiently "substantial." Although the Smithsonian is closely linked with the federal government, receives federal funding, has certain police powers to protect its physical plant, and publishes regulations in the Code of Federal Regulations, the court noted that it does not make binding rules of general application, determine rights and duties through adjudications, issue orders, or perform regulatory functions.[9]

Still other courts determining APA agency status have focused on whether an entity is one of the "centers of gravity" in the exercise of administrative power "where substantial 'powers to act' . . .are vested'" (see, e.g., Lee Constr. Co., above, 558 F. Supp. at 174, holding Federal Reserve Bank of Richmond was APA agency based on substantial delegated decision-making authority from Federal Reserve System Board of Governors), or whether the entity has "authority in law to make decisions" (see, e.g., Washington Research Project, Inc. v. HEW, above, 504 F.2d at 248, holding that the Department of Health, Education, and Welfare (HEW) peer review groups for grant applications were not APA agencies because they only recommended grants to a National Institutes of Health entity, which, in turn, made recommendations to the HEW Secretary).

[9]*Dong* involved whether the Smithsonian was an "agency" under the Privacy Act, which in turn adopts the definition of "agency" under FOIA. See 5 U S C § 552a(a)(1). FOIA incorporated the APA "agency" definition until 1974, at which point Congress broadened the core APA "agency" definition for FOIA purposes, but the portion of the *Dong* court's analysis cited here focuses on whether the Smithsonian was agency under the pre-1974 version of the APA

Applying these authorities and considering Advocacy's views, we conclude that Advocacy is an "agency" under the APA, and thus under FACA, because it possesses the requisite "substantial independent authority." First, it acts with independence. Although Advocacy is an "agency" within an "agency" (SBA), as noted, it has distinct statutory authorities and responsibilities and a separate statutory charter; a separate line-item budget request; its head can appear in court appeals to speak to the rulemaking agency's compliance with the RFA; and it does not have to obtain clearance of its comments and testimony. Unlike JAG in the McKinney case, above, which the court found was not an "agency" because its duties derived from the Army Secretary, the Chief Counsel's duties are related to but distinct from the SBA Administrator.

Second, Advocacy's authorities and duties under its organic statute, the RFA, and Executive Order 13272 are "substantial." As noted, it is responsible among other things for identifying and advocating the views and concerns of small entities throughout the Executive Branch and for developing proposed changes in the policies and procedures of federal agencies in order to further the interests of small business. Although it does not issue regulations, conduct adjudications, or otherwise take traditional "final and binding action," its views and recommendations must, by law, be accorded considerable weight. Taken as a whole, we believe it has substantial authority under the case law.

2. Are Advocacy's Roundtable Groups FACA "Advisory Committees"?

Having found that Advocacy is a FACA "agency," we examine whether its roundtables are FACA "advisory committees." As noted, FACA defines this term in part as "any committee, . . . panel, task force, or other similar group . . . which is established or utilized by one or more agencies, in the interest of obtaining advice or recommendations for . . . one or more agencies or officers of the Federal Government . . .." 5 U.S.C App. II, § 3(2). Because of Advocacy's particular statutory responsibilities, notably to identify and communicate concerns of small businesses and entities, Congress clearly contemplated that Advocacy would have a close relationship with small business. Its mission virtually requires consultation with these entities to obtain data, opinions and possible advice, and one way it has chosen to do this is by holding roundtable meetings.

In Advocacy's view, its roundtables are not FACA advisory committees It believes the roundtables help it achieve its mission;[10] indeed, Advocacy maintains that without the discussions that occur at roundtables, its "ability to fulfill its . . . statutory obligations would be severely curtailed." Advocacy Letter to GAO at 2. Explaining its position that these activities do not trigger FACA, it states

"[a] lthough the definition [in] FACA is broad, FACA does not apply to all committees, meetings, or groups In enacting FACA, Congress was concerned with formally organized advisory committees which the President or an executive department or official directed to make recommendations on identified governmental policy for which specific advice was sought It was not intended to apply to all amorphous, ad hoc group meetings; only groups having some sort of established structure and defined purpose constitute advisory committees within the act "

Advocacy Letter to GAO at 3 (citations omitted).

We agree with Advocacy that under the case law, not every group that provides information or advice to a federal agency is a FACA "advisory committee." Although no single aspect of a group's creation, structure or activities is controlling, most courts have focused on the formality, structure, and continuity of the group and whether the group is brought together to provide advice or recommendations as group rather than as a collection of individuals. As the Supreme Court explained in Public

[10]According to Advocacy· "Advocacy holds numerous roundtable discussions with small business stakeholders to educate them about ongoing legal and regulatory developments across the federal government and discuss their effect on small entities Roundtable attendance varies from meeting to meeting, and staff encourages wide public participation by encouraging invitees to forward roundtable invitations to interested parties to attend or to call in if in-person attendance is not practicable On many occasions, officials from federal agencies and Congress attend Advocacy roundtables to provide information regarding agency activities and approaches and to pose questions to small entities and their representatives directly Roundtables on specific topics also provide a platform for small businesses to provide their views on specific practices, policies and regulations promulgated by various government agencies Roundtables also serve to inform Advocacy staff of a wide variety of practical and economic challenges small businesses might be facing as a result of federal policies Advocacy's roundtables are particularly useful for the office because they allow staff to witness and foster dialogue among various stakeholders, including small businesses, their representatives, policymakers, and public interest groups These conversations often shed light on what are usually complex questions that deserve thorough consideration, on often very short notice, by Advocacy staff in their own evaluation of the impact of regulations on small entities "

Advocacy Letter to GAO at 1-2

Citizen, above, Congress did not design FACA to cover every formal or informal consultation between a government agency and a group rendering advice; such a literalistic reading would cover "far more groups and arrangements than Congress could conceivably have intended." 491 U.S. at 464-65

Several early cases addressed whether an informal or "ad hoc" group such as Advocacy's roundtables was an advisory committee. The court in Food Chemical News v. Davis, 378 F. Supp 1048 (D.D.C. 1974), considered whether two "informal" meetings of distilled spirits industry representatives, convened by the head of the Bureau of Alcohol, Tobacco and Firearms (BATF) to obtain advice on draft regulatory amendments, were subject to FACA. Noting that the act's purpose was to control the advisory committee process and to open to public scrutiny the manner in which government agencies obtain advice from private individuals, the court held it was "undisputed that [BATF] utilized an ad hoc committee of industry representatives in order to obtain advice. Such a relationship . . . clearly comes within the terms of . . . [FACA]." Id at 1051

The following year, the same court considered whether bi-weekly meetings held at the White House and attended by selected groups invited by the President's Assistant for Public Liaison were subject to FACA. In Nader v. Baroody, 396 F.Supp 1231 (D.D.C. 1975), the court concluded that the groups were not advisory committees, relying on two characteristics of the meetings: the absence of a specific request for advice on a matter of government policy and the lack of formal organization or continuity

The Second Circuit Court of Appeals considered Food Chemical News and Nader in National Nutritional Foods Association v. Califano, 603 F. 2d 327 (2d Cir. 1979). The Califano court determined that FACA applied to a single meeting between six officials from the Food and Drug Administration and six obesity experts "to assist the FDA in selecting the best course of action 'for regulating the production and promotion of [weight reduction products]. . . .'" Agreeing with the rulings of both previous cases, the court found the facts of Food Chemical News to be closer to the case before it because FDA had called on specific individuals to provide group advice on a particular proposed regulation and relied on the group advice.

The element of "group advice" continued to play a key role in the seminal case of Association of Am. Physicians and Surgeons, Inc v. Clinton, 997 F. 2d 898 (D.C. Cir. 1993) (AAPS), involving the Clinton Administration's

Health Care Reform Task Force. The D.C. Circuit Court of Appeals held in AAPS that "a group is a FACA advisory committee when it is asked to render advice or recommendations, as a group, and not as a collection of individuals." Id. at 913 (emphasis in original). "[A]n important factor in determining the presence of an advisory committee [is] the formality and structure of the group," the court held, laying out three criteria needed to implicate FACA: "an organized structure, a fixed membership, and a specific purpose." Id. at 914. Characterizing variation in these factors as a continuum, the court explained that at one end of the continuum is a "formal group of a limited number of private citizens who are brought together to give publicized advice as a group"—this group is covered—while at the other end of the continuum is "an unstructured arrangement in which the government seeks advice from what is only a collection of individuals who do not significantly interact with one another." Id. at 915.[11] See also Freedom Watch v. Obama, 807 F. Supp. 2d 28 (D.D.C. 2011) (applying AAPS criteria; finding colorable claim of FACA coverage based on fixed group membership and formation for specific policy purpose); Citizens for Responsibility and Ethics in Washington v. Leavitt, 577 F. Supp. 2d 427, 432 (D.D.C. 2008) (same; finding no FACA coverage where "[t]he groups had no formal organizational structure . . . . Attendees conveyed their own opinions regarding their individual areas of expertise" and "[n]o group report or other collaborative work product was created."). But see Aluminum Co. of America v. National Marine Fisheries Service, 92 F. 3d 902 (6th Cir. 1996) (cautioning against rigid application of AAPS criteria).

Implementing regulations issued by the General Services Administration (GSA), the agency responsible for administering FACA government-wide, rely in part on this case law in defining what constitutes a FACA advisory committee. In issuing its final FACA management rule in 2001, GSA "recognize[d] that the broad definition in the Act of an 'advisory committee' might be interpreted to extend coverage by the Act to any gathering of two or more persons from whom . . . Federal officers or agencies seek advice or recommendations. However, in the cases discussed above, the courts have rejected such a broad reading . . . ." 66 Fed. Reg. 37728, 37730 (July 19, 2001). GSA's regulations therefore exempt from FACA regulation "[a]ny group that meets with Federal

[11]The *AAPS* court remanded the case to determine whether a particular working group of President Clinton's Health Care Reform Task Force was a FACA advisory committee under these criteria

official(s), including a public meeting, where advice is sought from the attendees on an individual basis and not from the group as a whole. . . ." 41 C.F.R § 102-3 40(e) GSA regulations further state that development of consensus among meeting participants does not in itself convert the group to a FACA committee, nor does the presence of trade association or other organization representatives affect whether advice is obtained "on an individual basis." 41 C.F.R. Parts 102-3, Subpart A, App. A, Key Points and Principles II, III.

Applying these authorities and considering Advocacy's views, we conclude that Advocacy's roundtables are not FACA advisory committees. First, we recognize that roundtable participants are not random attendees but rather invited representatives of a particular "group"—the small business community—whose concerns and perspective it is Advocacy's very mission to identify and advocate.[12] As noted, however, Advocacy invites anyone (except the press) with an expressed desire to attend and thus there is no structured or fixed membership in a "roundtable group."

Nor is group consensus sought from roundtable participants. Under the standards in AAPS, 603 F.2d at 913, the group's activities are not expected to, and do not appear to, benefit from the interaction among the participants. Rather, as contemplated by the GSA regulations, information is solicited from participants as individuals (including individuals representing trade associations), although a consensus may develop. See 41 C.F R Part 102-3, Subpart A, App. A, Key Point II ("The development of consensus among all or some of the attendees at a public or similar forum does not automatically invoke FACA."). As in Leavitt, above, no group report or other collaborative work product is created. And as in American Society of Dermatology v. Shalala, 962 F. Supp. 141 (D D.C 1996), there is no attempt to create consensus among participants either overall or on any aspects of the issue under consideration. See id. at 148 (among the "main factors leading to the Court's determination that the panels fall into the non-advisory committee end of the [AAPS] continuum [is] . the absence of any attempt to achieve consensus.").

[12]As summarized in recent testimony, Advocacy was "created . to be a voice for small business within the federal government [and] advances the views, concerns, and interests of small business " Testimony of Dr Winslow Sargeant, Chief Counsel for Advocacy, U S Small Business Administration, before the House Committee on Small Business, Subcommittee on Investigations, Oversight and Regulations (Mar. 14, 2013)

Nor does Advocacy's submission of comment letters based on information obtained at roundtables establish that it convened the roundtable to obtain a group consensus. While Advocacy's position in a comment letter may represent a consensus of views expressed at a roundtable, that consensus appears to be a function of the fact that many of the participants, as small entities, share common concerns

Finally, according to Advocacy, it only obtains data and information from roundtable participants, not policy advice or recommendations. It is Advocacy itself that develops policy recommendations, it told us, based on information it obtains at roundtables and elsewhere and using its own judgment and expertise. Even if advice and recommendations were offered at roundtables, however (a small business representative recommending a regulatory policy change based on its impact on small business, for example), in our view, this would not outweigh the other factors indicating that the roundtables are not covered advisory committees.[13]

Conclusions

Advocacy is an "agency" under FACA first because it meets the statutory definition of this term in FACA and the Administrative Procedure Act incorporated by reference: it is an "authority of the Government of the United States, whether or not it is within or subject to review by another agency" and not subject to statutory exemption. In addition, Advocacy has the type of "substantial independent authority" and other indicia of "agency" status that courts interpreting the APA definition have required. However, Advocacy's roundtable groups are not FACA "advisory committees" because they do not have an organized or fixed structure; there is no attempt to reach consensus about an agency regulation or policy but instead viewpoints are sought from individual participants; and it is only data and information, according to Advocacy, rather than advice or policy recommendations, that participants provide.

[13]Because we conclude that Advocacy's roundtables are not FACA advisory committees for the reasons discussed here, we did not determine whether the additional FACA element was met of the roundtables being "established or utilized by" Advocacy 5 U S C App. II, § 3(2)

Appendix IV: GAO Contact and Staff Acknowledgments

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Staff Acknowledgments	In addition to the contact named above, Kay Kuhlman and Triana McNeil (Assistant Directors), Kristeen McLain (Analyst-in-Charge), Emily Chalmers, William Chatlos, John McGrail, Lauren Nunnally, Roberto Pinero, Jena Sinkfield, Jack Wang, and Carrie Watkins made key contributions to this report.

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DIGITALLY DRIVEN: 2021

U.S. Small Businesses Find a Digital Safety Net for Adaptation, Resilience, and Innovation During COVID-19

Presented by Connected Commerce Council | Google

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Foreword by Jake Ward

American small businesses have been forever changed by COVID-19. Businesses closed, jobs were lost, and far too many communities were badly hurt by a pandemic that caused massive upheaval. But even as small businesses continue their struggle, we can learn from their fight. Their experiences over the past year should be lessons for the future that will help speed communities' recovery and make their futures more sustainable.

This report goes deeper than previous research to understand the real impact of COVID-19 on American small businesses. It identifies what has driven surviving small businesses' success and resiliency: first and foremost, the 'Digital Safety Net' that is built on technology platforms and comprised of affordable and agile digital products and services. This Digital Safety Net has empowered millions of small businesses to shift resources, modify business plans, and continually evolve throughout the pandemic. Furthermore, through tracking the shift in digital tool adoption across the pandemic, it is clear that the gap between small businesses that are digitally driven and those that remain uncertain about the use of these technologies is growing. For those that have realized the value of vertically integrating digital tools into their businesses, and made the decision to invest themselves and their teams in using them, they are now far outpacing those who did not. This represents a serious challenge for policymakers and industry to tackle.

For struggling small business owners, this study highlights how the Digital Safety Net can improve business results and survival rates. For governments, NGOs, and industry, the collective story of those who have persevered, and in some cases even thrived, should inform how we strengthen the 25 million small businesses that will power a fully recovered and more resilient U.S. economy.

Digitally Driven: USA reflects the realities and perspectives of more than 2,000 small businesses, who collectively lead us to three primary findings: First, digital tools are critical for small business resilience. Second, for digitally advanced small businesses, digital tools have allowed them to pivot quickly, maintain more pre-COVID revenue, and hire many more employees. And third, there remain too many obstacles to broad adoption of digital tools by small businesses, particularly due to uncertainty about how to use and understand the value of technology in their business. We must address and solve this challenge.

For small businesses that embrace digital tools, the benefits are clear: greater revenue, stronger customer base, and a significantly improved outlook in an increasingly digital American market. To assist the digitally uncertain, policymakers and business leaders must create solutions, including investments that increase education, training, and small business access to the Digital Safety Net.

The Connected Commerce Council thanks our members for their continued support, along with small businesses across the U.S. for their determination in the face of perilous odds. Finally, I'd like to thank our partners in the production of this report, Google, Greenberg and Catalyst Research.





Jake Ward, President,
Connected Commerce Council

> *"But even as small businesses continue their struggle, we can learn from their fight. Their experiences over the past year should be lessons for the future that will help speed communities' recovery and make their futures more sustainable."*

FACT SHEET - SMBs and the Digital Safety Net

SMBs' use and continuing adoption of Digital Safety Net tools and services varies, due to several factors.

- Digital adoption among small businesses ranges from the digitally advanced (40%, that use a large and diverse number of tools) to the digitally uncertain (24%, that have low adoption rates and remain skeptical of digital tools).
- Nearly all (97%) digitally advanced small businesses adopted new digital tools and business strategies during the pandemic, while only half (51%) of digitally uncertain businesses did.
- Many SMBs are cautious about Digital Safety Net tools due to concerns about cost, ROI, regulatory risk and their own digital knowledge/ comfort, but digitally advanced SMBs overcome these concerns while digitally uncertain SMBs do not.

Digitally advanced small businesses have better revenue and hire more people.

- Digital adoption cut revenue losses by more than half (-12% for digitally advanced SMBs vs. -23% for digitally uncertain SMBs)
- Digitally advanced small businesses doubled hiring at a rate of 2X more employees on average vs. digitally uncertain SMBs.

Digitally advanced small businesses vastly outperform digitally uncertain small businesses on key success metrics and are well positioned to press their advantage into the future.

- Digitally advanced businesses retained customers at a 3.2X better rate and acquired new customers at a 20X better rate during the pandemic.
- Digitally advanced small businesses are more than twice as confident about making new hires in 2021 (88% vs. 36% of digitally uncertain).

While advanced small businesses furthered their use of digital tools, uncertain businesses have fallen further behind them in relative terms, creating a widening 'digital gap' among U.S. small businesses.

- Digitally advanced small businesses are over 3X more likely to state that digital tools are more helpful for running their businesses now vs. pre-pandemic.
- This gap between 'advanced' and 'uncertain' small business leaders has widened 22% in the last eight months, from 34% to 56%. Put differently, 8 months ago there was only a 2X difference between the groups, compared to over 3X now.
- There were also widening gaps (8-13% more in the last 8 months) for a number of more specific metrics, such as use of more digital tools, investment in digital tools, and plans to use more digital tools post-pandemic.
- Our data indirectly suggests that roughly 5% of non-advanced SMBs, or approximately 1.5 million companies, closed in the last 8 months.

FACT SHEET - Additional Findings

COVID-19 has pressured SMBs to adapt to a new normal by using and innovating with digital tools.

- 81% of SMBs report changing their business to incorporate new digital tools and strategies due to COVID.
- 98% of small businesses say digital tools are helpful in running their business, with 59% of small businesses saying they have been more helpful during the pandemic.
- 93% of small businesses report that they intend to maintain or increase their use of digital tools post-COVID.
- 81% of small businesses cite future preparedness as a top concern, with 89% of digitally advanced vs. 65% of digitally uncertain small businesses desiring to become more resilient.
- SMBs demonstrate an overwhelming preference for private companies (63%) when it comes to sources of digital tool training.
- Approximately 11 million small businesses (37%) would have closed all or part of their business without access to digital tools.

Across various measures of business success, the smallest businesses of under 20 people struggled the most during COVID-19.

- Solo SMBs (single owner/operator) (-22%) and Micro SMBs (1-19 people) (-23%) saw greater reductions in revenue than Small (20-249) (-13%) or Medium (250-499) (-9%) SMBs.
- Solo SMBs (-18.1%) and Micro SMBs (-16.8%) saw roughly 3X greater reductions in their pre-pandemic customer base during 2020 than Small (-5.8%) or Medium (-4.7%) SMBs.
- Solo SMBs (-20%) and Micro SMBs (-16.5%) saw roughly 5X greater reductions in their pre-pandemic new customer acquisition during 2020 than Small (-3.3%) or Medium (-3.7%) SMBs.

Older SMB leaders and female-led SMBs saw worse revenue declines than younger and male peers.

- SMBs led by women and older (>45) people saw more reduction in revenue compared to male or younger counterparts (younger men, -10%; younger women -17%; older men, -19%; older women, -25%).
- Young (<45) White male-led SMBs on average only saw a -1% decrease in revenue, far better than any other sub-group.

While SMBs led by People of Color saw worse revenue compared to White peers, they have also leaned into the use of digital tools more to help with recovery.

- Asian-led SMBs saw the greatest reduction in revenue (-27%), followed by Hispanic/Latinx (-24%), Black (-19%), and White-led (-15%) SMBs. (Overall average -17%)
- On average, POC-led SMBs are more likely (Black 68%, Asian 67%, Hispanic/Latinx 65%) to find digital tools helpful to their business than White-run SMBs (56%).
- Recovery from COVID-19 remains the top priority of POC-led businesses (52% vs. 38% White-led), while White-led businesses are focused more on business growth (47% vs. 41% POC-led).
- 94% of Asian-run SMBs made some kind of digital change in response to COVID since July (vs. 81% avg.), and a majority increased their investments in technology and digital tools (58% vs. 41% avg.)

A Brief Guide To the Research Findings Presented In This Report

→ A Note on Methodology

The results presented here are based on a quantitative research survey of 2,037 U.S. small and medium-sized business (SMB) leaders across a variety of business sizes and industries conducted from Feb 17–Mar 11, 2021. It is important to note that in order to be included in the study, SMBs had to be in business at the time of the research (i.e., operational); thus, businesses that closed during the pandemic prior to Feb. 17, 2021 were not surveyed.

SMBs are defined as businesses of 0–500 employees. Of the 2,037 SMBs surveyed, 377 (27%) were Solo SMBs without employees, 658 (23%) were Micro SMBs with 1-19 employees, 688 (40%) were Small SMBs with 20-249 employees, and 314 (10%) were Medium SMBs with 249-500 employees.

The survey was conducted by LRWGreenberg, a Material+ Company. Data were weighted by vertical, market, and business size for an accurate representation of SMBs as distributed by the number of people they employ.

The work presented in this report is a continuation of a large-scale global study of SMBs and their use of digital tools during the COVID-19 pandemic sponsored by the Connected Commerce Council (3C) and Google.

More detailed information can be found in the Methodology section of this report.

→ Terminology

SMB – Small and medium-sized enterprises are small businesses with fewer than 500 employees. The vast majority of SMBs have fewer than 20 employees and many are "Solo," with just an owner/operator who does everything.

Digital Tools – Digital tools are the platforms, services, marketplaces, and other software that power the digital world. For simplicity, we refer to all of these as "digital tools."

Business sizes – SMBs can be further classified into four business size groupings: Solo (0 employees), Micro (1-19), Small (20-249), Medium (250-500). We investigated whether and how SMBs of different sizes were affected differently by COVID-19 and/or used digital tools differently.

Digital Segments/Groups – Our analysis identified different groups of SMBs defined by their attitudes toward, and use of, digital tools. "Advanced" SMBs view digital tools as essential and use many of them, while "Uncertain" SMBs are the opposite. A third group, "Evolving" SMBs, are essentially in a transition between the two. These groups are further defined in the main report.

Digital Safety Net – The Digital Safety Net describes the positive financial and operational effects that digital tools have on SMBs, particularly to adapt, survive, and recover from economic or societal shocks.

Executive Summary

Digital Tools Create a Safety Net For American Businesses

In many cases, the pandemic's disruption has been lessened by a Digital Safety Net that has enabled adaptation, innovation, and resilience.

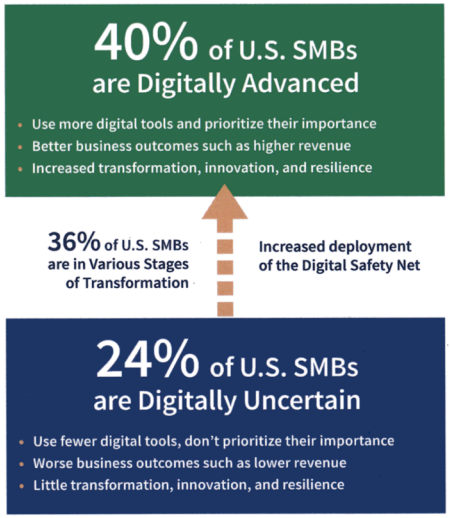
This report is the second major publication from our long-term study of small and medium-sized businesses (SMBs) of 1-500 people in the U.S. The first, based on data collected in Summer 2020, established that in the early months of the pandemic, SMBs were using digital tools to stay afloat, and those using them more estimated that their businesses would do relatively better in 2020 than their less-digital peer SMBs.

Here, we present new data and updated analysis that not only proves these 2020 estimated effects were real, but that the positive effects of a Digital Safety Net have continued throughout the pandemic to the present day. Moreover, digitally-driven SMBs have become even more so during the past year. In turn, they have seen less revenue loss, have maintained and grown their customer base, and in many cases hired people, too. The Digital Safety Net has literally been a small business lifeline.

That said, we also observed a troubling trend: about one-quarter of SMBs are struggling to overcome a "digital inertia" and have not only failed to become more digitally-inclined during the pandemic, but on average they have become somewhat less so. We also found indirect evidence that they are failing and closing during the pandemic more than digitally-driven SMBs. Put bluntly: SMBs not embracing digital tools increase their risk of going out of business permanently.

As the pandemic (hopefully) winds down, small business owners of all kinds will need to work within a post-COVID "new normal" fueled by digital tools - services, platforms, and marketplaces - that power efficiency, growth, and financial security for their businesses and families. While a small subset of SMBs can persist with analog business practices, most of them cannot over time, whether they realize it yet or not. Thus, a detailed understanding of how digital tools impacted and transformed small businesses during the economic disruption of the pandemic, as laid out in this report, provides a framework for future action.

Explaining the SMB Digital Safety Net



Digital Tools Create a Safety Net For American Businesses

The Digital Safety Net helped SMBs show better revenue performance, customer engagement, and job creation during the pandemic.

While all SMBs were disrupted by the pandemic, some adapted, stabilized, and even thrived much more than others. What we term Digitally Advanced SMBs (40% of the total) - those which proactively used digital tools and emphasized their importance pre-pandemic - outperformed Digitally Uncertain SMB counterparts (24%) on operational and financial metrics.

Digitally-driven SMBs outperformed others across a range of operational and financial metrics. Entering the pandemic, Advanced SMBs were better digitally prepared, utilizing 3.3X digital tools than less-advanced SMBs (13 kinds of tools vs. 4), on average. They also excelled at utilizing certain types of tools, such as enabling e-commerce on their business website, that appeared to confer particular advantage entering the pandemic (see main report). When compared to their Uncertain SMB counterparts, Advanced SMBs showed significantly better sales, revenue, customer retention, ability to attract new customers, and job creation.

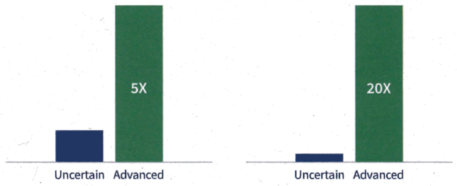
SMBs run by solo owner/operators realized major benefits from the Digital Safety Net. An important subgroup of SMBs which are typically at higher risk of failure as SMB owners - solo owner/operators or "Solo SMBs" - particularly benefited from the Digital Safety Net, with Advanced SMBs in that group seeing 12% (or 2X) better revenue outcomes than Uncertain SMBs. Solo SMBs - which make up a large proportion of all SMBs in the U.S. - demonstrate proper use of digital tools can compensate for other disadvantages.

Advanced SMBs using more digital tools for their businesses had better outcomes vs. their less-advanced counterparts:



better revenue outcomes

more new employees hired



better retention of existing customers

better acquisition of new customers

Digital Tools Create a Safety Net For American Businesses

Embracing and utilizing the Digital Safety Net will yield benefits for entrepreneurs, consumers, and economies beyond the current pandemic.

The ability for SMBs to adapt, survive, and recover from disruptions large and small, and bolster their competitive advantage during good times, is both valuable to them and benefits the broader economy. SMBs which do not, however, remain more vulnerable to disruptions and are more at risk of closing. For millions of SMBs not yet digitally-driven, that status is within reach with the right mindset, digital strategy, access to world-class digital tools and innovation, and training.

The digital transformation and success of the approximately 30 million total SMBs in the U.S. today is ultimately beneficial for consumers, individual countries, and the continent as a whole. Of these, roughly 18M are either Evolving or Uncertain SMBs, so there is considerable room for further transformation. And because we know that Advanced SMBs on average have better sales, revenue, customer retention and growth, and hire more employees, the continued evolution of America's SMBs will ultimately result in economic growth at the local and national level, translating into millions of dollars and thousands of jobs.

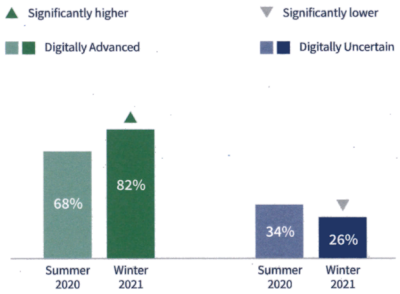
Unfortunately, millions of Uncertain SMBs are at risk of permanently falling behind. Since our previous survey in Summer 2020, on average they have made little progress toward being more digitally driven. By one metric, whether digital tools are more helpful in running their businesses, the gap between Advanced and Uncertain SMB leaders has grown from 34% last summer to 56% now - a 22% increase in just 8 months. There are numerous other indicators described in the main report.

Uncertain SMB leaders find themselves at a "Digital Crossroads" in which many of them know about digital tools, have tried them, and want to learn more about them, but have major concerns about cost, return on investment, their knowledge base, and that the tools ultimately won't help their businesses in the end. This report contains a number of recommendations for policymakers and technology companies that can help support the America's most vulnerable small businesses.

The digital gap between Advanced and Uncertain SMBs has grown over the last 8 months:

34%	56%	+22%
in Summer 2020	in Feb-Mar 2021	gap increase

Digital Tools Are More Helpful Running My Business Now vs. Pre-Pandemic



Digital Tools Create a Safety Net For American Businesses

SMB leaders should be empowered to access, understand, and use digital tools to maximize the sustainability of their businesses and the total SMB economic impact.

Those SMBs taking full advantage of the Digital Safety Net realized decidedly better business results. For those who didn't, on average they saw worse results financially and operationally. But a subset of those saw something even worse: total business failure.

By comparing the profiles of SMBs surveyed last summer and now, we can infer that 5% of SMBs - approximately 1.5 million businesses - that were not digitally advanced closed during the last 8 months. This dramatic metric demonstrates that not only does using tools confer financial and operational advantages, but also that not using digital tools, or not using them well enough, is a risk factor for SMB failure.

We know that digital tools improve economic outcomes overall, as well as financial and operational outcomes for SMBs. Both technology companies and policymakers therefore have a responsibility to ensure that SMBs have access to digital tools, understand their value for business strategy, and can easily train their employees to use them properly. We are living in a 'new normal' and SMBs are never going back to operating in a less digitally-driven world. In this new world, digitally-driven business is just business as usual. But key stakeholders have to make sure everyone can get to that place.

All stakeholders need to do their part to ensure that SMBs are aware of, have access to, and can operationalize digital tools. In particular, a key goal of economic and small business policy must be to convert "digitally uncertain" SMBs into "digitally advanced" ones, which requires helping them overcome doubts about their own knowledge, cost and return on investment, and regulatory risk (e.g., data privacy and protection).

Policymakers should act to maximize the resilience of the SMB community across the U.S., with particular attention to sole owner/operators (i.e., SMBs with just one person) plus POC and women entrepreneurs. Meanwhile, technology companies should help SMB leaders to understand the value of different types of digital tools they offer and how those tools can fit into a holistic business strategy. They should also make efforts to empower SMB leaders, many of whom are first-time entrepreneurs and treat them as important partners and stakeholders (vs. customers).

1.5M

loss of 'digitally uncertain' SMBs in the last 8 months

Top Recommendations To Enhance the Digital Safety Net for SMBs in the U.S.

→ For Policymakers

Access to capital and infrastructure: Governments can play a role as a financial safety net for self-employed citizens and entrepreneurs during tough economic times. If SMBs lack the basics, including secure and sustainable digital infrastructure, innovation becomes impossible. Create and make available grants, loans, public-private partnerships, or other programs to support the smallest plus POC- and women-led SMBs which tend to face more disadvantages than other SMBs.

Access to training: Support inclusive access to training for SMB leaders and employees at all levels of digital experience, mindful that entrepreneurs are incredibly diverse (nation, age, gender, race, and ability) and may take different paths toward becoming digital citizens. Such free platform-agnostic training should help SMBs understand and measure their return on investment. This is particularly important for early-stage entrepreneurs and digital novices.

→ For Tech Companies

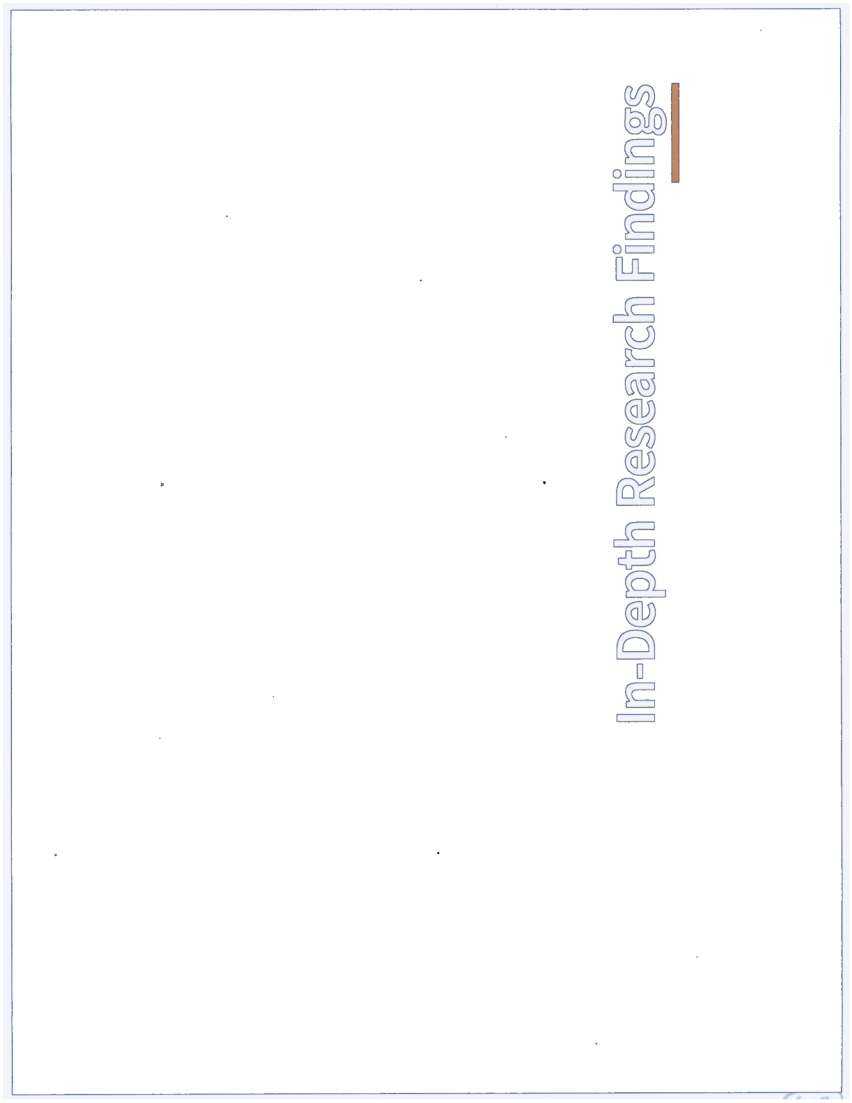
Access to tools: Companies can support SMB leaders by helping them understand which digital tools make sense for their business, how to make the most of free tools, and how to ensure success and measure return on their investment. They should also continue investing in research and development to create new low-cost tools for SMBs. Companies should identify new ways to engage SMB leaders - especially new entrepreneurs and those running tiny businesses - to grow awareness of the value of both free and paid digital tools, identify the right tools for SMB needs, how tools support a business strategy, and provide personalized tool recommendations.

Access to training: Companies should offer inclusive training on digital tools, both at the introductory and advanced levels. Such training should include how different companies' tools work together as part of a comprehensive digital strategy. Training should be specifically tailored for SMB owners, managers, and employees, with particular focus on the smallest and newest SMBs.

→ For SMB Leaders

Access to tools: This is a perfect opportunity for all SMB leaders to reset, pivot, and think big in order to evolve their businesses to match the digital expectations of a post-pandemic world. They should aspire to be skilled digital professionals - learning, experimenting with, and implementing digital tools as a part of their strategy. SMB leaders should identify gaps and opportunities within digital strategies, toolsets, and skills, based on their business's unique needs, and invest time in learning about tools before investing significant capital in them.

Access to training: SMB leaders, particularly new ones and those which are solo-run or POC- and women-led, should seek out educational opportunities - or empower a digital lead in the business that should lead efforts to do so - about digital business advantages, and should also learn about important regulations such as data privacy. Owners, managers, and employees should learn about the advantages and risks of digital tools, and be trained to maximize the advantages and manage compliance risk.


In-Depth Research Findings


INSTANT
PEACE
COLLECTIV
SUMMER
TIME
APYRUS
CHARMS

Introduction

The Effects of the COVID-19 Pandemic on U.S. SMBs

How the Pandemic Operationally and Financially Disrupted American SMBs

By any measure, the pandemic broadly disrupted SMBs throughout the U.S.

General health concerns, government-imposed lockdowns and restrictions, changes in consumer behavior and preferences, and a shift to more online commerce were all contributing factors to the disruption of American SMBs. 87% of the SMBs we surveyed reported being disrupted by the pandemic in some way. And while the situation has improved since the beginning of of the pandemic, 36% of SMBs reported reduced hours, 21% reported supply chain problems, and 17% had to lay off employees.

This report only includes data from currently active SMBs, and not those which were temporarily or permanently closed. But even among SMBs that have stayed in business in the year since the pandemic began, the effects have been felt - many have closed physical locations, reduced their hours and services, and in many cases changed their offerings and even entire business models. These disruptions and changes had financial implications for SMBs. Compared to pre-pandemic figures, SMBs saw an average 17% decrease in revenue for the year.

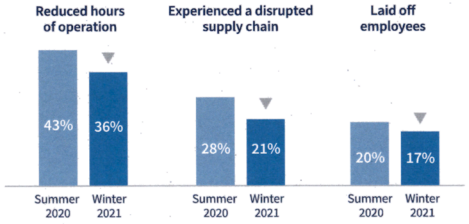
Larger SMBs fared better than the smallest ones. "Micro" SMBs with fewer than 20 employees saw their revenue drop over twice as much as the largest SMBs with 250-500 employees. And while Small and Medium SMBs tapped into public and private loans at somewhat higher rates, Solo and Micro SMBs - more likely to be run by a personally-invested owner/operator - relied on loans much less and tapped into their leaders' personal savings far more in order to access working capital to stay afloat.



87%
Disrupted by COVID-19
(vs. 93% 6 months ago)

How have the COVID-19 crisis and resulting restrictions affected your business?

▼ Significantly lower than other wave



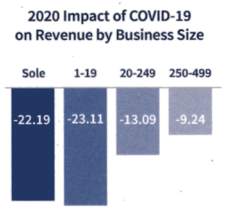
How the Pandemic Operationally and Financially Disrupted American SMBs

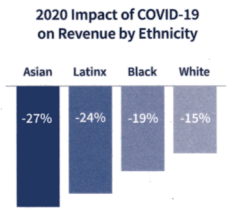
The COVID-19 pandemic especially disrupted the smallest SMBs, those with fewer than 20 employees and particularly solo owner/operator businesses.

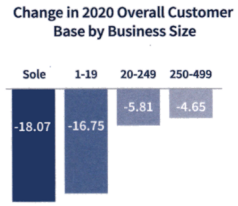
While generally all SMBs were negatively affected by the pandemic, by segmenting our data by business size, it is clear that the smallest small businesses have suffered the most, on average.

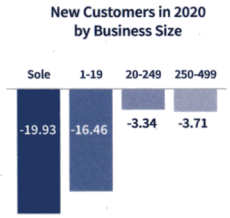
SMBs under 20 employees saw 2020 revenue reductions of 22-23%, which is over twice the reduction of larger SMBs with 250-500 employees. This is logical, as larger businesses tend to have more resources, products, and the like making it easier for them to withstand a crisis, but it illustrates the tough position of the smallest businesses during the pandemic. We measured similar effects of business size on the ability to maintain current customers and acquire new customers. In particular, Solo SMBs saw 18% and 20% reductions, respectively, 4-5X worse than the largest SMBs.

Finally, SMB leaders of different races also report a spectrum of revenue reductions, with Asians faring worst (-27%), nearly twice as bad as White-led SMBs. While we were not able, due to sample limitations, to perform a complete Ethnicity x Business Size x Revenue analysis, no doubt tiny businesses run by people of certain ethnicities have been hit especially hard.









How the Pandemic Operationally and Financially Disrupted American SMBs

The smallest SMBs also had more difficulty accessing working capital for their businesses.

Access to capital, whether through incoming revenue or other sources, is the lifeblood of small businesses - without it, nothing else is possible. We asked SMB leaders about working capital and how they were able to obtain it. While slightly less than half of SMBs of all sizes reported being able to use incoming revenue, we noted other disparities across business size.

Smaller SMBs, and particularly Solo SMBs, did not obtain either public (e.g., PPP) or private loans at very high rates in general, or in comparison to larger SMBs. (We note that PPP loans were not immediately available to solo owner/operators earlier in the pandemic, but are now.)

In addition, a full 37% of Solo SMBs tapped into personal savings (presumably of the owner or co-owner) in order to access working capital for the business. This also happened across all business sizes to some extent, but the amount for Solo SMBs was about three times what it was for the largest SMBs of 250-500 people. No doubt this is because smaller businesses are more directly intertwined with their owners' personal finances and lives, whereas larger businesses are more likely to have more revenue and savings and a more formalized leadership structure.

We also note that in general, Asian- (54%) and Black-run SMBs (49%) had a harder time finding financial resources compared to White-run SMBs (41%). This again is a situation that only exacerbates more general challenges all SMBs face during the pandemic.

Sources of SMB Capital During the Pandemic – Overall and By Business Size

	Winter 2021				Overall average
	Sole	1-19	20-249	250-499	
My business' savings	26%	39%	38%	31%	34%
My personal savings	37%	26%	20%	12%	25%
Loans	19%	41%	53%	60%	42%
Public loans	13%	32%	39%	39%	30%
Private loans	8%	15%	24%	35%	18%

Part 1

Emergence and Establishment of the Digital Safety Net in the U.S.

U.S. SMBs Cluster By Their Perception and Use of Digital Tools For Business

The story of the Digital Safety Net is about how SMBs have been using digital tools for resilience, efficiency, and sustainability during the pandemic.

But this story has relevance beyond that, for future challenges large and small, and for competitive advantage during normal times. Based on how SMBs characterized the pre-pandemic importance of digital tools to their business operations, and their actual use of digital tools entering the pandemic, we classified them into three categories.

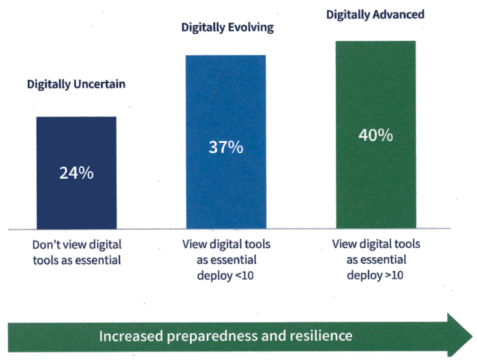
Digitally Advanced viewed tools as supporting or essential for their business and were already using 10+ of them (average of 12) entering the pandemic. Advanced SMBs are approximately 40% of the total.

Digitally Evolving mostly viewed tools as supporting or essential for their business, but were deploying <10 of them (average of 6) entering the pandemic. A smaller number actually used 10+ tools, but did not view them as important. Overall, these businesses recognize the importance of digital tools to a degree, but they aren't part of a strategy. Evolving SMBs make up approximately 37% of the total.

Digitally Uncertain viewed tools as having little to no importance prior to the pandemic, and were using few of them (average of 5). Uncertain SMBs make up approximately 24% of the total.

Contrasting the most divergent SMBs with regard to digital tools (i.e., Advanced vs. Uncertain) is informative and simple; thus, much of the analysis in this report utilizes this framework. However, our results are clearly applicable to the many Evolving SMBs that are in a transitional state.

SMBs fall into three categories based on their pre-pandemic perception and use of digital tools



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A Digital Safety Net Helped SMBs Operationally and Financially During the Pandemic

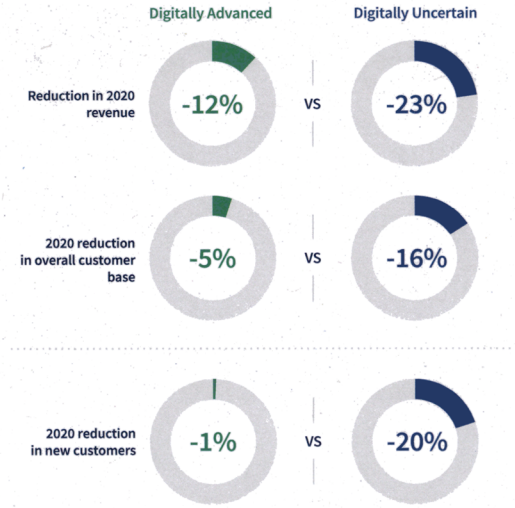
The most important thing to understand about the Digital Safety Net is whether and how digital tools have made an operational and financial impact on the SMBs who deploy them.

There are three types of metrics for this: (1) more sales and revenue; (2) better ability to retain customers and find new ones; and (3) job creation. Though both digitally Advanced SMBs and Uncertain SMBs saw general setbacks due to the pandemic, digitally Advanced SMBs excelled relative to Uncertain SMBs.

Working Capital: Financial metrics were down for SMBs during the pandemic. That said, Advanced SMBs reported 1.9X better revenue outcomes (-12 vs. -23%) and 2X better sales outcomes (-11 vs. -22%) than Uncertain SMBs. (We note that in this report we will use revenue as the standard Digital Safety Net metric.)

Customer Engagement: Advanced SMBs were both 3.2X more successful at retaining customers (-5 vs. -16%), and a remarkable 20X better at obtaining new customers (-1 vs. -20%).

Job Creation: Advanced SMBs were twice as likely (2X) to have hired any new employees (10% vs. 5%) and when they did, they hired 5X as many employees as Uncertain SMBs during the pandemic (1.93 vs. 0.38). Advanced SMBs are also 2.4X as likely as Uncertain SMBs to plan to make new hires in 2021 (88% vs. 36%). (Note that this metric by definition excludes SMBs run by a sole owner/operator.)



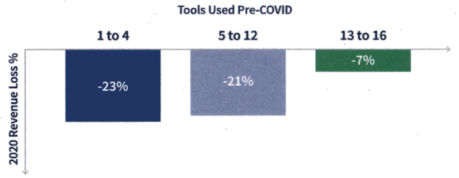
SMBs Entering the Pandemic Using E-commerce Experienced Better Financial Outcomes

If SMBs that use more digital tools perform better operationally and financially, exactly which kinds of digital tools are important?

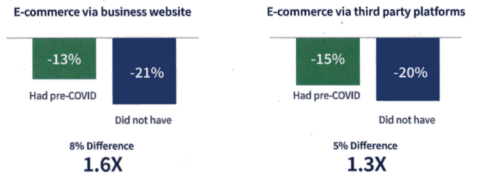
The main difference between Advanced SMBs and both Evolving and Uncertain ones is the number of digital tools used, where Advanced SMBs use at least 10 and the others <10. In a separate analysis (not shown) we discovered that by looking at the number of tools alone, SMBs using <13 digital tools show revenue reduction of over 20%, whereas those using 13-16 kinds of tools show revenue loss of only 7%. (We measured 16 categories of tools. See following page.)

First, because e-commerce is an obvious way to drive revenue, we investigated whether it was an important driver of competitive advantage during the pandemic. We found that both e-commerce on a SMB's website and conducted via third party platforms conferred advantage during the pandemic.

Relationship Between Number of Digital Tools and Pandemic Revenue



Relationship Between Pre-Pandemic E-Commerce and Pandemic Revenue (Revenue Loss %)



SMBs Utilizing Digital Tools in Combination Pre-Pandemic Had Better Financial Outcomes

E-commerce via SMB business websites was an important driver of competitive advantage during the pandemic - but not the only one - so we looked to other categories of digital tools.

In total, our survey asked SMB leaders about 16 categories of digital tools, hypothesizing that some combination of these account for revenue differences between Advanced and Uncertain SMBs.

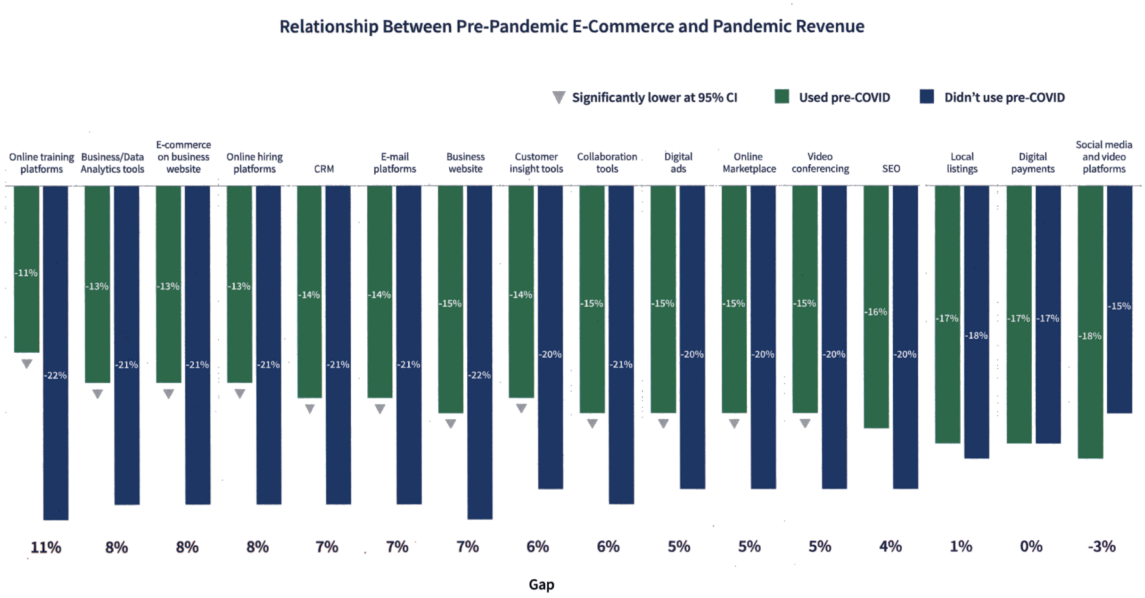
Indeed, this analysis found that, besides digital tools underlying website e-commerce, SMBs using 10 additional kinds of tools entering the pandemic realized a 5-11% positive difference in revenue outcomes than those not using those tools. Interestingly, the digital tools conveying the most advantage to Advanced SMBs fit into three groups mainly related to creating extra value through optimizing digital and business assets:

- **Talent:** Hiring, training, and collaborating with people
- **Analytics:** Gathering insights, measuring success, and optimizing
- **Selling:** E-commerce sales via SMB websites

Generally, we can conclude that, when the pandemic began, SMBs already utilizing some or all of these types of digital tools had created a competitive advantage in a more challenging market, and probably pulled ahead of competitors who initially spent significant time researching, training on, and implementing such tools.



SMBs Utilizing Digital Tools in Combination Pre-Pandemic Had Better Financial Outcomes



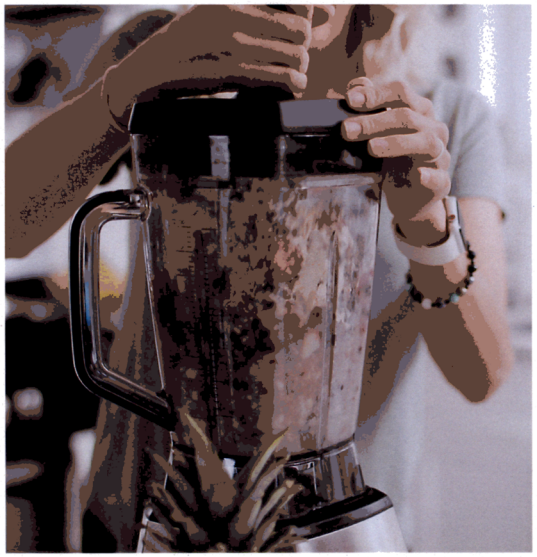
SMBs Utilizing Particular Digital Tools Pre-Pandemic Had Better Financial Outcomes

Advanced SMBs generally used digital tools more, and saw better outcomes - but is that because they used particular tools conferring competitive advantage more?

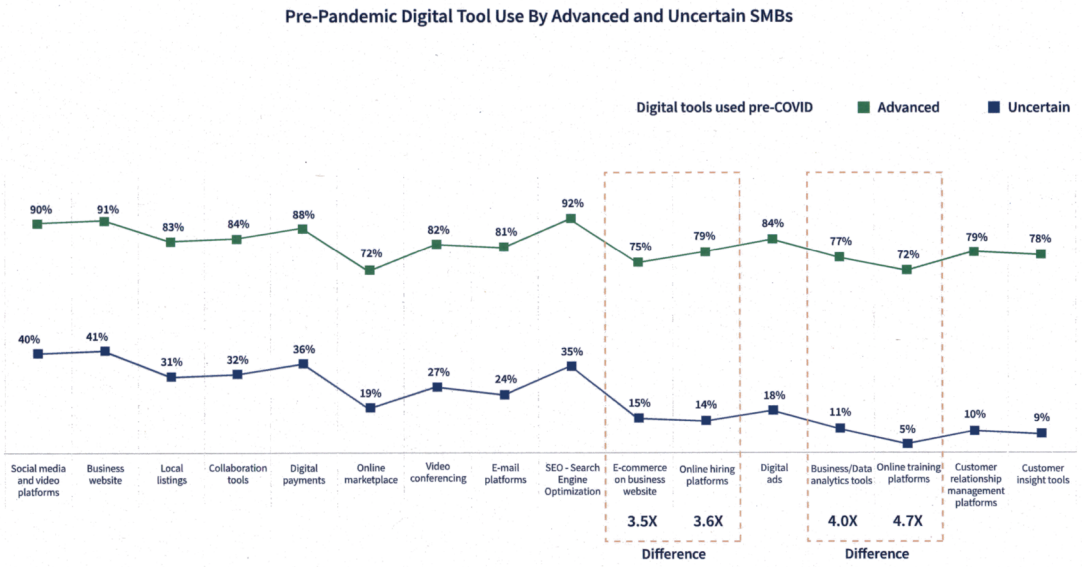
Advanced SMBs were using about twice as many digital tools as Uncertain SMBs prior to the pandemic, but that analysis assumes all tools are essentially alike. Since it appears that they are not, we investigated the differences between Advanced and Uncertain SMBs tool by tool.

First, not surprisingly, Advanced SMBs were using every type of digital tool we asked about more than their Uncertain counterparts. Further, the differences are substantial, ranging from 2.25X (using social media and video platforms) to 8.7X (using customer insights tools). Not one category of digital tool was used by a majority of Uncertain SMBs prior to the pandemic.

Second, and more importantly, Advanced SMBs excelled at using the digital tools that confer the most advantage. For the categories of digital tools that conferred the very most revenue advantage (see orange asterisks on graph), Advanced SMBs were using them 5-14X as much as Uncertain ones. This means that there is not only a digital divide, but by using the most valuable tools such as online training platforms, business/data analytics tools, and website e-commerce more, Advanced SMBs create a positive feedback loop that gives them greater advantage over time.



SMBs Utilizing Particular Digital Tools Pre-Pandemic Had Better Financial Outcomes



Part 2

The New Normal and Growing Divide of Digitally-Driven SMBs

Digitally-Driven SMBs Are Adapting Faster To the Uncertainty Generated By the Pandemic

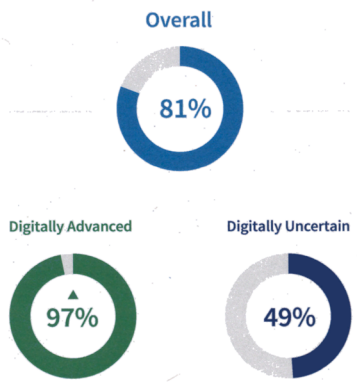
While, in the aggregate, most businesses adapted digitally during COVID, Digitally Advanced businesses did so at double the rate of Digitally Uncertain ones.

Advanced and Uncertain SMBs, by definition, began the pandemic with different digital tool use and prioritization. However, once the pandemic began, Uncertain SMBs could have more highly prioritized digital tools and evolved faster to catch up to their more digital peers. However, this does not appear to have occurred based on a number of metrics presented on the following pages.

We start with a generic metric. By looking at an aggregate measure of possible "digital changes" SMBs could have made in their businesses, we found that 81% of SMBs overall made at least one change since the start of the pandemic. By itself, this number is a remarkable barometer of the digital evolution of SMBs in the U.S during the past year or so.

However, when comparing the Advanced and Uncertain groups of SMBs, we found a wide disparity between them. Nearly all (97%) of Advanced SMBs have made digital changes to their businesses since the start of the pandemic (16% above the average), whereas only half (49%) of Uncertain SMBs have. In other words, about twice as many Advanced SMBs as Uncertain ones have digitally evolved since the pandemic began.

SMBs That Made Digital Changes in Response to COVID-19



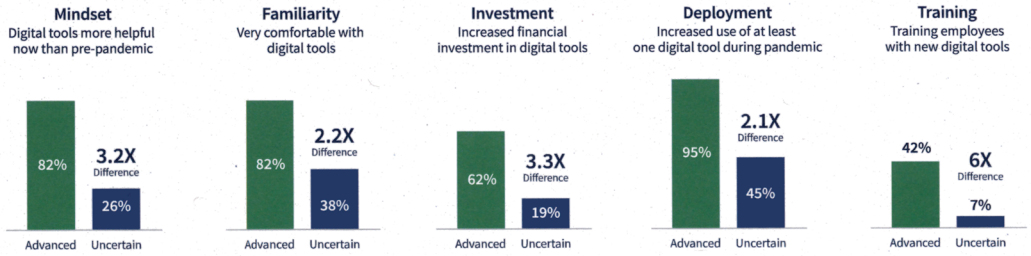
Digitally-Driven SMBs Are Adapting the Pandemic's Uncertainty By Every Metric

Pre-pandemic digital tool use is a strong indicator of SMB success - but how has SMB digital tool use evolved during the pandemic?

A significant gap exists between groups of SMBs in both pre-pandemic digital preparedness and their success during the pandemic. However, we also know that the pandemic was a shock that forced SMBs to change many aspects of their businesses. Have they changed their attitudes or priorities about or use of digital tools?

Overall, the broad majority of SMBs made digital changes during the pandemic, demonstrating the broad application and value of digital tools. Underlying this are three possibilities: Advanced and Uncertain SMBs have increased their use at the same rate; Uncertain SMBs are closing the gap; Advanced SMBs are increasing the divide. Here we show that Uncertain SMBs have not closed the gap, and that Advanced SMBs accelerated the digital divide between the groups.

Higher Pre-Pandemic Digital Tool Usage Is Correlated With 'Digital Acceleration' During the Pandemic



Digitally-Driven SMBs Are Adapting the Pandemic's Uncertainty By Every Metric

Mindset: Advanced SMBs are more than three times as likely to describe digital tools as being more helpful to their businesses now than pre-pandemic.

Familiarity: Advanced SMBs are more than twice as likely to describe themselves as very comfortable with digital tools.

Investment: Advanced SMBs are more than three times as likely to have increased their investment in both digital tools and employee training.

Deployment: Advanced SMBs are 2.1X more likely to have increased their use of at least one digital tool during the pandemic. Virtually all (95%) of Advanced SMBs increased their use of at least one kind of tool, in fact.

Training: Advanced SMBs are 6X more likely to be interested in training their employees with new digital tools. Almost no (7%) of Uncertain SMB leaders feel this way.



SMBs Are Generally Optimistic About the Future, With Digitally-Driven Ones Leading the Way

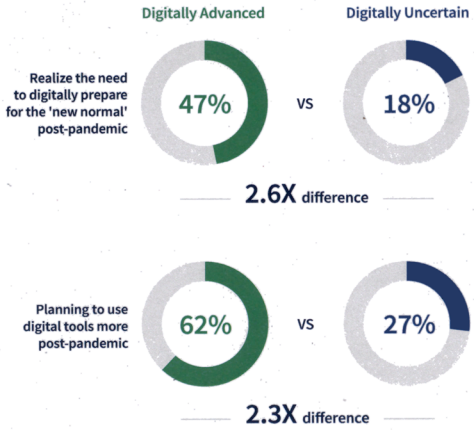
96% of SMB leaders believe their business will fully recover from the effects of the pandemic after it ends, with 74% believing that will be within one year and 51% within six months.

We took a deeper look at forward-leaning indicators of SMB digital tool use to understand their confidence. In addition to already doing better up until now, we found that Advanced SMBs are more optimistic about, and are planning better for, a digitally-driven future.

Mindset: Advanced SMBs are 2.6X as likely as Uncertain ones to have realized the need to digitally prepare their business for a 'new normal' post-pandemic. Only 18% of Uncertain SMBs are preparing for a more digitally-driven business future.

Deployment: Advanced SMBs are 2.3X more likely to report that they are planning to use digital tools more post-pandemic.

Higher Pre-Pandemic Digital Tool Usage Is Correlated With Planned Post-Pandemic 'Digital Acceleration'



The Digital Gap Between Advanced and Uncertain SMBs Appears To Be Widening

The digital gap between Advanced and Uncertain SMBs has widened in the 8 months since summer 2020.

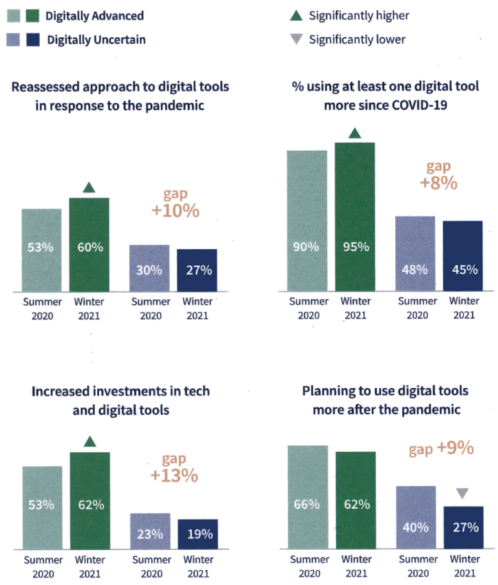
By comparing our first survey data collected May 28-July 3, 2020 (Survey 1) with this updated survey conducted from Feb 17-Mar 11, 2021 (Survey 2), we can look for significant differences within SMB digital segments over time, which in turn can indicate whether Advanced and Uncertain SMBs are becoming more similar or more different during the pandemic. We found they are becoming more different - a negative trendline heading into a more digitally-driven world.

Approach to digital tools: Since Summer 2020, roughly 7% more Advanced SMBs have reassessed their approach to digital tools, a significant increase. And while not statistically significant, Uncertain SMBs have slightly lower levels (-3%).

Using more digital tools: While 90% of Advanced SMBs were already using at least one more digital tool between the start of the pandemic and last summer, an even higher percentage (95%) are now - a significant difference. While not statistically significant, fewer Uncertain SMBs reported using at least one new digital tool than they did last year (-3%).

Increased investment in digital tools: Since last summer, 9% more Advanced SMBs have increased their financial investment in digital tools. The percentage of Uncertain SMBs who did so decreased by 4%. This is a major increase in the gap that may have taken longer to manifest due to the more serious nature of making purchases versus just experimenting.

Planning to use more digital tools post-pandemic: Here we see the opposite pattern, where Advanced SMBs have slightly lower but not significantly lower levels (-4%) but Uncertain SMBs are significantly lower, with 13% less reporting this than last summer, which may indicate that they are discouraged or choosing not to adopt digital tools.



The Digital Gap Between Advanced and Uncertain SMBs Appears To Be Widening

The digital gap between Advanced and Uncertain SMBs has widened in the 8 months since summer 2020.

Digital tools help run my business: Since Summer 2020, the gap between Advanced and Uncertain SMBs for measuring whether they believe digital tools have been more helpful post- vs. pre-pandemic has significantly widened, with +14% Advanced and -8% Uncertain feeling that digital tools are more helpful during the pandemic than before it. This already sizable gap increased from 35% to 56% in only 8 months.

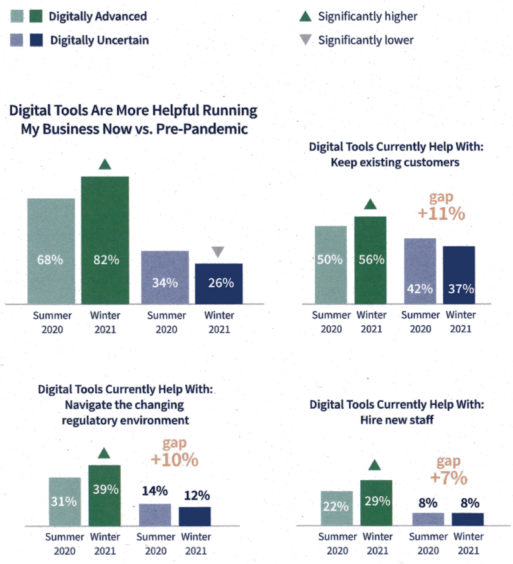
Digital tools help my business retain customers: The percentage of Advanced SMBs who feel digital tools help retain customers significantly increased 6%, while Uncertain fell 5%.

Digital tools help my business navigate regulations: Here, the percentage of Advanced SMBs who feel that digital tools help navigate a changing regulatory environment significantly increased 8%, while Uncertain levels fell 2%.

Digital tools help my business hire new staff: Finally, 7% more Advanced SMBs reported that they view digital tools as helpful for hiring new employees, but Uncertain SMBs stayed at the same level.

Uncertain SMB leaders are at risk of falling permanently behind in a New Normal and find themselves at a "Digital Crossroads" in which many of them know about digital tools, have tried them, and want to learn more about them, but have major concerns about cost, return on investment, their knowledge base, and that the tools ultimately won't help their businesses in the end.

This gap has widened 22% (from 34% to 56%) in just 8 months:



SMBs Have Concerns About Digital Tools, and Want To Learn More About Them

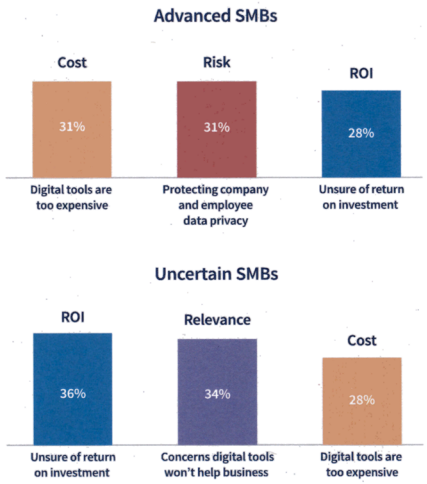
Since many SMBs are not fully digitally prepared and are still learning about and adopting new tools, we investigated what common impediments prevent them from using digital tools more in their businesses.

One year into the pandemic, most SMBs know, or have begun to realize, that the future of business is digitally-driven, and they are already learning about and deploying new digital tools against their highest business priorities: connecting with customers (70% overall average); sustaining business operations (52%); understanding customer behavior (51%); navigating regulations (50%); financial resources/access to capital (44%); and managing digital tools (41%).

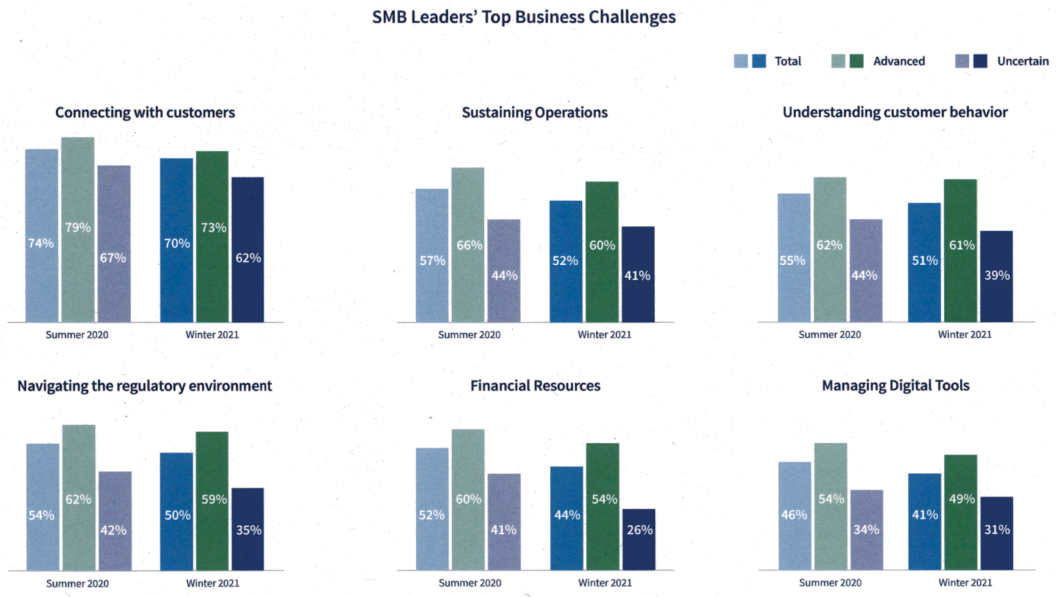
While digital tools can help with all of these objectives, SMB leaders also have numerous concerns about them: they are unsure of return on investment (31%); worried about the cost (30%); concerned that digital tools won't help their business (25%); think they lack skills and knowledge (23%); and concerned about protecting employee/customer data privacy (22%). The concerns of Advanced and Uncertain SMBs somewhat differ. Interestingly, Advanced SMBs have cost and privacy as higher priorities, perhaps as they deal with more sophisticated tools and more customer data. Uncertain SMBs are more concerned about the return on investment and whether digital tools will actually help their business.

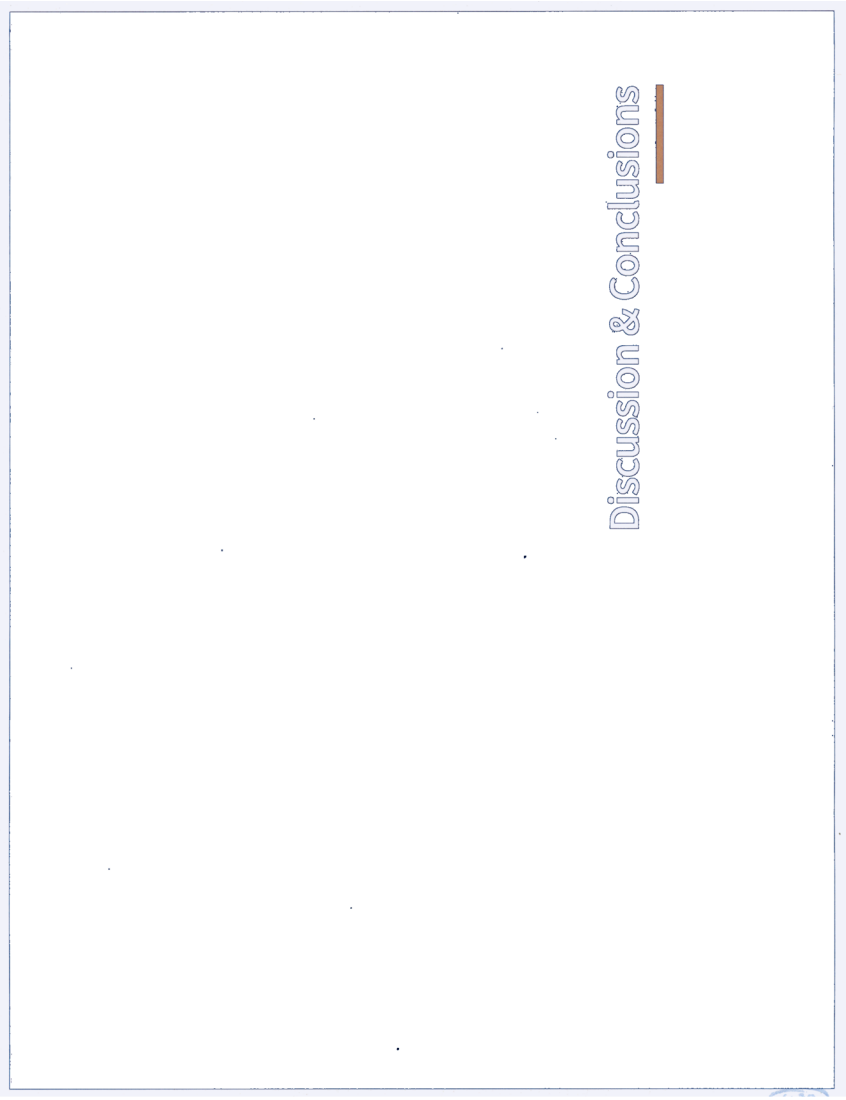
Importantly, a majority (61%) of all SMB leaders are interested to learn more about digital tools for their business; and 69% of SMB leaders reported that digital tool literacy is important for new hires (for some job functions like IT and marketing, that figure is even higher). For such training, SMB leaders prefer step-by-step video tutorials (35% of SMBs); 1:1 consultations (32%); case studies (30%); webinars/livestreams (30%); and, when available, in-person classes (30%).

SMB Leaders' Top Concerns About Digital Tools



SMBs Have Concerns About Digital Tools, and Want To Learn More About Them




Discussion & Conclusions

During the Past Year, Digital Transformation Became Digital Urgency For SMBs

Everyone is now living in the "New Normal" - we are simply not going back to a less-digital world.

During the early stage of the pandemic in 2020, society realized a decade's worth of digital transformation. The urgency for everyone to innovate and transform is real, and practically required for future success. Those SMB leaders who have not already begun to rethink everything they do need to start now, including:

- Hiring, training, and collaborating with employees
- Finding, connecting with, and understanding customers
- Selling products and services, and creating new ones
- Analyzing business data and measuring results

As described in this report, a suite of digital tools can help SMBs with all of the above and more. Success for SMBs can now be defined as:

SMB Success = Agility + Efficiency + Digitally Driven Revenue

The business value of digital tools changes in different environments. During times of crisis, digital tools act as a Digital Safety Net for SMBs. They can keep employees in touch, help find new customers, sell products in different ways, and so on. During normal business times, digital tools act as a 'bridge' to fill gaps that SMBs may have. And in competitive situations, smarter deployment of digital tools can multiply efforts and make an SMB more agile, more efficient, and better able to compete for talent, customers, and sales.

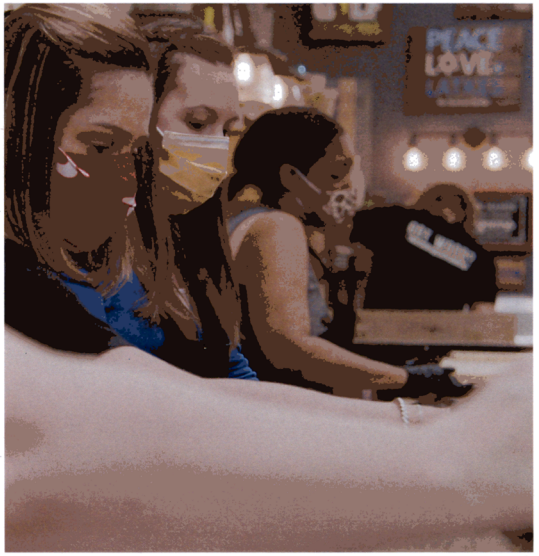


Widespread SMB Access To Digital Tools Enables Transformation, Innovation, and Resilience

While there is more to be learned about how specific digital tools help to drive SMB competitive advantage, one thing is clear - access to world-class digital tools clearly provided a Digital Safety Net for small businesses throughout the U.S.

Equally, a reduction in access to digital tools in a digitally-driven global economy would decrease SMB revenue, job creation, and overall transformation and innovation, which would in turn have cumulative effects on national economies. We also found evidence that a large number of SMBs using digital tools less or inefficiently went out of business since last summer. Policies that inhibit SMB access to digital tools would have clearly have negative consequences.

More importantly, however, policymakers should cultivate a regulatory environment that nurtures SMB access to world-class digital tools and transformation and creates a higher level of digital innovation in the economy to foster competition, increase small business growth, and enhance the wide-ranging benefits to consumers not just in the U.S., but across the global economy.



Closing the Growing Digital Divide Between 'Advanced' and 'Uncertain' SMBs

A major conclusion of this research is that the gap between Advanced and Uncertain SMBs is largely attributable to a lack of "digital optimization" in the business.

What is the actual cause of the digital divide between Advanced and Uncertain SMBs? While we cannot fully answer this question, we suggest an interpretation rooted in our findings.

Uncertain SMBs are aware of digital tools - they used an average of five of them even before the pandemic, and during the pandemic their digital tool use increased. They have also thought through various challenges or risks of using them, such as the cost and return on investment. Finally, many SMB leaders say they would like to learn more about digital tools. They face a Digital Crossroads of sorts in which they are delaying a major decision about whether to make their businesses more digitally driven.

Related to this, Advanced SMBs appear to excel at optimization - that is, using certain kinds of digital tools to optimize their use of other tools and their business as a whole. For example, implementing e-commerce tools on a business website makes the website itself more valuable for driving revenue. Using data analytics to understand paid ad spend makes the ads more cost-effective for attracting new customers to a business website. Together, this has an exponential impact on a SMB.

Policies, plans, and programs to assist SMBs who lag in this regard should have a particular focus on solving for this SMB digital gap. What Advanced SMBs appear to excel at, and where other SMBs need help the most, is making the strategic decision to aggressively innovate and adapt to an increasingly digitally-driven world.



Closing the SMB Digital Divide Would Have Broadly Positive Economic Implications

The digital transformation and success of the approximately 30 million SMBs across the U.S. is, ultimately, success for consumers, workers, and the country as a whole.

Based on our research findings and government data on SMBs, there are approximately 12 million Advanced, 11.1 million Evolving, and 7.2 million Uncertain SMBs in the U.S. right now. For the millions of SMBs who are not yet digitally-driven, that status is within reach for them with the right mindset, digital strategy, access to digital tools, training, and hard work.

Because there are roughly 18 million SMBs we have classified as either Evolving or Uncertain, there is considerable room for further transformation. And because we know that Advanced SMBs on average have better sales, revenue, customer retention and growth, and hire more employees, the continued evolution of America's SMBs will ultimately result in economic growth at the local and national level, translating into millions of dollars and thousands of jobs.



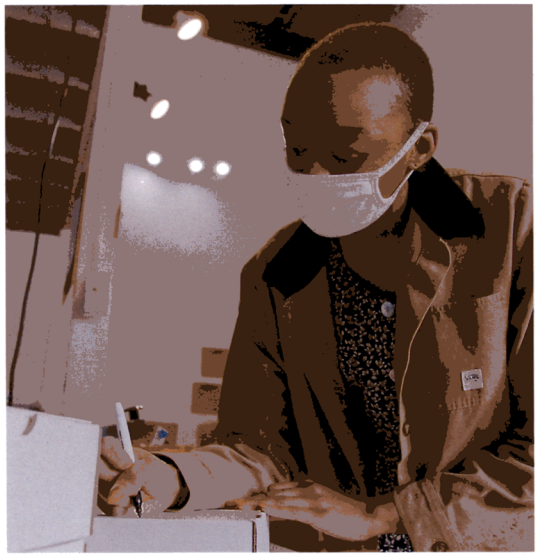
How the SMB Community in the U.S. Moves Forward From the COVID-19 Pandemic

The pandemic has been an economic and societal shock to not only SMBs in the U.S. but to everyone around the world. Ultimately, the lessons learned from the research presented in this report at the intersection of digital tools and small business will be useful for future shocks as well.

American SMBs have been, and to some degree still are, devastated by the effects of the pandemic. While there is a patchwork of regulations state-by-state and even at the city level, at the time of publication many places still have restrictions in place that inhibit business operations. It is also important to remember that the research detailed in this report was conducted only with SMBs which were operational at the time (and willing and able to participate). It is important not to forget how many SMBs have permanently and temporarily closed as well as those who are on their last dollar, customer, or employee and not sure what the future holds for them.

Despite everything, many SMBs will bounce back from the effects of the pandemic, in one form or another, some by utilizing the Digital Safety Net we've explored in this report. In fact, a majority of SMB leaders were optimistic that they would be back to normal business within a year. And other entrepreneurs knocked down by the pandemic will start a new business in the future. They all can take the findings and recommendations in this report and use them in practical ways.

To achieve the vision of a digitally transformed and more resilient U.S., technology companies, policymakers, and SMB leaders must focus on eliminating barriers and creating systems that support greater digital adoption. Through better education, increased access and funding and financial incentives, the public and private sectors can help small businesses recover faster, while increasing the reach and effectiveness of the Digitally Safety Net in the future.



Methodology, References, & Acknowledgements

Methodology

→ Research Survey Approach

The results presented here are based on a quantitative research survey of 2,037 U.S. small and medium-sized business (SMB) leaders across a variety of business sizes and industries conducted from Feb 17–Mar 11, 2021. It is important to note that in order to be included in the study, SMBs had to be in business at the time of the research (i.e., operational); thus, businesses that closed during the pandemic were not included in our work.

SMBs are defined as businesses of 0–500 employees. Of the 2,037 SMBs surveyed, 377 (27%) were Solo SMBs without employees, 658 (23%) were Micro SMBs with 1-19 employees, 688 (40%) were Small SMBs with 20-249 employees, and 314 (10%) were Medium SMBs with 249-500 employees.

The survey was conducted by LRWGreenberg, a Material+ Company. Data were weighted by vertical, market, and business size for an accurate representation of SMBs as distributed by the number of people they employ.

The work presented in this report is a continuation of a large-scale global study of SMBs and their use of digital tools during the COVID-19 pandemic sponsored by the Connected Commerce Council (3C) and Google. In 2020, they published their initial *Digitally Empowered* and *Digitally Driven* reports with early results from the United States. In 2021, they published *Digitally Driven: Europe*, with comparable results from 28 countries across Europe.

→ Terminology Used In This Report

SMB – Small and Mid-size Enterprises are small businesses with less than 250 employees. Many SMBs have less than 10 employees and many are "Solo," with just an owner/founder who does everything. For comparative purposes, note that this is typically called "SMB" (small and medium sized businesses) in the U.S. to include those with 1-500 people.

Digital Tools – Digital tools are the platforms, services, and other software that power the digital world. For simplicity, we refer to all of these as "digital tools" in this report.

Business sizes – SMBs can be further classified into four business size groupings: Solo (0 employees), Micro (1-19), Small (20-249), Medium (250-500). We investigated whether and how SMBs of different sizes were affected differently by COVID-19 and/or used digital tools differently.

Digital Segments/Groups – Our analysis identified different groups of SMBs defined by their attitudes toward, and use of, digital tools. "Advanced" SMBs view digital tools as essential and use many of them, while "Uncertain" SMBs are the opposite. Another group, "Evolving" SMBs, are essentially in a transition between the two. These groups are further defined in the main report.

Digital Safety Net – The Digital Safety Net describes the positive financial and operational effects that digital tools have on SMBs, particularly to adapt, survive, and recover from economic or societal shocks.

Methodology

→ Correlation vs. Causation

The results presented in this report, and additional results not shown here, demonstrate a clear statistical relationship between greater use of digital tools (the "Digital Safety Net") and better business outcomes for SMBs. This alone does not prove a causal link (as distinct from an experimental design, which would have randomly assigned digital preparation levels to then compare business outcomes). However, the correlations observed here, along with SMB's own self-reports about the particular importance and helpfulness of digital tools during the pandemic, strongly suggest that digital tools played an important role in these businesses' resilience.

→ Industry Breakdown

Our U.S.-wide sample contains SMBs from industries as follows:

- Services (21%)
- Healthcare (19%)
- Retail (12%)
- Manufacturing (11%)
- Food Service (11%)
- Other (11%)
- Travel (8%)
- Arts, Entertainment, Education, Recreation (7%)

Acknowledgements

→ Thank you to those involved in the creation of this report.

The **Connected Commerce Council (3C)** is a non-profit membership organization with a single goal: to promote small businesses' access to essential digital technologies and tools. 3C provides small businesses with access to the market's most effective digital tools available, provides coaching to optimize growth and efficiency, and works to cultivate a policy environment that considers and respects the interests of today's small businesses.

Learn more at connectedcouncil.org/about/



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March 8, 2022

Chairwoman Nydia Velázquez
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515

Dear Members of the Committee on Small Business,

Engine is a non-profit technology policy, research, and advocacy organization that bridges the gap between policy makers and startups. Engine works with government and a community of thousands of high-technology, growth-oriented startups across the nation to support the development of technology entrepreneurship through economic research, policy analysis, and advocacy on local and national issues. We accordingly appreciate the committee's attention to the issues impacting competitiveness in the startup ecosystem and are grateful for the opportunity to provide feedback on those issues.

For startups, all policy is competition policy. This is reflected in the range of issues raised in members' questioning of witnesses—not merely regarding the role of mergers and acquisitions, but inflation, regulation, intellectual property, talent and hiring, and access to capital. Policy responses to each of these issues must be tailored and must heed the unique perspective of startups. This is particularly true for competition and antitrust issues, which are often considered with only the largest firms in mind.[1]

Engine works with startups located in virtually every congressional district, across nearly every industry, with a variety of business models, and antitrust is rarely, if ever, raised at all, and never as a primary concern. In our internal surveys, startups consistently rank access to capital and access to talent as the top issues they encounter. This is echoed in the testimony of Dr. Holtz-Eakin and comments of members alike.[2] In the survey of small businesses conducted by the National Federation of Independent Businesses that Dr. Holtz-Eakin cites in his testimony, myriad issues,

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[1] *Evaluating Competition Proposals with the Startup Perspective,* Engine, (Jun. 17, 2021), https://www.engine.is/news/category/evaluating-competition-proposals-through-the-startup-perspective.

[2] *See Competition and the Small Business Landscape: Fair Competition and a Level Playing Field: Hearing before the Committee on Small Business,* 117th Congress (2022) (Testimony of Douglas Holtz-Eakin), https://smallbusiness.house.gov/uploadedfiles/03-01-22_dr._holtz-eakin_testimony.pdf; *and see also, e.g., Competition and the Small Business Landscape: Fair Competition and a Level Playing Field: Hearing before the Committee on Small Business,* 117th Congress (2022) (Remarks of Rep. Young Kim), *https://docs.house.gov/Committee/Calendar/ByEvent.aspx?EventID=114436*.

including labor/talent issues, regulation, and inflation, rate high as the most important issue facing their business.[3] Competition from large businesses (0%) is at the bottom of the list.[4]

The treatment of mergers and acquisitions are implicated in startups concerns around capital access. There is a strong, positive relationship between acquisitions and startup investment.[5] Opportunities for successful exits are necessary to promote the flow of capital in the startup ecosystem, and for founders to get the resources they need to succeed. There are, of course, legitimate and important reasons for merger enforcement. However, public policy barriers to successful exits, including exit via acquisition, must be minimized such that deterring illegal anti-competitive conduct does not unduly and unintentionally harm startups.

To view the consequences of getting this balance wrong, one only need consider the other method of successful exit—becoming a public company—and the regulatory framework around it, the Sarbanes-Oxley Act, and its consequences. Sarbanes-Oxley was legislated in response to a series of high-profile accounting scandals. While no member of Congress (or the public) is or was in favor of corporate fraud, several did warn of the consequences of burdening capital formation for small companies like startups. Then-Representative Jeff Flake cautioned against proceeding without knowing "what cost we're going to impose, particularly on small businesses."[6] Senators Gramm and Bond respectively voiced concern that the law would "use up the resources" of small companies, and "damag[e] the economic framework for small companies to reach our capital markets."[7] These concerns have borne out. The burdens of being a public company now easily exceed $1 million annually, resulting in fewer companies deciding to go public, and those that do are larger and older.[8]

Today, startup founders are warning Congress to avoid the same mistakes by enacting competition policy that "risks similar unintended consequences."[9] Congress and policymakers across government must endeavor to not unduly burden the ability of startups to undergo exit via acquisition. As the committee engages on these issues of antitrust and competition at the intersection of startups, we are happy to be a resource for the committee, and have attached relevant research to that end.

---

[3] William C. Dunkelberg and Holly Wade, *Small Business Economic Trends Monthly Report,* NFIB, (Jan. 2022) at 18, https://assets.nfib.com/nfibcom/SBET-Jan-2022-Final.pdf

[4] *Id.*

[5] *See The State of the Startup Ecosystem,*Engine (Apr 2021), https://static1.squarespace.com/static/571681753c44d835a440c8b5/t/60819983b7f8be1a2a99972d/1619106194054/The+State+of+the+Startup+Ecosystem.pdf (regarding startup investment, the relationship between and investment, and the implications for policymaking).

[6] *Partial Transcript. Your World with Neil Cavuto*, Fox News (Jul. 30, 2002), https://www.foxnews.com/story/sen-paul-sarbanes-d-md-rep-jeff-flake-r-ariz

[7] *See* 148 Cong Rec. S7353 (2002) (Remarks of Sen Gramm) https://www.congress.gov/crec/2002/07/25/CREC-2002-07-25-pt1-PgS7350-4.pdf, *and id* at S7361 (remarks of Sen Bond).

[8] *See, e.g, Startup Ecosystem, Supra* at note 5, *and, The Cost of Being a Public Company in Light of Sarbanes-Oxley and the Federalization of Corporate Governance: Hearing before the Subcommittee on Investor Protection, Entrepreneurship and Capital Markets* 115th Congress (2017) (Remarks of Chairman Huizenga), https://www.govinfo.gov/content/pkg/CHRG-115hhrg28750/html/CHRG-115hhrg28750.htm

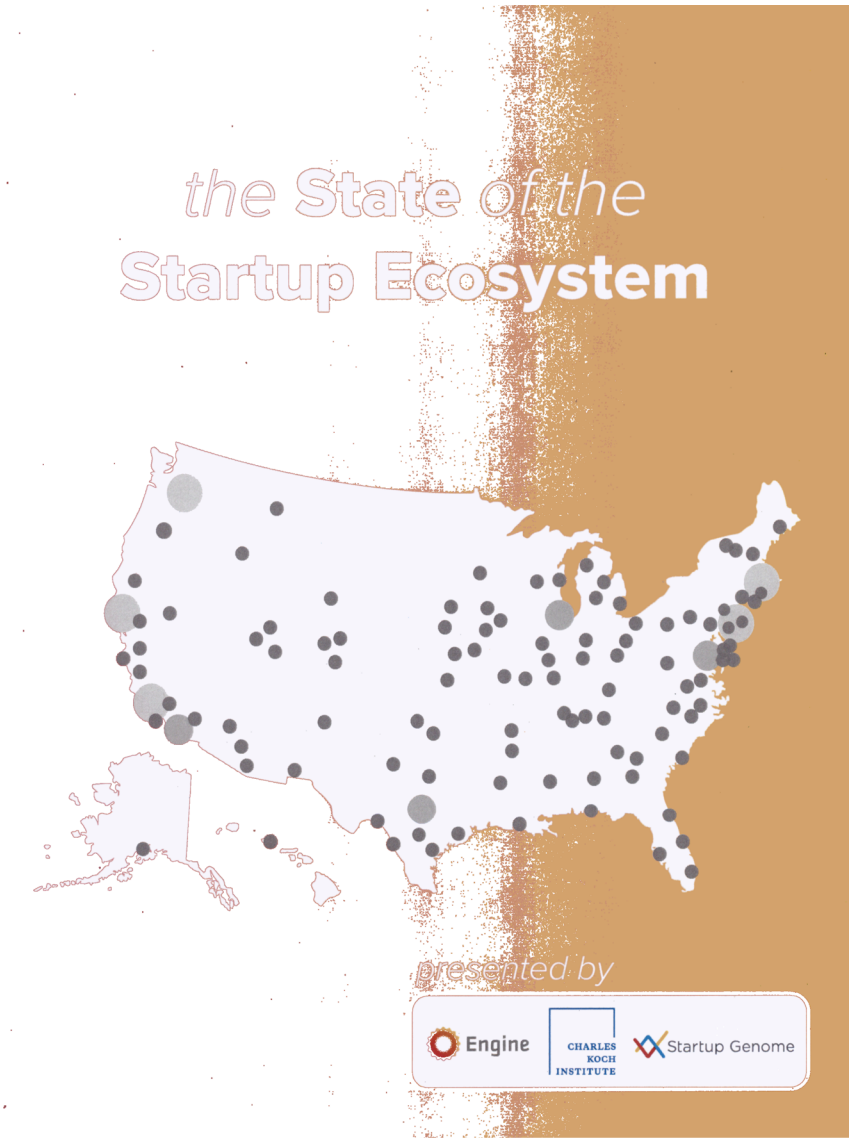
[9] *The Impact of Consolidation and Monopoly Power on American Innovation: Hearing before the Subcommittee on Competition Policy, Antitrust, and Consumer Rights of the Committee on the Judiciary,*117th Congress (2021) (Testimony of Bettina Hein).

***

Engine is grateful for the opportunity to submit feedback to the committee on issues impacting startups, and looks forward to engaging with the committee in the future.

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APPENDIX:


the State of the
Startup Ecosystem
presented by
Engine
CHARLES KOCH INSTITUTE
Startup Genome

Engine

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INTRODUCTION

Startups operate in every state and every congressional district across all sectors of U.S. industry. They are impacted by policymakers' decisions across a range of issues, yet their perspective can be left out or misunderstood by policymakers—especially in debates that center around large tech companies. For example, concerns about the state of competition in the technology sector, debates about intermediary liability frameworks, or conversations about a federal privacy law can often fail to reflect the consequences of policy changes on the startup ecosystem.

Along with listening to startup voices and crafting policy with startups in mind, it is essential that policymakers are able to understand and monitor their impact on startups. Yet the data necessary to understand those impacts is missing. Indeed, there is surprisingly little agreement as to the current health of the startup ecosystem. Advocates and researchers often turn to proxies that are ultimately inadequate in the context of today's active tech policy conversations. Some advocates will cite generic business formation statistics to assess the health of startups, but this overbroad approach captures data about any newly formed business and fails to provide a crisp picture of emerging tech startups. Data highlighting trends in startup financing, growth, and exits are publicly available, but this information has not been compiled and analyzed in ways that help policymakers, researchers, and advocates consider specific questions.

Through this report, Engine seeks to narrow this knowledge gap by providing an empirical survey of the startup landscape to generate a better understanding of the health of U.S. startups and inform a range of public policy debates. The report studies startup health by evaluating trends in startup fundraising across several stages, assessing individual U.S. ecosystems, analyzing startup exits, and contextualizing the capital needs of the average investor-backed startup.

METHODOLOGY

Data presented in the report were provided by Startup Genome, a world-leading innovation policy advisory and research firm. Through partnerships and extensive survey research, Startup Genome has access to a comprehensive picture of the startup ecosystem. The main datasets integrated and consulted for this report include those from Crunchbase, Dealroom, Pitchbook, and Orb Intelligence, in addition to Startup Genome's original research and data from Forbes 2000, GitHub API, International IP Index, Meetup.com, OECD R&D Spending, Salaries Data from Glassdoor, Salary.com and Pay-Scale; Shanghai Rankings; Times Higher Education Rankings; Top 800 R&D Hospitals, Webometrics; USPTO and WIPO; and World Bank Ease of Doing Business. Funding values discussed in this report were provided by Startup Genome in nominal dollars, and they are presented as such. For consistency throughout the report we have not adjusted them. The overall trends in this report are significant compared to the small factor of inflation and do not change dramatically when adjusted. Further, doing so would confuse the discussion of individual years of funding that occurs throughout the report, but especially for the ecosystem highlights, for example. Due to the lag endemic to early-stage funding data, most trends presented in this report end with the year 2018 and present the previous ten to fifteen years. This report, therefore, does not include data that reveals the effects of the COVID-19 pandemic on the startup ecosystem. There are publications available about such effects using early data and estimates that policymakers can consult as they consider their response to the pandemic-related economic crisis. Situating the crisis in broader trends, however, will require years of not yet collected data.

The report assesses startups that are U.S.-based technology and innovation companies founded after 1995. Subsectors for analyses presented in the report were prepared by Startup Genome using the descriptions of the companies, keywords, and keyword combinations before they were run through a quality control process to clean the data. Subsectors are defined where they are discussed but are generally not mutually exclusive nor collectively exhaustive. In other words, a particular startup may be considered in multiple subsectors, while another may not be considered in any subsector discussed in this report. Subsectors that aren't discussed in greater detail in the report are presented in the appendix for policymakers and researchers to independently consider.

While the datasets drawn on for this report may be among the most comprehensive available, they are not without imperfection. For a funding round to be captured here, it must have been reported, which does not occur reliably for every funding round, especially for smaller raises. The natural bias is toward formal and larger funding rounds, which are reported with the goal of showing momentum and driving additional investor interest. Trends for such rounds are explored in this report, including seed and angel, Series A, and venture capital. Definitions can be found in the Glossary section of this report.

Data about the smallest of funding rounds is critical for policy debates, as it is representative of the resources that the most nascent companies have at their disposal, but this data is also the least reliable. For this reason, funding rounds under $125,000 were removed by Startup Genome in their preparation of the seed and angel funding data. Additionally, few startups overall receive venture funding—just .05 percent did in 2013, the middle year in the range considered in this report.[1] Instead, many startups exist outside of these commonly thought of funding networks and rely on other methods of raising capital, like family investment, personal loans, and bootstrapping.[2] It is important to view the data reported here—especially average funding amounts for the seed and angel rounds—with this context in mind. At the same time, we can be very confident that the trends observed are reflective of reality—the number of startup fundings and the total values of those deals have increased meaningfully over the past decade.

In addition to looking at trends in startup investment and exits overall, this report also examines those trends without the top five ecosystems (Silicon Valley, New York City, Boston, Los Angeles, and Seattle) and without the top nine ecosystems (the above plus Washington, D.C., San Diego, Austin, and Chicago) to reveal how startup investment has fared outside of the nation's innovation hotspots. These ecosystem groupings were suggested by Startup Genome based on their proprietary ecosystem lifecycle analysis.[3] This allows policymakers to get a sense of whether startup funding and success is concentrated in a few areas or distributed across the country.

While the analyses included in this report do not seek to provide comprehensive explanations for the trends observed, they can serve as a baseline for public policy analysis and follow-on research. For example, positive trends in startup funding can provide much needed color to policy debates about competition in the startup sector, while average early-stage startup funding amounts can be used to weigh the costs and benefits of potentially onerous regulation, such as repealing current intermediary liability frameworks or dialing back measures meant to promote balance in intellectual property systems.

GLOSSARY

Accelerator
A program that is aimed at speedlining the growth of young, existing startups by providing mentorship, resources, and financial capital. For some accelerator programs, capital is exchanged for equity stake in the startup. These programs can last several months but are usually less time intensive than support provided by incubators.

Incubator
Community spaces that bring together entrepreneurs and professionals from different backgrounds to carry out the ideation process and launch startups. Individuals are provided with networking opportunities, advisors, and other resources. These programs can last for extended periods (a year or more in some cases).

Bootstrapping
The process of funding a startup with personal capital from the founder(s), their families or friends, or with revenue from the company itself.

Exit
Occurs when an investor in a startup liquidates some or all of their shares/ownership in the company. This may come in the form of cash, debt, or equity in another company.

- **Acquisition**
  An event in which a company obtains a majority—if not all—of the assets of another company and is now in primary control.

- **Initial Public Offering (IPO)**
  The first case of selling shares to the public by a previously private company in order to generate capital. After an IPO, a company would no longer be considered a true startup.

- **Merger**
  An agreement between two separate companies to combine together into one entity.

Ecosystem Value
A measure of the economic impact of the ecosystem, calculated as the total exit valuation and startup valuations over a 30-month period.

Runway
Refers to the amount of time a startup can operate before they need to raise additional capital. Often measured in months, runway can be thought of as the amount of time before a startup runs out of money.

GLOSSARY

Seed & Angel
Seed is the earliest round of formal investing, where money is exchanged for equity within the company or convertible debt. It primarily comes from the personal networks of the startup or angel investors, but some venture capital firms will invest at the seed stage as well. Angel investors are individuals or small groups of investors that provide financial capital from their own personal funds. Startup Genome combines all seed, pre-seed, angel, and pre-Series A funding rounds to report as seed/angel funding, and removes those rounds that are less than $125,000.

Series A
A large scale investment round (usually in millions) that occurs after the seed stage of a startup. This financing can come from either venture capital or private equity firms.

Series B+
After a startup has raised its Series A round, the next investment rounds continue with lettered rounds B, C, D, etc. which are usually successively larger. Series B+ referenced in this report refers to all venture capital rounds from Series B onward. Like Series A, this financing can come from either venture capital or private equity firms.

Startup
In this report, a startup is a U.S.-based technology and innovation company founded after 1995.

Startup Ecosystem
A network of individuals, startups, and other community stakeholders that utilize their resources and interact with one another to promote innovation within their region. Startup Genome ranks ecosystems using a number of factors including: performance, funding, market reach, talent, connectedness, and knowledge. This report analyzes trends inside and outside of the nation's top ecosystems to provide a picture of how startups are faring even outside of the top tech hubs, which are listed below.

- Top 5 Ecosystems: Silicon Valley, New York City, Boston, Los Angeles, Seattle
- Top 9 Ecosystems: The above, plus Washington, D.C., San Diego, Austin, Chicago

Venture Capital
A subset of private equity, venture capital is capital pooled together from investors and given to startup companies in exchange for equity within the company. Investors might be high-wealth individuals, foundations, pension funds, endowments, or other institutions, and they are known as limited partners. Their pool of capital constitutes a venture fund, which is managed by the venture capital firm. The general partners at the firm choose the startups to invest in, which are typically technology-based with high-growth potential.

LIFECYCLE OF A STARTUP

No two startup companies follow the same path to launch and grow. This diagram explores what that path might look like for a startup that comes to be funded by traditional venture capital.

IDEATION AND LAUNCH



Every startup begins somewhere, even if not literally in the idyllic garage. As a company is launched, any employees are typically founders or co-founders who may still have other full-time jobs or are paying themselves a minimum wage to reduce costs. Funding at this stage generally comes from bootstrapping, personal savings, friends and family, grants, or accelerator programs, and is generally under $120,000.[4]

BUILD



As a startup builds and validates its product, the founders may expand the team, either by adding co-founders, internal employees, or independent contractors. At an average age of 22 months, startups complete their seed round. The median U.S. seed funding round was $740,000 in 2018.

EARLY-STAGE GROWTH



As a startup takes its product to market and grows its customer base, it will raise another funding round to support these and other goals, like expanding its team—now typically numbering in the tens to hundreds.[5] On average, another 22 months elapses before a startup raises its Series A round. In 2018, the median Series A round was $5 million.

LATE-STAGE GROWTH



By this stage, a startup's product is likely becoming widely used, but additional funds can juice their expansion. Companies raise additional venture rounds as they continue to grow, with Series B and C raises coming an average of another 24 and another 27 months after their previous funding rounds.[6]

MATURITY



A startup is said to reach maturity when it goes through an exit event. While a venture-backed startup can exit at any stage through acquisition—which represented 92.8 percent of all exits in 2018—startups that exited through an initial public offering (IPO) in 2018 were just over seven years old on average, with a standard deviation of five years and three months. In 2018, the average value of an IPO was $1.2 billion.

STATE OF THE AMERICAN STARTUP ECOSYSTEM: TRENDS AND TAKEAWAYS

Key Takeaways

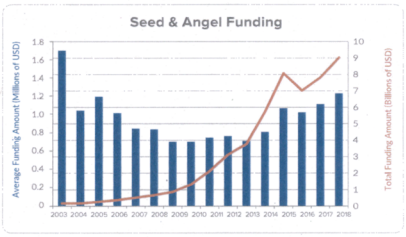
- The startup ecosystem is healthy. Both the number of startup fundings and the value of those fundings have grown meaningfully over the past decade. This positive trend is present across all funding rounds—from seed and angel rounds, to Series A, to venture capital as a whole.
- Acquisitions are a beneficial and necessary part of the startup ecosystem. Investors are able to take profit at this exit and use the proceeds to fund new investment in new startups. This is borne out by the data. There is a strong positive correlation between investment and acquisitions.
- The average seed round was $1.2 million in 2018. While that may seem like a lot of money, it must be viewed with the context of a seed-stage startup. This is often the only money coming into the company for almost a two-year period and must cover everything from personnel to R&D. It is also important to remember that number only includes reported raises from investor-backed startups, which make up a small percentage of startups overall, so not all 22-month-old startups have these resources. Overall, with margins thin, even minor policy changes can have major cost impacts on startups.

Investment

Capital is the lifeblood of startups, the fuel needed to launch and grow. Accordingly, trends in investment can reveal much about the state and health of the startup ecosystem. This section examines trends in startup funding at seed and angel, Series A, and for venture capital overall, both within the nation's top startup ecosystems and outside of them.

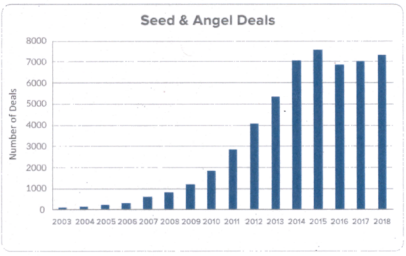
Seed & Angel

By and large, the startup ecosystem has seen more early-stage funding every year for the last fifteen years. Seed and angel funding is generally the first formal investment round in a startup, where investors exchange money for an equity stake in the company. Here, Startup Genome has combined all seed, pre-seed, angel, and pre-Series A funding rounds to report as seed/angel funding, and removed those rounds that are less than $125,000 to prevent noise in the data.



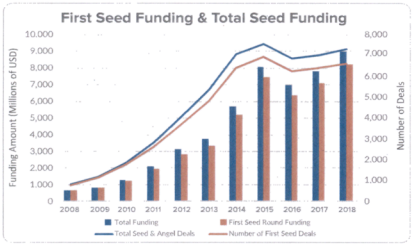
Total seed and angel funding and the number of seed and angel funding rounds have grown consistently over the past 15 years, with the exception of a correction in 2016. That correction is due to a sharp drop in the valuations of software-as-a-service (SaaS) companies in early 2016, and is called the "valuations crisis" in this report.[7] It had ripple effects throughout the startup ecosystem, and the correction is present across all funding rounds examined in this report.

Average funding values dipped during the Great Recession, the worst economic crisis since the 1930s that reached its trough in mid-2009, to around $700,000 in 2009-10.[8] Average funding values have since recovered to over $1 million for the past few years. The year 2003 had a high average funding value, but this is reflective of the very few fundings that occurred that year and a few high-value fundings shifting the numbers rather than reflecting a figure that should be held up as a high-water mark for deal values. When considering average funding values throughout this report, remember that while it is responsive to overall economic factors like recessions, it reflects the amount an average individual startup received, not necessarily the health of the overall ecosystem. Its relative consistency over time more likely reflects that companies receiving funds are of similar ages and valuations, and thus receiving similar funding amounts.



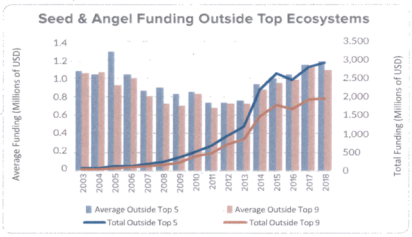
Total Seed and First Seed

The growth in seed and angel funding is likely indicative of a healthy startup ecosystem. Since some companies receive multiple seed rounds, looking deeper at this trend can help evaluate how good a proxy the number of seed and angel investments is for the number of startups earning investment. While more startups have begun to receive multiple seed rounds in the last decade, this isn't representative of most startups. The number of startups raising multiple seed fundings has grown from under 40 in 2008 to nearly 700 in 2018, but has remained small as a percentage of total seed fundings, hovering between eight and nine percent for most of the past decade. The growth in the number of startups receiving multiple seed rounds has contributed to the overall upward trend in both total number of seed fundings and total value of seed fundings. However, because it is a small contributor to that trend, it does not explain the overall growth in seed fundings. Rather, this growth is likely indicative of a healthy startup ecosystem, where more startups are receiving more investment.

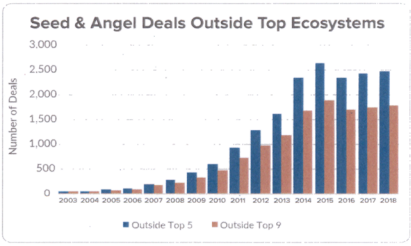


Seed and Angel Funding Across the Country

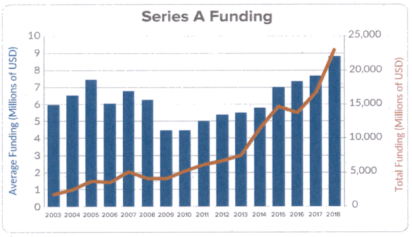
The overall upward trends indicating a healthy and growing startup ecosystem are evident even outside of Silicon Valley and other hotbeds of innovation and startup growth. Seed and angel fundings without the top five (Silicon Valley, New York City, Boston, Los Angeles, and Seattle) and top nine (the top five plus Washington, D.C., San Diego, Austin, and Chicago) ecosystems follow the same broad trends as with seed and angel across all U.S. ecosystems. Total funding trends upward over the fifteen years from 2003 to 2018, with a correction in 2016. Average funding values dip from the Great Recession before recovering. However, unlike nationwide trends, the 2016 correction cannot be seen in average funding values here, while the correction to total funding amounts is predictably less pronounced given lower concentrations of SaaS startups in these regions.



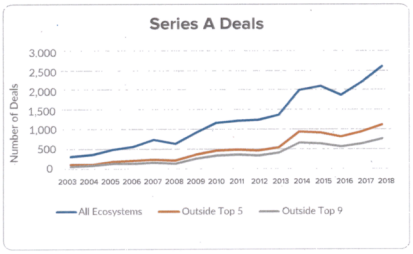
Notably, average funding values with the top five and top nine ecosystems removed do not depart widely from average funding values in all ecosystems. In 2018, the average seed round was just four percent lower when removing the top five ecosystems, and 11.5 percent lower without the top nine. For the year 2018, seed and angel deals outside the top five ecosystems represented a third of overall U.S. deals and a third of their total value. Fundings outside the top nine ecosystems represented about a quarter of overall deals and about 22 percent of their value that year. While this reflects a concentration of higher-value deals within the top ecosystems and the continuing need for geographic diversification of startup investment, it also alleves the notion that startups only receive sufficient funding in these ecosystems. The ability of startups to succeed and receive funding outside of top ecosystems reflects the relevance of startup ecosystems spread across states and congressional districts, and policymakers should consider this finding as they evaluate the startup ecosystem as a whole.



Series A

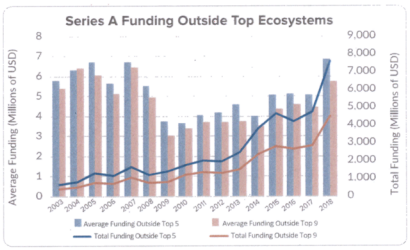


Over the last 15 years, the total amount of money going into Series A funding rounds and the number of Series A deals has increased, demonstrating the availability of investment as startups continue to grow. Series A funding is the earliest stage of venture funding and is typically the next round of funding that startups raise after their seed round. Funding amounts and the number of Series A raises in the U.S. grew significantly over the years 2003 to 2018, with total funding growing almost 1200 percent and the number of deals growing nearly 800 percent during this period. Total funding only failed to grow during 2008 and 2009 as a result of the Great Recession and in 2016 as a result of the market correction that year. Average deal values fell from around $6 million in 2003 to a low of about $4.5 million during the Great Recession years of 2008 and 2009, before growing 97 percent to $8.8 million in the decade since.



Series A Funding Across the Country

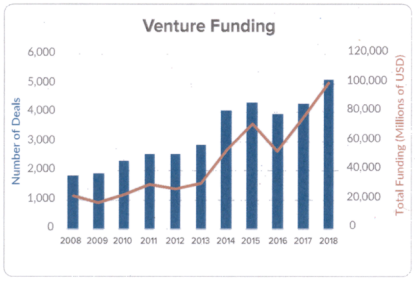
As Series A funding grew over the last fifteen years, more of that growth has started to shift to areas located outside of the largest ecosystems. From 2003 to 2018, the number of Series A fundings grew faster outside of the top ecosystems as those rounds began to comprise a larger share of all Series A deals. The number of Series A rounds outside of the top five ecosystems grew nearly 900 percent, while the number of rounds outside of the top nine grew nearly tenfold. In 2003, the share of Series A fundings outside of the top five ecosystems was 38 percent. That share grew to 43 percent in 2018. For fundings outside the top nine ecosystems, the share of total fundings grew from less than a quarter of all fundings in 2003 to nearly a third in 2018. The increase in deal location diversity over this period reflects an increasing spread in venture capital investment across the country and less centralization of investment in areas like Silicon Valley. There is still much room for improvement though, as VC investment is still concentrated in top ecosystems.



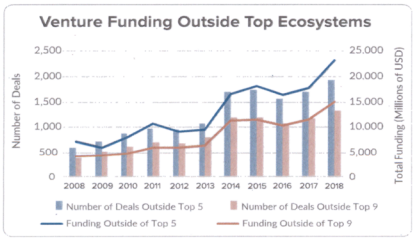
Without the top five and top nine ecosystems, Series A total funding values follow the same trend as funding in all ecosystems and show impressive growth, with total values in each growing more than tenfold over the fifteen years presented. Similar to the overall trend for Series A, average funding values dropped sharply outside of the top five and top nine ecosystems during the Great Recession, but only eclipsed their 2003 values by 18 and 7 percent respectively in 2018, despite each growing nearly 90 percent from their recession-era troughs.

The peaks and valleys within a limited range for average values should not be alarming. While impacted by overall economic conditions, like the Great Recession, an average funding value reflects what a typical funding round was in an individual company—which is responsive to factors like company age and valuation. Because company age at investment does not change widely over this period, we shouldn't expect their valuation or capital needs to depart widely either. That is to say, startups of the same age are getting similar amounts of money.

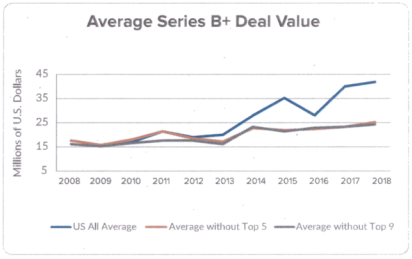
Venture



While the trends examined above of seed and angel and Series A rounds create a picture of early-stage investment in startups, it is also important to consider venture funding overall when assessing the health of the startup ecosystem. Venture funding presented here includes Series A and the lettered rounds beyond Series A—Series B, C, D, and so on. Venture funding overall grew significantly over the past decade, more than tripling, even outside of the top ecosystems. In addition to the correction visible in 2016, venture deals and deal values sagged in 2012 and 2013—something that is present but less pronounced in the Series A data examined above—as hangover effects of the Great Recession. It took longer for the later funding rounds added in here to recover than the early funding rounds. Series B and C rounds didn't recover past their pre-crisis levels until 2013 and 2014 respectively, making the sag more present here than in the above trends in early funding data.[9]

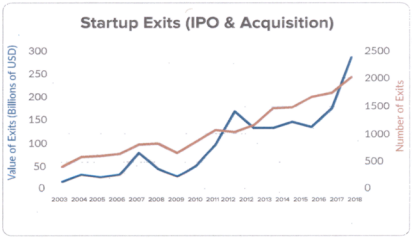


Consistent with what is observed with Series A, average deal values for venture capital investment overall show meaningful growth countrywide, while average values outside of the top ecosystems struggled to recover from the Great Recession in the same manner. Even though we see that the share of venture deals occurring outside of the top ecosystems crept up over the past decade, the departure in average deal value highlights the continued concentration of the largest-value deals in the nation's largest startup ecosystems. By removing Series A funding, we can see clearer that the largest rounds are more prevalent and rising in the largest ecosystems. This growth is driven by the global reach of the top ecosystems.

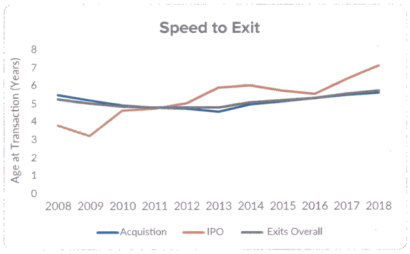


Exits

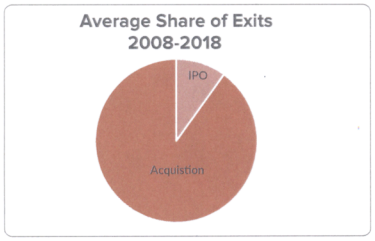
Exits are an important moment in the lifecycle of a startup and an integral part of the innovation ecosystem. Startup founders are focused on putting one foot in front of the other as they grow their businesses, but they think about long-term goals too, including their exit strategy, or how they make money for themselves and their investors. In a 2019 survey, for example, 50 percent of startup executives listed acquisition as a long-term goal, while 18 percent said initial public offering (IPO) was their long term goal.[9] This section explores startup exits over the past decade, trends in the two principal types of exits, and their relationship with startup funding.



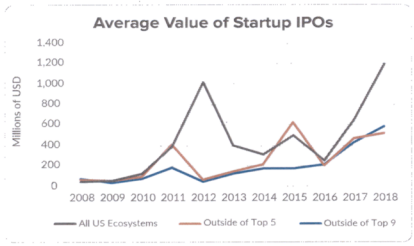
Overall, startup exits have increased in number and value by 383 percent and 1847 percent respectively from 2003 to 2018, evincing the growth in the amount of successful and maturing startups. Familiar troughs experienced during the Great Recession and valuations crisis that we observe in the funding trends section above are also present here.



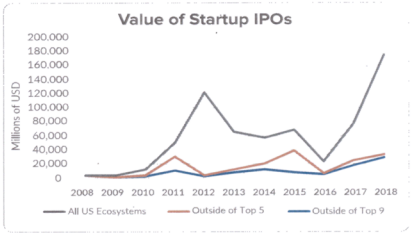
The speed to exit—the average age at which a startup is acquired or goes public through an IPO—has remained relatively steady over the past decade, ticking up slightly from five years and three months to five years and eight months. The standard deviation from the average speed to exit is relatively large—around three years for acquisitions and four years for IPOs, meaning there is quite a bit of variance from that average. The speed to exit overall tracks very closely with the average age at which companies are acquired—the speed to exit via acquisitions—reflecting the greater number of exits through acquisition than through IPO. In fact, over the eleven years from 2008 to 2018, 90 percent of startup exits were via acquisition.

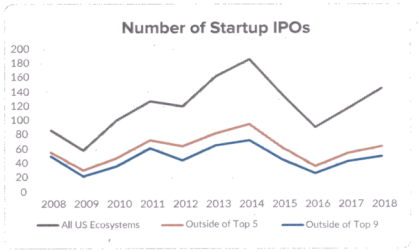


IPO



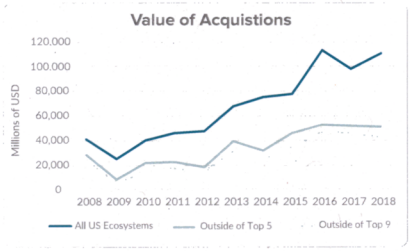
Coupling the fact that there are fewer IPOs with their comparative higher value helps the average value of an IPO to bounce around a lot. In other words, the average IPO value is easily influenced by a few large deals occurring in any given year. Consider, for example, 2012—when Facebook raised $16 billion by going public—the overall number of startup IPOs dipped, but the overall and average value peaked. Whether a company decides to go public in a given year is also subject to greater influence of investor sentiments and conditions in public markets when compared to acquisitions, further contributing to this noise. Regardless, whether looking at the moving average or a trendline, the number and value of startup IPOs has grown over the past decade, spelling success for startups and providing an incentive for further innovation.

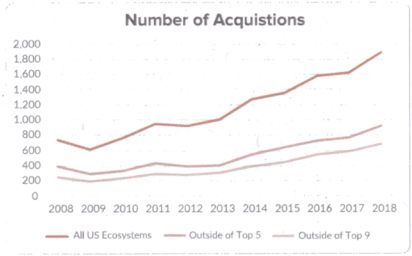




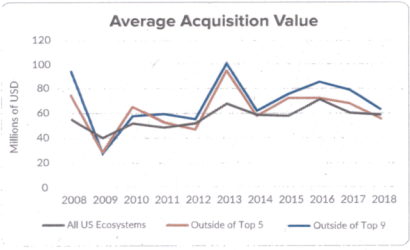
Acquisitions

Acquisitions are a more common method for startups to exit, and this makes the growth in the number and overall value of acquisition steadier. The growth in the number and value of acquisitions—156 percent and 170 percent respectively over 2008 to 2018—indicates a healthy ecosystem where entrepreneurs are rewarded and investors and entrepreneurs are able to fund new ventures with their profits, incentivizing and supporting additional innovation.





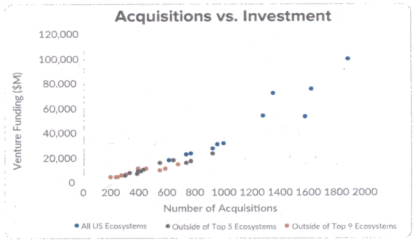
The average value of a startup acquisition remains essentially flat over this time period, showing that the increase in the overall value of acquisitions is primarily driven by the increasing number of acquisitions year-over-year. This isn't really cause for concern for two reasons. One, more acquisitions is a good thing, as discussed above. Two, the average age at which a company is acquired hasn't moved much. That the dollar value of the average acquisition is also flat means valuations of companies of the same age stayed about the same. For example, if company A and company B were both five years old and valued at $60 million dollars at the time of acquisition, we expect them to have been acquired for about the same amount, regardless that company A was acquired in 2012 and company B in 2017.



This is opposed to the case of IPOs, where the age of a startup going public increased and average IPO value increased—as we should expect—because companies that are older should have higher valuations. Both average acquisitions value and average IPO value are influenced when deals are few in number or are outsized deals involving 'unicorns,' leading to the sharp fluctuations observed.

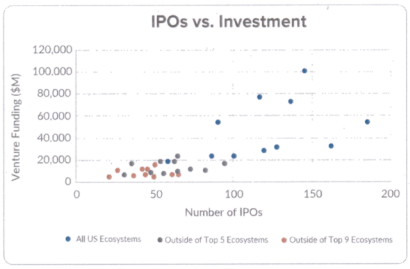
Exits and Their Relationship to Investment

While exits via IPO and acquisitions both reward founders and investors and provide incentives to innovate, acquisitions have a stronger, more positive relationship to investment in startups, making them a necessary component of the startup ecosystem. Plotting venture investment against the number of acquisitions reveals a strong positive correlation, with a linear regression coefficient of determination, $R^2 = .899$. This confirms the model often relayed anecdotally—investors and entrepreneurs are able to take profit at this exit and use the proceeds to fund investment in new startups. Acquisitions are also especially valuable to startups outside the nation's largest hubs. From 2008 to 2018, the average value of an acquisition was greater outside the top nine ecosystems for ten of those eleven years. As policymakers consider changes impacting the ability of companies to complete mergers and acquisitions, they must grapple with the ripple effects that changes could have throughout the startup ecosystem.



IPOs and investment, on the other hand, have a very weak association, $R^2 = .185$. This association is less positive and deteriorates further when the largest five ecosystems are removed, to $R^2 = .049$. The weak relationship between IPOs and investment might be explained by a few factors. Due in part to global competition for capital and higher regulatory burdens, there are comparatively few IPOs each year, meaning fewer overall opportunities for an investor to turn around and reinvest their profits into a new venture. The method in which the return is delivered might also impact this relationship. Rather than receiving cash like an investor might in an acquisition, going public means the investor has to liquidate stock to 'cash out.' They might not do so all at once or near

the time of transaction, meaning any reinvestment in other startups that occurs will not be associated with the IPO event.



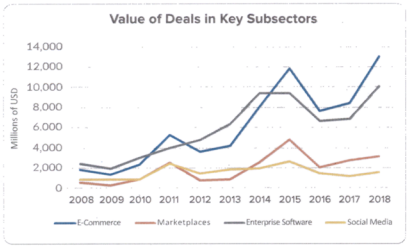
IPOs not only have a weaker relationship to investment outside of larger ecosystems, but also are less valuable. The average IPO was only more valuable outside of the top five ecosystems three out of the eleven years from 2008 to 2018. IPOs of companies located outside the top nine ecosystems were more valuable than those in the top ecosystems just once—in 2008. Encouraging more IPOs through policy reforms is a positive change to seek, but they should not be considered perfect substitutes for other methods of exit, like acquisitions, especially when considering smaller ecosystems.

KEY SUBSECTORS

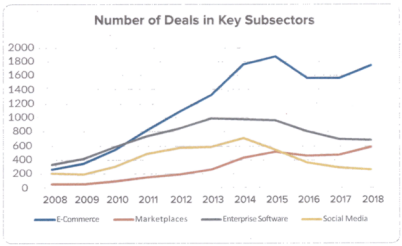
Just as tech startups are not ubiquitous when it comes to the type and amount of funding they receive, trends in the number and value of investments in startups vary by industry subsector as well. This section looks at four key subsectors: e-commerce, marketplaces, enterprise software, and social media. There are certainly many more subsectors in which technology enabled startups operate—too many to reasonably fit in this space. Instead, information about those several subsectors—from AI and AgTech to GovTech and life sciences—is presented in the appendix of this report for policymakers and researchers to scrutinize and explore further.

Each of these subsectors might bring to mind an archetype of the kind of company that fits into each, but these classifications are defined by Startup Genome.

- E-commerce includes software that provides the engine behind the scenes of an online store, making it possible to easily manage inventory, add or remove products, calculate taxes, and everything else required to operate a website and fulfill orders.
- Enterprise software is computer software used to satisfy the needs of an organization rather than individual users—like businesses, schools or governments, for example. Enterprise software would include HR tools or customer relationship management software, for example, but does not include FinTech or HealthTech software solutions, as those each have their own subsector.
- Marketplaces are two-sided platforms where transactions are carried out by multiple users, where some are buyers and some are sellers.
- Social media is a technology that facilitates the sharing of ideas—such as photos, files, and videos—through an electronic medium. This, by design, enables people and communities to share electronic content via electronic devices.[11]



The number and value of investments in each of these subsectors—e-commerce, marketplaces, enterprise software, and social media—grew over the past decade. Still, not all subsectors grew at the same rate. The number of fundings seen by marketplace startups increased 895 percent—from just 59 percent in 2008 to 587 percent in 2018—while social media startups saw a 27 percent increase over the same period. Total funding grew 80 percent for startups in the social media sector—from $879 million in 2008 to nearly $1.6 billion in 2018. For e-commerce startups, the sum of deal values went from $1.9 billion to $13 billion over that period—a 592 percent increase. Each of these subsectors saw overall investment drop in 2016, to varying extents. This is likely reflective broader market trends related to the valuations crisis discussed earlier.



Startup fundings in the social media sector appear to lag behind others, and the number of fundings in enterprise software startups similarly appear to have plateaued in recent years, but it is important to consider unique traits of each sector when explaining this trend. Subsectors entering the maturity phase of their lifecycle where the presence of large incumbent firms have increased may hold some explanatory power, but that does not tell the whole story. For example, Facebook's acquisitions of Instagram in 2012 and WhatsApp 2014 are often cited as innovation-harming, but investment in social media startups actually increased in the year following each of those deals. In fact, between 2012 and 2015, investment in social media startups rose 84 percent—from about $1.4 billion in 2012 to about $2.6 billion in 2015. Criticism of these deals does not seem to line up with the trends we see in investment, and such criticism probably does not help us fully explain the trends we see.

These sectors, especially social media, are frequently critiqued for consolidation, despite the fact that the data bears out growth in these spaces. They lend themselves to such consolidation

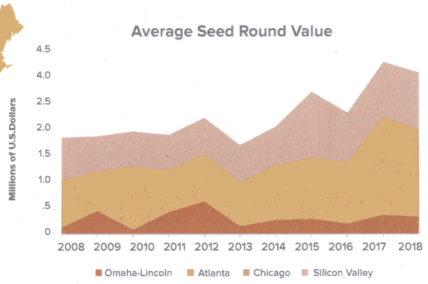
through a few factors. Social media is characterized by network effects—the idea that a platform becomes more valuable to a user when more people use it—which leads to a natural consolidation and few large firms. Similarly, switching costs—the costs borne to switch to a new service—can lead users to stuck with their existing firm, meaning naturally fewer enterprise software startups. The presence of these factors may help markets to reach maturity faster. Despite those factors, startups are still able to operate, earn investment, and succeed in these industries.

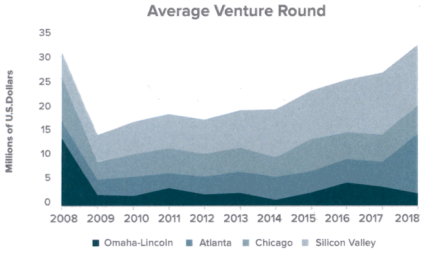
We would also be remiss to not consider some of the more recent developments in subsectors like social media, even if we do not yet have full data coverage due to data-lag, especially in earlier rounds. Though not an American startup, TikTok was the fastest social media company to reach a billion monthly active users, and has since become a household name.[12] In the fall of 2020, when considering a sale to an American technology partner, the company was valued at $60 billion.[13] More recently, audio-based social media startups have taken off in popularity. Clubhouse jumped from 2 million users in January 2021 to 10 million in February.[14] The company is currently seeking funding at a $4 billion valuation, four times its valuation in January.[15] To compete with Clubhouse, Sweden-based Spotify recently acquired Betty Labs, the company behind the live sports app Locker Room.[16] And entrepreneur and serial investor Mark Cuban is a co-founder of a similar app called Fireside, expected to launch later this year.[17] The introduction of video shorts and audio-based social media, the rise of new apps, and adoption of similar features by competitors underscores how the social media sector continues to be dynamic and evolve. It remains to be seen what kind of impact these developments will have on startup funding in the social media sector overall, but early data for 2019 indicate an increase in funding for social media startups, spelling the potential for future success stories.

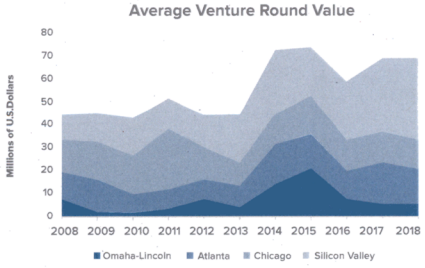
ECOSYSTEM HIGHLIGHTS

Looking at broad, national trends can make it easy to forget that we're talking about real people and real startups in real communities across the country. This section highlights four startup ecosystems from across the country—Silicon Valley, Chicago, Atlanta, and Omaha-Lincoln—that represent not only varying locations, but also varying stages of ecosystem development. Silicon Valley is the world's leading and most developed ecosystem, producing more than 96 'unicorns'—startups valued at more than $1 billion—through year-end 2019. At the other end of the spectrum, the Omaha-Lincoln ecosystem is regional and still gaining startup experience as it grows.









ECOSYSTEM HIGHLIGHTS



Silicon Valley

Ecosystem Value: $677 billion

- Average Software Engineer Salary: $122,586
- During the years 2008-2018, the median seed round ranged from $500,000 (2011) to $1.05 million (2017).
- The median series A round ranged from $3.2 million (2009) to $9 million (2018).
- The median series A+ ranged from $7.2 million (2008) to $16 million (2018).
- Startups closed their seed round at an average age of 18-and-a-half months in 2018. The youngest was eight-and-a-half months (2011) and the oldest was 19 months (2017).
- Startups in Silicon Valley exited at an average age of five years and a month in 2018, its oldest average age at exit during the years 2008-2018. The youngest was four years and four months (2013).



Chicago

Ecosystem Value: $21.4 billion

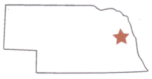
- Average Software Engineer Salary: $80,774
- During the years 2008-2018, the median seed round ranged from $200,000 (2008) to $750,000 (2017).
- The median series A round ranged from $1.5 million (2011) to $4. 7 million (2008). In 2018 it was $4 million.
- The median series A+ ranged from $2.6 million (2009) to $9 million (2008). It was $6.1 million in 2018.
- Startups closed their seed round at an average age of 21-and-a-half months in 2018. The youngest was 11-and-a-half months (2011) and the oldest was 22 months (2017).
- Startups in Chicago exited at an average age of five years and 10 months in 2018. The youngest was three-and-a-half years (2011) and the oldest was six years and two months (2014).



Atlanta

Ecosystem Value: $16.4 billion

- Average Software Engineer Salary: $79,681
- During the years 2008-2018, the median seed round ranged from $250,000 (2012) to $1.15 million (2008). It was $500,000 in 2018.
- The median series A round ranged from $1.9 million (2009) to $4.2 million (2018).
- The median series A+ ranged from $3.5 million (2011) to $10 million (2008). It was $7.4 million in 2018.
- Startups closed their seed round at an average age of 20-and-a-half months in 2018. The youngest was 13 months (2012) and the oldest was 26 months (2008).
- Startups in Atlanta exited at an average age of six years in 2018. The youngest was four years and two months (2011) and the oldest was six years and four months (2017).



Omaha-Lincoln

Ecosystem Value: $595 million

- Average Software Engineer Salary: $74,763
- During the years 2008-2018, the median seed round value bounced around from $25,000 (2008) to $1 million (2012), reflecting both overall economic conditions and few deals in the area.
- The median seed value has since settled and was $300,000 in 2018.
- The median series A round ranged from $750,000 (2014) to $13 million (2008). In 2018 it was $2 million.
- The median series A+ ranged from $1.4 million (2009) to $7.1 million (2014). It was $3.1 million in 2018.
- Startups closed their seed round at an average age of 25 months in 2018. The youngest was seven-and-a-half months (2011) and the oldest was 35 months (2017).
- Startups in Omaha-Lincoln exited at an average age of five-and-a-half years in 2018. The youngest was 18 months (2015) and the oldest was nine years (2011).

MICRO ANALYSIS

To draw useful policy-related conclusions from these funding trends and data, it is essential to put them in the proper context. In 2018, the average startup that successfully closed a seed round raised just over $1.2 million, and the median startup seed round that year was $740,000. Depending on one's perspective, that could seem like a lot of money. But that sticker-based reaction fails to account for the capital needs of startups related to personnel and product development, for example. Accordingly, this section attempts to contextualize the capital needs and pressures facing investor-backed startups as they seek to grow and thrive.

Startups are often pre-revenue, need to show growth, and must account for the time that will elapse before they raise their next round. In addition, many startups were caught off guard by the pandemic-related crisis and may decide to build in a longer runway to protect against future economic uncertainty. If startups are distracted from these core activities by the possible existential threat of frivolous litigation or uncertainty due to policy debates playing out in Washington or state capitals, the capital allocated to them is further diluted. Startup funding is pulled in so many directions, and even tweaks around the edges of policies could have a substantial impact.

It is also critical to remember those dollar figures above only reflect startups that raised funds through conventional, formal means, and do not include startups relying on earlier or other methods of financing, like personal loans or bootstrapping. Those companies generally have fewer resources but face similar business and policy pressures.

A seed-stage startup has a number of goals to accomplish—like expanding its team, developing its product, and acquiring customers. And it must do all of this with the investment it has earned before it can successfully raise its next round, which will come an average of 22 months later.[18] Putting the average seed-stage startup's total $1.2 million raise into monthly flows, they are working with about $55,000 a month, or about $655,000 a year. Yet it has to accomplish a lot with that money. Core startup activities, like customer acquisition and product development, require spending on marketing and hiring employees or contractors. Teams are expensive. In Silicon Valley, it can cost over $120,000 a year to hire a software engineer. Even outside of the top ecosystems, software engineer salaries hover around $80,000 annually. To stretch every dollar, some founders even pay themselves minimum wage (or forgo a salary altogether). Capital isn't free either. Considerable time is spent preparing and pitching, and, while low—around 0.5 percent to one percent—there are legal costs associated as well.[19] The margin for error for startups at this stage is small, making external threats from onerous regulation or frivolous litigation loom large.

For example, there are patchworks of regulations taking shape across the country and the globe which set disparate standards or create competing obligations in the areas of privacy, digital services taxes, content moderation, and more. These patchworks impose barriers not just in the substance of the regulations themselves, but in the different requirements startups have to decipher to operate in different locations. This takes time and resources and can alter the growth strategy for a startup. The Internet is borderless, but variance in regulation can steer where it is easiest for a slim-resourced startup to operate. Larger, established, more-resourced competitors have the capacity to better navigate such regulatory environments, spelling implications for competition and innovation.

In addition, law and policy influence when and how often startups are sued in even frivolous cases. Changing the law in ways that increase the cost and risk of litigation, or make it harder to predict and avoid lawsuits, can impose additional costs and depress innovation and competition. For example, in the context of intermediary liability lawsuits, companies that host user-generated content—like product reviews or message boards—can be sued based on the activities of their users. But such suits are relatively rare because startups can use frameworks like Section 230 of the Communications Decency Act or Section 512 of the Digital Millennium Copyright Act as part of their defense. Even under the current law, however, it can cost $15,000 to $80,000 to get a meritless suit dismissed. And proceeding just to summary judgment can cost over $500,000.[20]

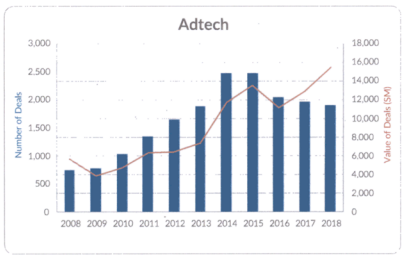
Without frameworks like Section 230 and Section 512, we could expect suits to be filed against intermediaries more often and come at an even higher cost. Even if intermediaries are likely to win on the merits—for example, avoiding liability for user speech on First Amendment grounds or based on a finding of no copyright infringement—legal defense could cost an order of magnitude more. For an investor-backed, seed-stage startup with $55,000 a month, such suits could be ruinous. The situation would be more dire for companies that do not or

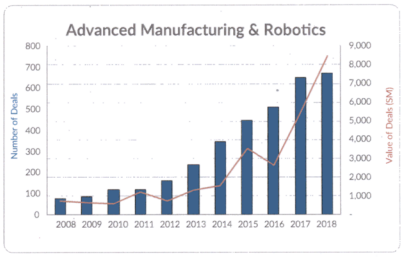
have not yet raised formal funding rounds. In either scenario, changes in the law that increase the cost or rate of litigation would mean only the largest companies would be able to operate in these spaces.

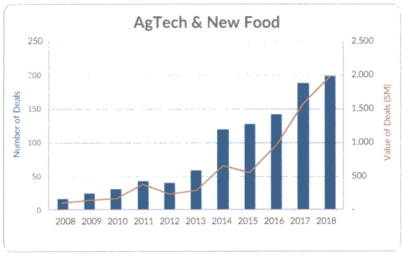
Similarly, frivolous patent suits filed against startups by patent assertion entities (PAEs) highlight how resource strapped even investor-backed startups can be. In a practice also known as patent trolling, PAEs sue or threaten to sue, seeking to enforce low-quality patents and leverage high court costs to extract nuisance-value settlements from startups. Some PAEs target startups that have recently publicized successful funding rounds, and both the amount in controversy and associated legal costs usually rise with company size.[21] Even for smaller patent cases where less than $1 million is at stake, it can still cost a startup $25,000-$40,000 just for initial case management, and $750,000 to defend at trial.[22] While settling for less than that is often an option (and the PAE's goal), some startups would rather pay their lawyers than settle an abusive case.[23] These costs are burdensome, and time wasted dealing with frivolous litigation rather than focusing on a startup's core goals of growth and product development is equally damaging.

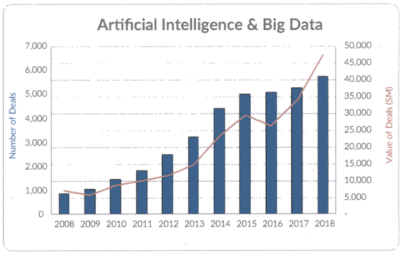
As lawmakers weigh potential costs of policies in the technology sector, it is important to appreciate the resource constraints of startups. A million dollars may seem to be a lot of money to some, but in reality the margin for extra costs is small. That margin is even smaller for startups that aren't investor-backed or within typical funding channels. A lawsuit could quickly evaporate a startup's runway. And additional or overly burdensome regulation without respect to the realities facing startups can add cost and shorten how far that money can go, threatening the vitality of startups and innovation in the technology sector.

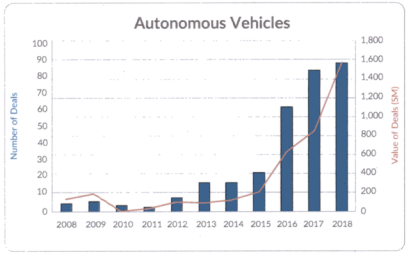
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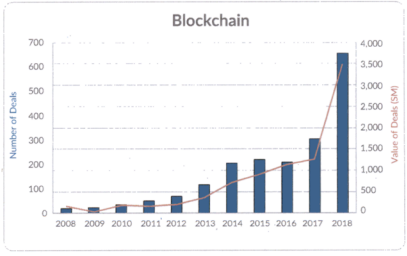

Adtech
Number of Deals
Value of Deals ($M)
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

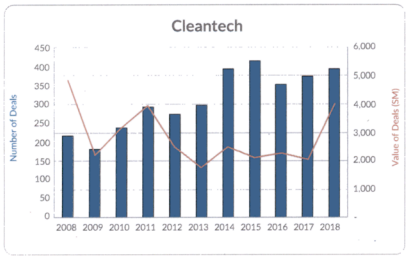

Advanced Manufacturing & Robotics
Number of Deals
Value of Deals ($M)
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

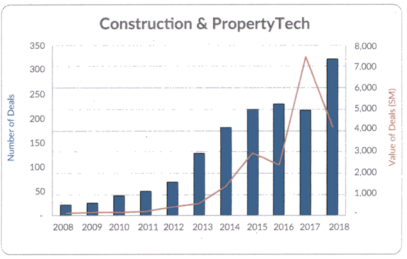

AgTech & New Food
Number of Deals
Value of Deals ($M)
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018


Artificial Intelligence & Big Data
Number of Deals
Value of Deals ($M)
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

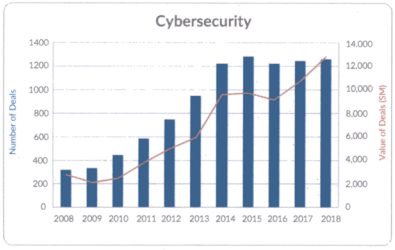

Autonomous Vehicles
Number of Deals
Value of Deals ($M)
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

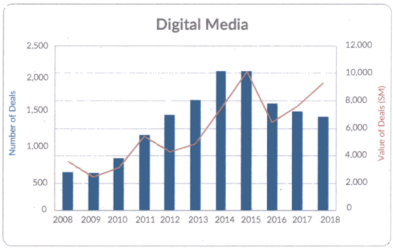

Blockchain
Number of Deals
Value of Deals ($M)
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

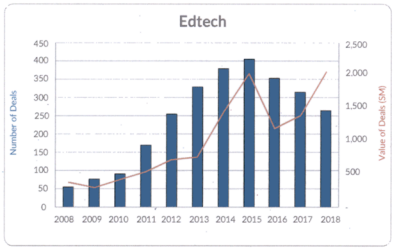

Cleantech
Number of Deals
Value of Deals ($M)
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

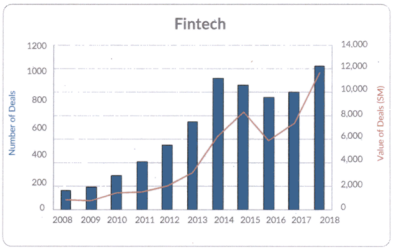

Construction & PropertyTech
Number of Deals
Value of Deals ($M)
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

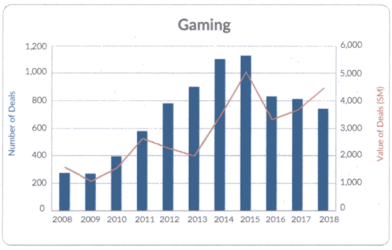
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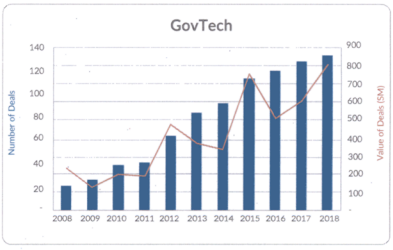

Cybersecurity
Number of Deals
Value of Deals ($M)
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

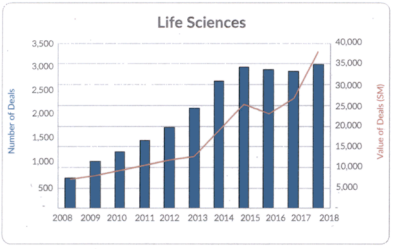

Digital Media
Number of Deals
Value of Deals ($M)
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018


Edtech
Number of Deals
Value of Deals ($M)
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018


Fintech
Number of Deals
Value of Deals ($M)
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018


Gaming
Number of Deals
Value of Deals ($M)
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018


GovTech
Number of Deals
Value of Deals ($M)
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018


Life Sciences
Number of Deals
Value of Deals ($M)
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

NOTES

[1] Laura Entis, "Where Startup Funding Really Comes From," Entrepreneur, 20 Nov 2013. https://www.entrepreneur.com/article/230011.

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"The Impact of Consolidation and Monopoly Power on American Innovation"

Written Testimony of
Bettina Hein
Founder and Chief Executive Officer
juli

Submitted to the
Subcommittee on Competition Policy, Antitrust, and Consumer Rights
of the
Committee on the Judiciary
United States Senate
December 15, 2021

Chair Klobuchar, Ranking Member Lee, and members of the subcommittee, thank you for the invitation to testify today.

My name is Bettina Hein and I am a serial software entrepreneur who has built technology companies in both the United States and Europe. Most recently, I am the founder and CEO of juli – an artificial intelligence-powered digital health and wellness startup based in Boston, Massachusetts that helps our customers manage chronic conditions. juli is my third software company. I am also the founder of Pixability, a video advertising company also based in Boston, and co-founder of SVOX, a Switzerland-based speech technology company.

I'd like to begin by thanking you, Madame Chair, for your leadership regarding entrepreneurship and innovation issues as the co-chair of the Senate Entrepreneurship Caucus. In particular, your work regarding the unique barriers and challenges that confront women entrepreneurs – and there are many! – is especially appreciated.

Also, while I know it's not the specific purview of this subcommittee, since this is the Judiciary Committee, I would be remiss if I didn't respectfully urge the passage of immigration reform – and specifically the creation of a Startup Visa. As you may know, the United States is one of the few industrialized countries without a specific visa category to attract and retain foreign-born entrepreneurs.

I was born in Germany, built my first company in Switzerland, and then launched Pixability in 2008 and juli in 2019 in the United States. My experience as an immigrant entrepreneur has been one of all-too frequent uncertainty and anxiety about my visa status, despite starting two successful U.S. companies and creating jobs for many Americans. Though juli is an American company, I run it from Switzerland – where I am speaking to you from now – in part because of continuing visa complications. If the United States is to remain a global innovation leader, such circumstances need to change. Nothing could be more 'America First' than taking steps to ensure that the world's best and most innovative entrepreneurs launch their companies in the United States rather than somewhere else.

Turning to the topic of this hearing, I want to begin by emphasizing that I am not a policymaker or an antitrust attorney. I am an entrepreneur – a three-time entrepreneur – and I am here to share with you my perspective regarding the likely impact of acquisition restrictions and other market interventions on entrepreneurs like me.

Acknowledging that the intention of the legislation is to address the size and influence of large technology platforms, it is my view – based on the specifics of the bill and ramifications that followed the enactment of similarly sweeping legislation – that the risk of unintended consequences of this legislation is very high, and that those unintended consequences will disproportionately impact and potentially damage the nation's entrepreneurial ecosystem.

Thriving entrepreneurship is critical to a strong and growing economy – and, therefore, to the post-COVID recovery. Repeated research in recent years has demonstrated that new businesses – "startups" – account disproportionately for the innovations that drive productivity growth,[1] economic growth,[2] and net new job creation.[3]

But entrepreneurship is also risky – a third of new businesses fail by their second year, half by their fifth. For fragile startups, there are three principal outcomes: fail, go public, or be acquired. Failure is the most common outcome. Many entrepreneurs dream of taking their company public, but most startups never achieve the scale that going public requires.

Acquisition, therefore, is by far the most likely avenue for entrepreneurs and their employees to realize the value of what they have created through years of hard work and sacrifice. In a typical year, ten times as many startups are acquired as go public.[4] According to a recent report by Silicon Valley Bank, nearly 60 percent of startups expect to be acquired.[5]

Importantly, acquisitions also enable startup investors to reclaim their invested capital, realize any gains, and recycle their capital into the next generation of startups, fueling the ongoing process of innovation-led economic growth and job creation.

With these realities in mind, the **Platform Competition and Opportunity Act** is of great concern. By severely restricting and even potentially banning the acquisition of startups by larger companies, the legislation will profoundly undermine the incentive for entrepreneurs to take the personal and financial risk of launching a new company, and short-circuit the process by which value-creating innovation helps fund the next generation of new businesses.

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[4] National Venture Capital Association, 2019 Yearbook.

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As a serial entrepreneur, I understand in a very personal way the threat the legislation poses to the startup ecosystem. In 2001, I started SVOX, a Switzerland-based company that developed text-to-speech software for automotive and mobile device applications. After years of hard work, my partners and I sold the company to Nuance Communications for $125 million.

In 2006, I moved to Cambridge, Massachusetts, earned a master's degree in technology management from M.I.T., and then, in 2008, launched Pixability, a pioneer in video marketing software and services that now employs 85 people in Boston. On the eve of the pandemic, I founded juli. For the third time in my career, I have launched an investor-financed company that will have to return the invested capital – by either going public or getting acquired.

But if my investors are unable to liquidate their investment to reclaim capital and potential gains – through either an IPO or an acquisition – they won't risk their capital by investing in my company in the first place. And without investors, there is no juli – or the services we provide to our customers, or the economic activity my colleagues and I have generated, or the American jobs that we have created. Indeed, without investors, there is no startup ecosystem.

I want to make clear that I am very much aware that, as currently written, the bill restricts acquisitions only among companies with a market capitalization of $600 billion or more. As an entrepreneur, that gives me little comfort, for several reasons:

- First, what is the significance of $600 billion? Have any economic analyses been conducted to show that a market capitalization of $600 billion is the appropriate demarcation of the restrictions imposed by the bill? Have any hearings like this one been conducted to solicit the input of experts to determine any rigorous analytic support for that conclusion?

- Second, that number could easily change, either before this legislation is finalized or in subsequent years. The definition of a "systemically significant financial institution" was defined in the Dodd Frank Act of 2010 and then changed in 2018. Indeed, within 24 hours of the introduction of the bill, there were charges by the press and among antitrust advocates that $600 billion is far too high and should be lowered to capture other large companies with digital platforms.

- More fundamentally, activity restrictions aimed at only four or five companies will introduce enormous structural distortions into the marketplace. Sound public policy should apply clearly and transparently to all market participants – not single out a few by establishing an arbitrary Rubicon of legislative and regulatory scrutiny.

But there is an even more serious and insidious risk posed by the bill – that it will accomplish exactly the opposite of what it intends by tilting regulatory circumstances decidedly in the favor of the larger companies it targets. The risk of this unintended effect is very real because it has happened before, and more than once.

In 2002, in the wake of corporate accounting scandals involving large corporations such as Enron, Tyco, and WorldCom, Congress passed the Sarbanes-Oxley Act to enhance the quality and reliability of financial data reported by publicly traded companies. Section 404 of the Act

requires companies to disclose the findings of an external audit of the scope, adequacy, and effectiveness of the company's internal control structure and procedures for financial reporting. Though just 170 words in length, section 404 has accounted for the majority of the cost of complying with Sarbanes-Oxley, estimated to be well over $1 million annually. The substantial cost and burden of complying with section 404 has amounted to a major obstacle for many new and rapidly growing companies hoping to access the capital markets to secure the financing they need to continue growing and creating jobs.

In an interview with Bloomberg, in March of 2012, Steve Case, co-founder and former chief executive of America Online, said: "When AOL went public 20 years ago, we only raised $10 million. Nobody could do that now because of the cost of Sarbanes-Oxley."[6]

Indeed, in testimony before the House Financial Services Committee in June of 2012, David Weild, former vice chairman of Nasdaq, noted that small company IPOs valued at $50 million or less plummeted by 92 percent in the six years following enactment of Sarbanes-Oxley.[7]

For me personally, Sarbanes-Oxley meant giving up – for now – on my girlhood dream of running a public company.

The Dodd Frank Act of 2010 provides a similar warning. That legislation was enacted to reign in the size and risk to the economy posed by large banking companies following the financial crisis of 2008 and the Great Recession that followed. Ten years after enactment, large banks are bigger and more profitable than ever and account for a larger share of the industry than ever. Meanwhile, more than 2,000[8] community banks have disappeared and lending to small businesses has decreased significantly.[9]

The **Platform Competition and Opportunity Act** risks similar unintended consequences. By dramatically increasing the regulatory hurdle and compliance costs of acquisitions, the Act would benefit large incumbent companies who have the money and teams of lawyers to navigate the new legal landscape. Many smaller acquirers would be shut out – particularly if the $600 billion threshold is lowered, as is reasonable to expect.

And narrowing of the acquisition market to only the largest companies would drive down prices for smaller companies like mine. In this way – ironically – the bill would likely deepen and widen the competitive moat protecting large incumbent companies from smaller and more innovative challengers.

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[6] "Case Wants to Build Startup Culture in America," Bloomberg News, March 13, 2012.

[7] Testimony of David Weild, Senior Advisor, Grant Thornton LLP, before the U.S. House of Representatives Financial Services Committee Capital Markets and Government Sponsored Entities Subcommittee, June 20, 2012.

[8] FDIC Community Banking Study, December 2020.

[9] "Small Business Lending Declined after Dodd-Frank Passed" Steve Maas, National Bureau of Economic Research, The Digest: No. 6, June 2018.

Some may argue that the legislation does not explicitly prevent acquisitions, even by the large digital platforms – it only requires that they prove to regulators that the acquiree does not compete with the acquiring company, now or in the future.

As an entrepreneur, I have several practical criticisms of that standard. First, proving whether something may or may not happen in the future – especially given the accelerating pace of change in our modern economy – is an absurdly hypothetical and impossible exercise. Who could have predicted as recently as 2006, that a device called the iPhone – introduced to the world by Steve Jobs in January of the following year – would so fundamentally transform not only the global telephone market, but the way we work, get our news, take and share photographs, navigate our cars, monitor our home security, do our banking, trade stocks, and so many other aspects of life?

More fundamentally, and more punitive to entrepreneurs like me, the costs of meeting such a standard will be in the many millions of dollars – potentially tens or even hundreds of millions of dollars. Large acquirers will "pay" for those costs by simply reducing the value of transactions – in other words, by reducing what they are willing to pay for my company. This not only penalizes me and my colleagues in the value of that transaction, but also reduces the capital we have to invest in our next startup.

Finally, large companies will use the new uncertainty surrounding acquisitions against entrepreneurs when negotiating transaction values. Currently, large companies often justify a lower price for an acquiree due to uncertainty regarding the status of a startup's intellectual property or tax assets like net operating losses – uncertainty created by Congress by way of the Tax Reform Act of 1986 in an attempt to address so-called "loss trafficking" by acquiring companies. Startups are powerless to push back against such claims because larger companies have vastly greater resources. It is easy to imagine how acquisition uncertainty will be used by large companies to justify lower acquisition prices.

In short, large technology companies won't be hurt by this legislation – entrepreneurs like me will be. And given the economic importance of startups to innovation, economic growth, job creation, and expanding opportunity, the U.S. economy and American families, workers, consumers, and investors will also be hurt.

Madame Chair, and Ranking Member Lee, to protect competition and innovation, we don't need the blunt sledge-hammer of sweeping legislation with all its risks of market distortions and unintended consequences. Rather, we need a surgeon's scalpel to carefully dissect, understand, and appropriately address the unique circumstances, details, and market implications that each proposed acquisition entails – and that scalpel resides with the regulators.

The FTC's suit, filed on December 1st, to block the acquisition of chip designer Arm by Nvidia is the most recent example of the current system working precisely as it should.[10]

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[10] https://www.ftc.gov/news-events/press-releases/2021/12/ftc-sues-block-40-billion-semiconductor-chip-merger

The far better course of action, therefore, is to significantly increase the frequency and capacity of existing regulatory scrutiny by augmenting the resources of the Federal Trade Commission and the Justice Department's Antitrust Division, which already have the authority to block anti-competitive mergers. Indeed, between 2010 and 2020, the government prevailed in 79 percent of mergers challenged in federal court.[11]

Thriving entrepreneurship is the essential pathway to faster economic growth, job creation, and opportunity expansion the American people need and deserve – particularly in the wake of the Covid-19 pandemic. Legislation that would severely restrict a major avenue of exit for entrepreneurs and their investors, strengthen the competitive position of large incumbents, and reduce the value of acquired startups like mine risks major damage to America's entrepreneurial ecosystem and the post-Covid recovery.

Thank you very much for the opportunity to participate in today's important hearing.

[11] "Judicial Response to the 2010 Horizontal Merger Guidelines," Carl Shapiro and Howard Shelanski, Review of Industrial Organization, pp. 51-79, January 24, 2021.

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THE IMPACT OF COVID-19 ON US FIRMS

Nicholas Bloom
Robert S. Fletcher
Ethan Yeh

Working Paper 28314
http://www.nber.org/papers/w28314

NATIONAL BUREAU OF ECONOMIC RESEARCH
1050 Massachusetts Avenue
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January 2021

We would like to thank the Kauffman Foundation for their financial support. We would like to thank Patrick Collison, Alex Novet, Eilin Francis, and Nate Hilger for advice and research support on the survey. We would also like to thank seminar participants at Stanford University and the Census Bureau. All user data in this research was opt-in and obtained with permission via written informed consent. Contact nbloom@stanford.edu The views expressed herein are those of the authors and do not necessarily reflect the views of the National Bureau of Economic Research.

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Electronic copy available at: https://ssrn.com/abstract=3772594

The Impact of COVID-19 on US Firms
Nicholas Bloom, Robert S. Fletcher, and Ethan Yeh
NBER Working Paper No. 28314
January 2021
JEL No. E0,J0,L0

ABSTRACT

We use survey data on an opt-in panel of around 2,500 US small businesses to assess the impact of COVID-19. We find a significant negative sales impact that peaked in Quarter 2 of 2020, with an average loss of 29% in sales. The large negative impact masks significant heterogeneity, with over 40% of firms reporting zero or a positive impact, while almost a quarter report losses of more than 50%. These impacts also appear to be persistent, with firms reporting the largest sales drops in mid-2020 still forecasting large sales losses a year later in mid-2021. In terms of business types, we find that the smallest offline firms experienced sales drops of over 40% compared to less than 10% for the largest online firms. Finally, in terms of owners, we find female and black owners reported significantly larger drops in sales. Owners with a humanities degree also experienced far larger losses, while those with a STEM degree saw the least impact.

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1. Introduction

COVID-19 early impacts on businesses across the U.S. were record breaking in their swiftness. Many businesses closed in response to state government mandates, while others closed on their own accord, and many of those that remained open have had to substantially alter their operations (Balla-Elliott et al. 2020). While most states have since removed their initial mandates and businesses have begun to recover, there remain large questions about what the recovery will look like going forward. Using an innovative panel survey of business founders, we show that the brunt of the economic impact was not evenly felt by businesses in the economy, and that the recovery will likely further reveal these inequalities rather than dissipate them.

The panel survey, known as The Study of Internet Entrepreneurship, is an ongoing, opt-in quarterly survey of businesses that began in early 2019 with a focus on business forecasts (Bloom, Fletcher, Yeh 2020). The survey is innovative in soliciting information from firms on the past, present and future impacts of COVID, with a reward for accuracy based on alignment with transactions data. Using this framework, we were well positioned to survey firms throughout the onset of pandemic and elicit their estimates of impacts and forecasts for the future impacts of COVID-19.

We use the survey to first confirm that many businesses experienced a large and negative short-run impact of the pandemic, a result corroborated by other firm surveys as well (e.g., Fairlie 2020, Bartik et al. 2020). Our results most notably show that firms on average saw their sales drop 29% over quarters 2 and 3 of 2020. Other papers have shown similar negative short-run impacts on numerous other measures including employment (Barrero et al. 2020a), business closures (Gourinchas et al. 2020), and business activity (Fairlie 2020).

We further highlight that these impacts have been incredibly varied by business, and these differences are likely to persist well into 2021. While almost 25% of firms lost more than half their sales at the peak of the impact, over 40% of firms report either no impact or a positive impact. Continuing into 2021 firms whose sales benefitted expect to maintain their bump in sales almost entirely, while firms who lost sales will only have a partial recovery by quarter 2 of 2021, a year after the peak of the impact. These two very different experiences mimic the similar split recession and recovery found by Chetty et al. (2020) and Cajner et al. (2020) in the labor market.

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Some of these differences can be explained by firm characteristics. We find that offline firms are much more negatively impacted than online firms as the online economy has been largely able to escape the worst of the pandemic. Large employers have likewise fared much better than small employers and non-employers. In particular, small offline firms are significantly worse off than their larger online counterparts: non-employer firms who receive less than 50% of their revenue online lost over 45% of their sales while 20+ employee firms with at least 50% of their revenue online lost only 10%. This highlights the great inequality of the economic impact of COVID-19.

Last of all, these impacts were not equally shared across demographics. Women-owned businesses fared significantly worse. Black-owned businesses likewise were more negatively impacted. These results echo the earlier findings of Fairlie (2020), Alekseev et al. (2020), and (Bloom, Fletcher, and Yeh 2020), and broader findings of the particularly damaging impact of the COVID-19 pandemic on women (e.g., Alon et al. 2020). Controlling for business characteristics explains most of the difference between men and women, although it does not appear to explain the difference between White-owned and Black-owned businesses.

This links to a rapidly growing literature showing the damaging impact of COVID on firms (e.g. Bartik et al. 2020a, Gourinchas et al. 2020, Papaniklaou and Schmidt 2020, and Buffington et al. 2020), labor markets (e.g. Chetty et al. 2020, Kahn et al. 2020, Cajner et al. 2020 and Barrero et al. 2020b), and its particularly damaging impact on women and lower educated groups (e.g. Adams-Prassl et al. 2020, Alon et al. 2020, Hupkau and Petronglo 2020, Mongey et al. 2020 and Sevilla and Smith 2020). Our survey is distinct in eliciting detailed current and future survey data on the impact of COVID-19, and obtaining high survey and item response rates by paying firms for survey participation and accuracy.

Section 2 gives an overview of the survey and related data used in the analysis. Section 3 presents the results of our analyses on the impact of COVID-19. Section 4 concludes.

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2. Data

2.1. Survey Design and Details

The Study of Internet Entrepreneurship survey is an opt-in panel survey of business founders in partnership with a large payments technology company in the United States, henceforth referred to as TechCo for convenience.[1] All user data from the survey and in this research was obtained with user permission via written informed consent. The sample was constructed from the universe of businesses using TechCo's online payment services. To be eligible for the survey, businesses had to have had at least ten transactions on TechCo. To limit the inclusion of businesses that had already closed, they also had to have had a transaction in the 90 days prior to when they were sampled. Businesses had to be for-profits, and the emails that TechCo had listed for them had to be non-generic (i.e., they could not consist of phrases such as info@, admin@, or contact@).

Our surveys were targeted at business founders. If the founder was not available or was no longer affiliated with the business, then we accepted the responses of someone who was intimately familiar with the financials of the company and the TechCo account itself. In 92% of responses, we were able to get a response from the founder themselves.

The eligible firms were divided into three strata: funded, small non-funded and large non-funded. Funded firms were those known to have venture capital backing. Non-funded firms were then split into small and large based on the amount of revenue they had on TechCo in the prior year. Firms with below $10,000 in revenue the previous year were labeled small and firms above $10,000 were labeled large. Our sample is made up of 1/3 funded, 1/3 small, and 1/3 large.

We sampled a total of 26,400 firms. Firms were contacted with an invitation e-mail and three follow-ups spaced approximately a week apart. Firms were given $50 to respond to the first wave of the survey and then $25 for each subsequent wave. In addition (as discussed below) they were also given a $25 per survey wave accuracy bonus for their TechCo revenues forecasts for the next quarter if they came within 10% of their realized TechCo revenue.

[1] The company is Stripe, which employs one co-author. To facilitate this research, Stripe allowed the authors to communicate with its customers to request their survey participation and limited, anonymized access to data from users that granted permission and opted-in to the study.

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Firms who did not respond were then contacted again in the following round of the panel and re-invited to participate with an invitation and two reminder emails. A total of 5,299 firms responded, for a response rate of 23.7%.[2] We did not find any significant difference across firms in their response rates beyond size, with smaller firms slightly more likely to respond (see Appendix Table A1).

We contacted 18,000 businesses throughout the spring of 2019. Firms were then re-contacted in the summer of 2019. Those who had not completed the first round were re-invited to take the baseline survey, while those who had already completed the baseline survey were given the second-round survey. The third round of the survey took place at the end of 2019. Firms who had only completed the baseline survey were invited to complete the third round with the other firms, thus skipping the second round. We also refreshed our sample with an additional 4,400 businesses at this point, giving us a total sample of 22,400 firm.

A fourth round was then sent out during April and May 2020. This round coincided with the onset of the COVID-19 pandemic, and so included the questions on the impact of the crisis which form the basis of our COVID-19 analysis. A fifth round was then sent out during September through November 2020. This round followed the peak of the COVID-19 economic impact and so allows us to analyze retrospective data, as well as compare forecasted and actual impacts. As in previous rounds, we added an additional refresh sample of 4,000 firms for a full sample of 26,400 firms.

2.2. Founder and Business Characteristics

From the baseline survey, we collected a number of characteristics on the founder and their business. Table 1 and Figure A1 provide some basic demographics on our survey and compare them to businesses from the Annual Survey of Entrepreneurs, which is a nationally representative survey of all (rather than TechCo) small businesses. We see the average entrepreneur in our survey is 39 years old, below the 42 years of age of the average US entrepreneur (from the Annual Survey of Entrepreneurs), with 95% of TechCo business leaders more than 25 years old. We also see that

[2] While this 23.7% response rate may seem low, it is high for firm surveys, especially during the pandemic. Prior COVID-19 firms surveys obtained response rates that were substantially lower, for example 0.017% for Bartik et al. (2020) and 1.5% in Alekseev et al. (2020, while pre-pandemic US firm surveys typically obtained response rates between 10% to 30% (e.g. see Altig et al. 2020).

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72% of firms are run by college graduates, reflecting the increasing importance of education for entrepreneurship in the new-economy. Finally, most of these firms are young, with 65% of them having been founded within the last 5 years, in contrast to all US firms which have an average age of 17 years.

The firms span the entire United States with coverage across almost all states (as shown in Appendix Figure A2), noting that some smaller states have small samples of less than 10 firms. These firms also have a broad industry mix (Appendix Figure A3), with a skew towards industries like travel and clothing that have a higher online representation.

2.3. Payment Data

Through TechCo data we are able to track the aggregate revenue, total transactions and average transaction value for each firm directly. This is valuable in allowing us to assess survey data against businesses actual revenue data – comparing founder expectations against actuals, as well as identifying and cleaning up any major outliers. While the latter helps to reduce survey measurement error, the data do have certain limitations. Most notably, we are only able to observe the revenue that occurs on TechCo, which represents 52% of our sample's business revenue on average, according to the survey data (Table 1). This also means that we cannot observe revenue before the business joins TechCo, or easily distinguish between a business leaving TechCo and a business closing[3]. On the other hand, compared to administrative data we can observe businesses before they formalize, so are able to capture information on very early-stage entrepreneurship. The TechCo transactions data is also direct revenue data, rather than data reported to tax, accounting or statistical authorities, so is less susceptible to measurement error.

3. Results

In this section we present results on the large, negative, and heterogenous impacts of the crisis.

[3] We address this with survey data as best we can in the results section, however, there may be bias in the fraction of closed businesses that respond to our survey after they have closed.

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3.1. Measuring the Impact of COVID-19

The impact of COVID-19 was collected in two-parts. First, respondents were asked to identify for a given quarter whether they were negatively impacted, positively impacted, or not impacted at all by COVID-19 (Figure A9a). For example:

What was the impact of COVID-19 on your firm's sales revenue over Quarter 1, 2020?

- *Lower*
- *No Effect*
- *Raise*

If they suggest that their sales were lowered or raised, they are asked to specify the magnitude of the impact (Figure A9b). For example:

> *"By what percentage did the impact of COVID-19 (raise/lower) your firm's sales over Quarter 1 (January 2020 through Match 2020)?"*

This two-part structure was developed after piloting to avoid recording errors for negative numbers. Many business owners are familiar with brackets (that is the "( )" symbol) being used to denote negative numbers as these are the default indicators for negative values in Excel and other accounting software packages. As a result they were sometimes confused by a negative sign (that is the "-" symbol) in testing. Given the large negative impact of COVID correctly identifying negative versus positive impacts was essential, so this two-part question structure was required.

We then convert these $impact_{it}$ values to a percentage over the average baseline and use this to calculate the arc-percentage change following Davis, Haltiwanger and Schuh (1996), which is often called the "DHS change" measure. This DHS change measure compares the COVID sales (100+ the impact growth rate of COVID) against the baseline sales (100) and divides by the average of the two.

$$DHS_{it} = \frac{(CovidSales_{it} - Baseline)}{(0.5 * CovidSales_{it} + 0.5 * Baseline)}$$

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We use this DHS growth measure[4] rather than the raw percentage change to allow for firms with zero sales in some quarters (those going from zero to positive sales receive a +2 and those from positive to zero a -2).

As one basic check on the survey reliability we compare firms' responses on the impact of COVID on their sales over 2020 Q2 and Q3 versus the change in revenue on TechCo between 2019 Q2 and Q3 and 2020 Q2 and Q3. We find an extremely tight relationship, for both positive and negative values, indicating a very close correspondence between survey responses and actual transaction data for the corresponding period (see Appendix Figure A8).

3.2. The Overall Impact of COVID

The impact of COVID on our sample has been large and negative as shown in Figure 1. Firms on average saw their sales drop 29% over 2020 Q2 and Q3. The mean, however, masks significant heterogeneity in the impact on firms with 43% of firms reporting a zero or positive impact of the pandemic compared to 57% of firms reporting a negative impact. This highlights not only the large negative mean impact of the pandemic but also the huge dispersion in effect across firms.

We plot in Figure 2 the time series of the reported impact of COVID by quarter, from 2020 Q1 to 2021 Q2, noting that while results for 2020 are mostly known at the point of the November 2020 survey the values for 2021 are forecasted. We see an extremely persistent impact of the COVID pandemic with again evidence of a wide dispersion of impact. In quarter 2 of 2020, the bottom 5% of firms, in terms of impact, have had their sales completely wiped out, while the top 5% experienced a 50% or greater growth in sales. Firms at the 25th percentile lost 60% of their sales, while those at the 75th percentile were not impacted at all.

These varied effects are expected to persist well into 2021. The firms which experienced increased sales, however, maintained the sales bump with very little to no tapering of the effects. A year after the peak of the economic impact, quarter 2 of 2021, firms in the bottom at the 5th percentile still expect to have lost 75% of their sales while those in the 75th percentile expect to have lost 10%.

[4] Careful readers will note this is numerically the same as $impact_{it}/(0.5*impact_{it}+100)$

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Those in the top 5% expect to fully maintain their 50% gain in sales, a trend that is seen across the board for the upper half of the distribution. These divergent trajectories are in line with what is commonly referred to as a "K-shape" recovery where some firms and industries recover while others do not.

3.3. Online Vs. Offline

A huge factor in explaining why firms experienced such different impacts is the degree to which their businesses were online. Sales impacts of COVID have been and likely will continue to be far worse for offline firms than online firms.

Our primary measure of how online businesses perform is self-reported data on the percent of their revenue that they received online over the last 12 months. We find that fully online firms saw an average impact of -23% in 2020, while firms with less than 15% of their revenue online saw an average impact of -39% (Figure 3). This difference is extremely persistent as well (see Appendix Figure A4 for details). One year after the peak of the economic impact, quarter 2 of 2021, firms with at least 85% of their revenue online expect a -6.6% impact on their sales while firms with at least 85% of their revenue offline expect a -18.4% impact.

We verify our results using a second, less direct measure of how online businesses are. For a subset of firms we asked whether they considered themselves to be an online business only, a physical business only, or a combination of both. This breakdown shows a very similar result (see Appendix Figure A5). Businesses that are fully offline or partially offline report a 36.4% drop in sales, while fully online businesses report only a 23.3% drop.

3.4. Business Size

While the degree to which a business is online heavily determines the impact of COVID-19 on sales, effects vary widely by size and industry as well. Large businesses experience smaller impacts overall, with non-employer businesses bearing the worst of the crisis (figure 4). As a particularly dramatic example of the heterogeneity, primarily offline non-employee businesses lost 45.0% of their business over 2020 Q2 and Q3, while primarily online businesses with 20 or more employees only lost 10.7%, a four-fold difference. One possible explanation is management practices, since larger firms tend to be better managed (e.g. Appendix Figure A6 and Bloom et al.

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2019) and may also be better able to cope with the pandemic recession. Another possible explanation is financial position, as larger firms typically have better access to credit so may be more able to weather a period of losses.

These effects persist, as well. Businesses with 20 or more employees forecast a full recovery on average by quarter 2 of 2021, while non-employers forecast that they will still be losing 16.4% of their sales a full year after the peak (Appendix Figure A7).

We also see that industry plays an important role in firm performance (details in Appendix Figure A3). Digital businesses (i.e. producers of software and digital content) fare substantially better than travel (a 56% decline) or clothing (a 37% decline). Artists and photographers, a group in our data that largely consists of wedding and event photographers, experienced a 45% loss in sales.

3.5. Demographics – gender, race and education

Beyond which businesses are being impacted, we are also able to say something about which groups of people are bearing the brunt of the impact. We find that Black and female business owners are the worst impacted. Within demographic groups, there is still substantial variation by whether or not a business is mostly online. Differences in impact by gender are seemingly explained by differences in business characteristics.

Figure 5 shows that businesses owned by women are impacted harder than businesses owned by men. This is true regardless of whether or not they are online. Table 2 shows that female-owned businesses experienced 8% greater impacts on sales in column (1). Notably, however, these differences are largely explained by business characteristics. In particular when including a full set of industry controls (fixed effects) in column (2), the size of the business (the log of number of employees) in column (3), and the percent of their revenue that is online in column (4) the difference in impact between male and female-owned businesses drops. When we include all three of these factors in column (5) – industry, size and share of sales online – the female gap falls by three quarters and is no-longer significant. As such, we can largely account for the worse performance of female owned businesses during the pandemic in our sample by these firm characteristics.

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There is also notable racial heterogeneity in the impact of the COVID-19 pandemic. Black-owned businesses are the most negatively impacted, as shown in Figure 6. Here we show the impact on businesses by quarter, with black owned business showing a particularly large drop in the first three quarters of the pandemic. In Table 3 we evaluate this result in regression format. In column (1) we see that black-owned businesses on average had an 8% worse impact from COVID-19 than white owned businesses (the omitted base-line category). But this result is not statistically significant because of the relatively small number of black businesses in the sample. Nevertheless, this potential gap is investigated further in the rest of the regression table. We include controls for industry, firm size and online revenue share individually in columns (2) to (4), and collectively in column (5). We see that the coefficient on black owned businesses remains large and relatively unchanged by these controls, suggesting that industry, firm size or online share does not explain the majority of the black greater sales loss under COVID-19.[5] One possible explanation is that the black community has been (medically and economically) worse hit by the virus, and if black-owned businesses have greater sales among this community, it may have left them more exposed to the pandemic downturn.

We also see that Asian-owned businesses appear to be less impacted than White-owned businesses. These differences disappear, however, when controlling for business characteristics, in particular industry, reflecting their relatively greater representation in digital and medical industries.

Last of all, we turn to area of education. In Figure 7 we see that businesses run by individuals with degrees in the humanities are the worst hit, particularly those that are offline, which lose on average 43% of their sales. On the opposite end of the spectrum, STEM businesses which are primarily online lose 19% of their business. As with previous results, the differences in impacts persist strongly over time. As we show in Table 4, however, once you control for business characteristics of industry, size, and share online this humanities gap falls significantly, suggesting these businesses tend to be in more impacted industries, smaller and more off-line. Interestingly, businesses owned by founders with a business or economics degree also perform less well (than STEM businesses which are the omitted category), but this is not well explained by their industry, size, or online composition.

[5] With the same caveats for small sample sizes and statistically insignificant results.

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4. Conclusions

We use survey data on a panel of around 2,500 US small businesses to assess the impact of COVID-19. We find a significant negative sales impact that peaked in Quarter 2 of 2020, with an average loss of 29% in sales. The large negative impact masks significant heterogeneity, with over 40% of firms reporting zero or a positive impact, while almost a quarter report losses of more than 50%. These impacts also appear to be persistent, with firms reporting the largest sales drops in mid-2020 still seeing large sales loses a year later in mid-2021. In terms of business types, we also find the smallest offline firms experienced sales drops of 45% compared to 10% for the largest online firms. Finally, in terms of the owners we find female and black owners reported significantly larger drops in sales. Owners with a humanities degree also experienced far larger losses, while those with a STEM degree saw the least impact.

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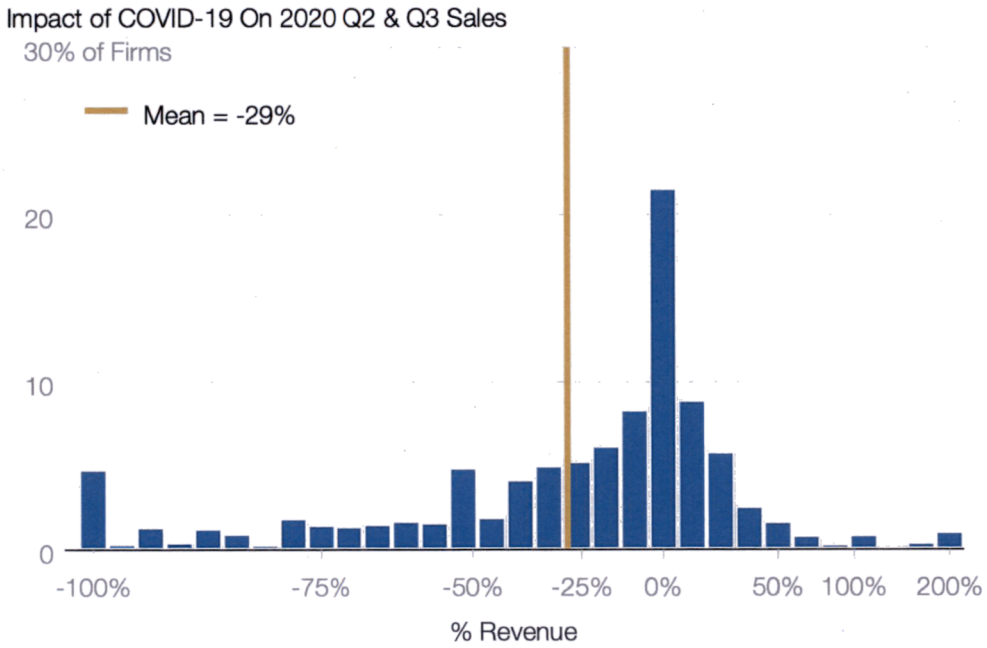
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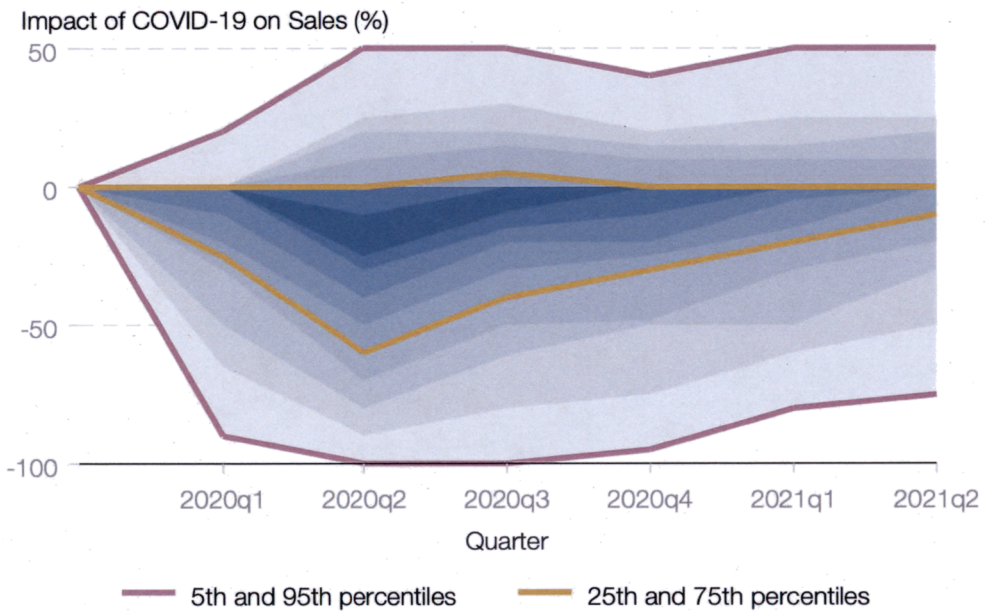
Figure 1: The COVID-19 Impact on Sales was 17% on Average, but Extremely Varied



Note: Data for 2,393 firms in the Stanford-Stripe survey from October-November 2020.

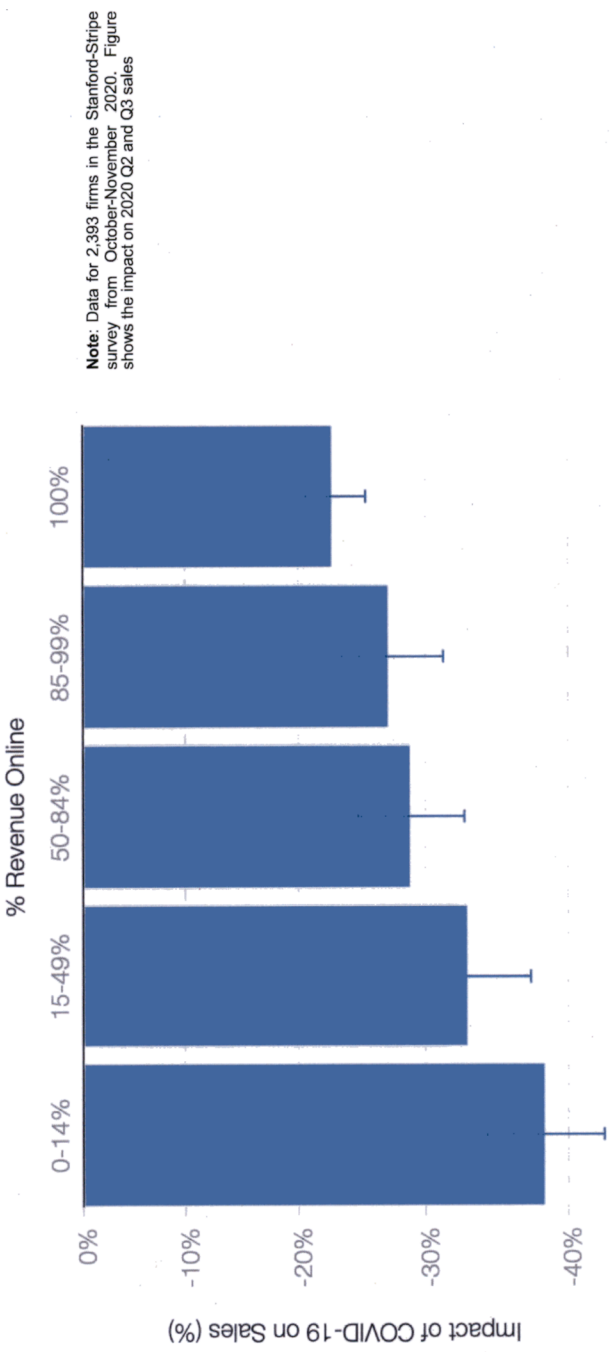
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Figure 2: The COVID-19 Impact Was Worst In Quarter 2 of 2020



Note: Data for 2,393 firms in the Stanford-Stripe survey from October-November 2020. 2020 quarter 1, 2, and 3 data is reported, while 2020 quarter 4 and 2021 data is forecasted. Purple shading is darkest for 45 to 55-percentile band, and gets lighter for deciles moving outwards from the center (e.g. the 40 to 44 and 56 to 60 is the next shade lighter etc.).

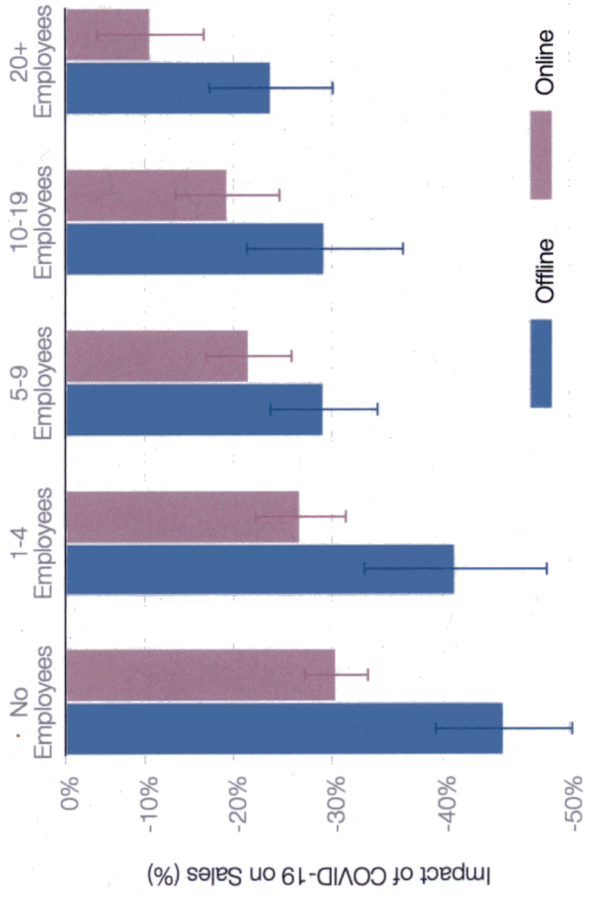
Figure 3: The Impact of COVID-19 Was Worse for Offline Firms



Note: Data for 2,393 firms in the Stanford-Stripe survey from October-November 2020. Figure shows the impact on 2020 Q2 and Q3 sales

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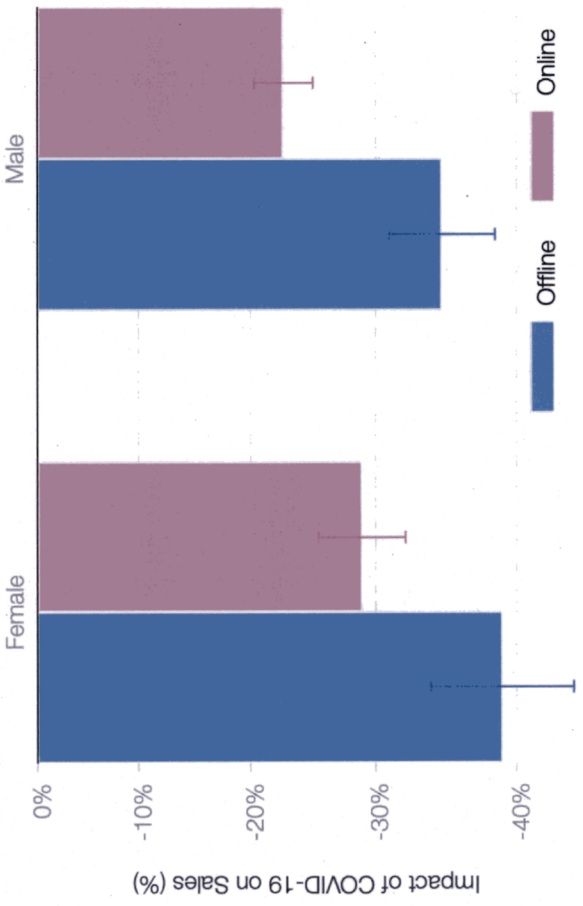
Figure 4: The Impact of COVID-19 was Worse for Smaller Firms



Note: Data for 2,393 firms in the Stanford-Stripe survey from October-November 2020. Online firms = (>50% of revenue online). Figure shows the impact on 2020 Q2 and Q3 sales

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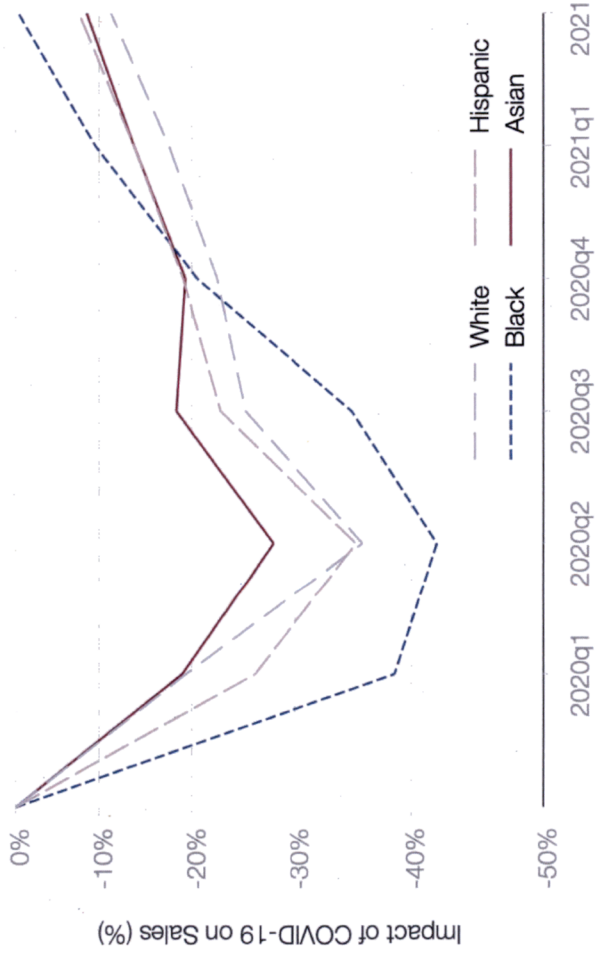
Figure 5: The Impact of COVID-19 was Worse for Female Owned Firms



Note: Data for 2,393 firms in the Stanford-Stripe survey from October-November 2020. Online firms = (>50% of revenue online). Figure shows the impact on 2020 Q2 and Q3 sales

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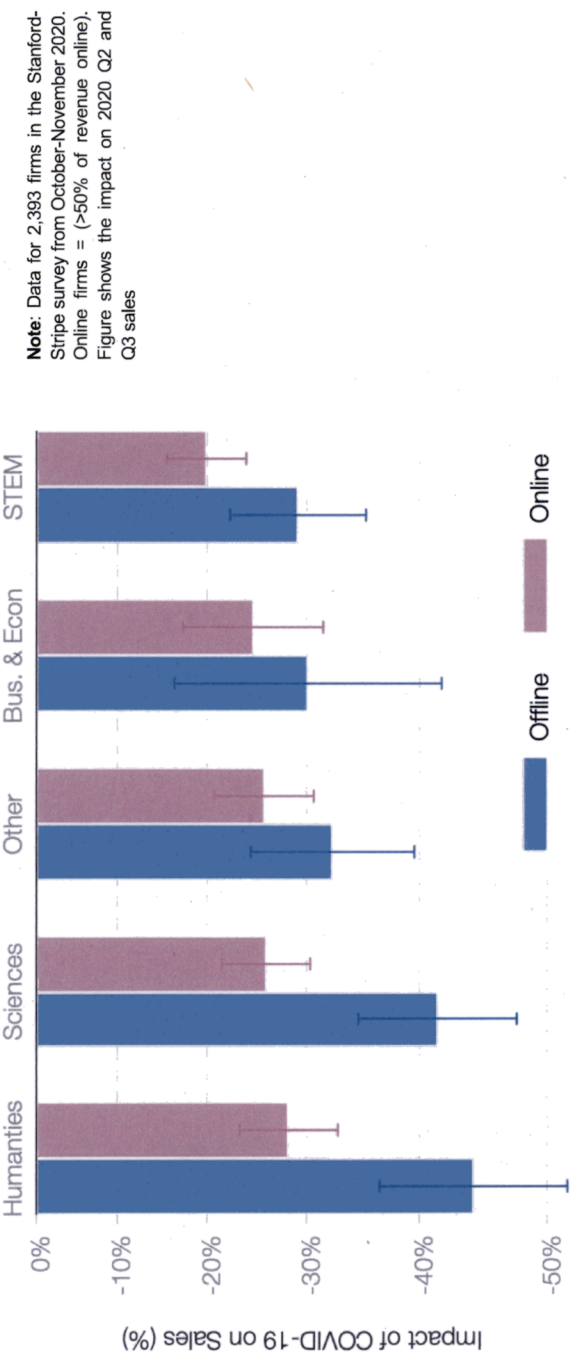
Figure 6: Impact of COVID-19 was Worse for Black Owned Firms



Note: Data for 2,393 firms in the Stanford-Stripe survey from October-November 2020. 2020 quarter 1, 2, and 3 data is reported, while 2020 quarter 4 and 2021 data is forecasted.

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Figure 7: The Impact of COVID-19 was Worse for Owners with Humanities Degrees



Note: Data for 2,393 firms in the Stanford-Stripe survey from October-November 2020. Online firms = (>50% of revenue online). Figure shows the impact on 2020 Q2 and Q3 sales

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Table 1: Descriptive Statistics

	N	Mean	Median	SD	Min	Max
Age	2380	38.80	37	10.20	16	72
Hours Per Week	2259	37.06	40	22.00	0	100
Businesses Owned	2252	1.47	1	0.79	1	5
Other Employment	2266	0.23	0	0.42	0	1
Previous Founding Experience	2252	0.95	1	1.25	0	5
Annual Income ($ '000s)	2265	58.93	30	85.81	0	560
Number of Founders	2252	1.54	1	0.84	1	5
Number of Employees	2282	8.04	2	34.56	0	1025
% Revenue Online	2267	72.15	95	36.55	0	100
% Revenue Fintech	2320	52.34	50	38.55	0	100
% Revenue International	1906	8.76	0	19.01	0	100
Observations	2393					

Note: Data for firms in the Stanford-Stripe survey from January 2019-November 2020. Number of employees includes owners, and part-time employees are counted as 0.5 (including owners if they are part-time). Hours per week is the number of hours spent on the business they founded

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Table 2: The More Negative Female Impact is Accounted for By Industry, Firm Size and Share Online

	Sales Impact	Sales Impact	Sales Impact	Sales Impact	Sales Impact
Female	-0.078***	-0.042	-0.040	-0.071**	-0.009
	(0.029)	(0.031)	(0.030)	(0.029)	(0.031)
Log Employees			0.094***		0.093***
			(0.014)		(0.014)
% Rev. Online				0.002***	0.002***
				(0.000)	(0.000)
Industry FEs		Yes			Yes
Dep. Mean	-0.320	-0.320	-0.320	-0.320	-0.320
# Obs	2083	2083	2083	2083	2083

Note: Data for 2,393 firms in the Stanford-Stripe survey from October-November 2020. Standard errors are robust.

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Table 3: The More Negative Impact on Black Owned Firms is Not Accounted for by Industry, Size or Share of Sales Online

	Sales Impact	Sales Impact	Sales Impact	Sales Impact	Sales Impact
Asian	0.125**	0.093*	0.084	0.100*	0.029
	(0.055)	(0.054)	(0.055)	(0.055)	(0.053)
Black	-0.079	-0.081	-0.054	-0.093	-0.074
	(0.080)	(0.082)	(0.079)	(0.079)	(0.080)
Hispanic	0.014	0.011	0.019	0.019	0.020
	(0.058)	(0.058)	(0.057)	(0.059)	(0.057)
Log Employees			0.090***		0.090***
			(0.015)		(0.015)
% Rev. Online				0.002***	0.002***
				(0.000)	(0.000)
Industry FEs		Yes			Yes
Dep. Mean	-0.319	-0.319	-0.319	-0.319	-0.319
# Obs	1906	1906	1906	1906	1906

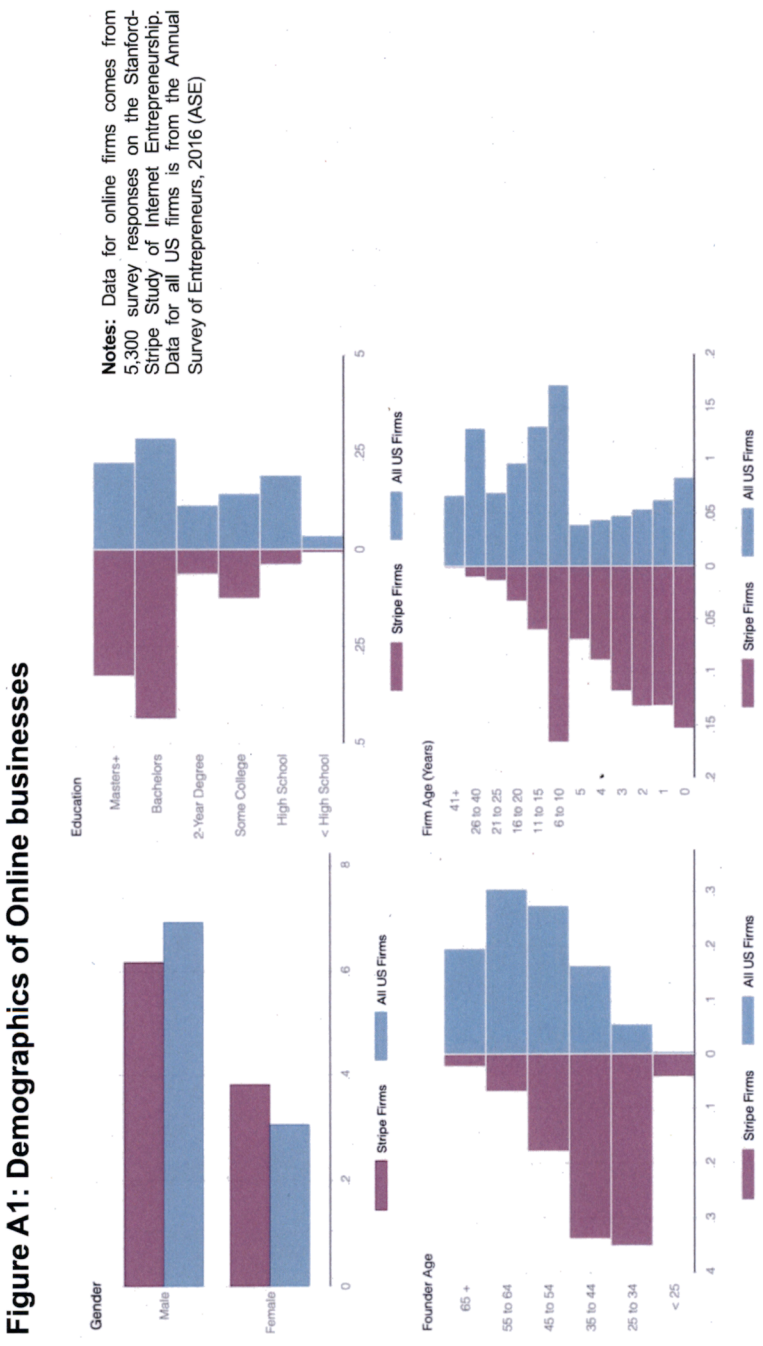
Notes: White owned businesses are the omitted category. Data for 2,393 firms in the Stanford-Stripe survey from October-November 2020. Standard errors are robust.

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Table 4: Negative Humanities Effect Accounted for Mainly by Industry, Size and Share Online

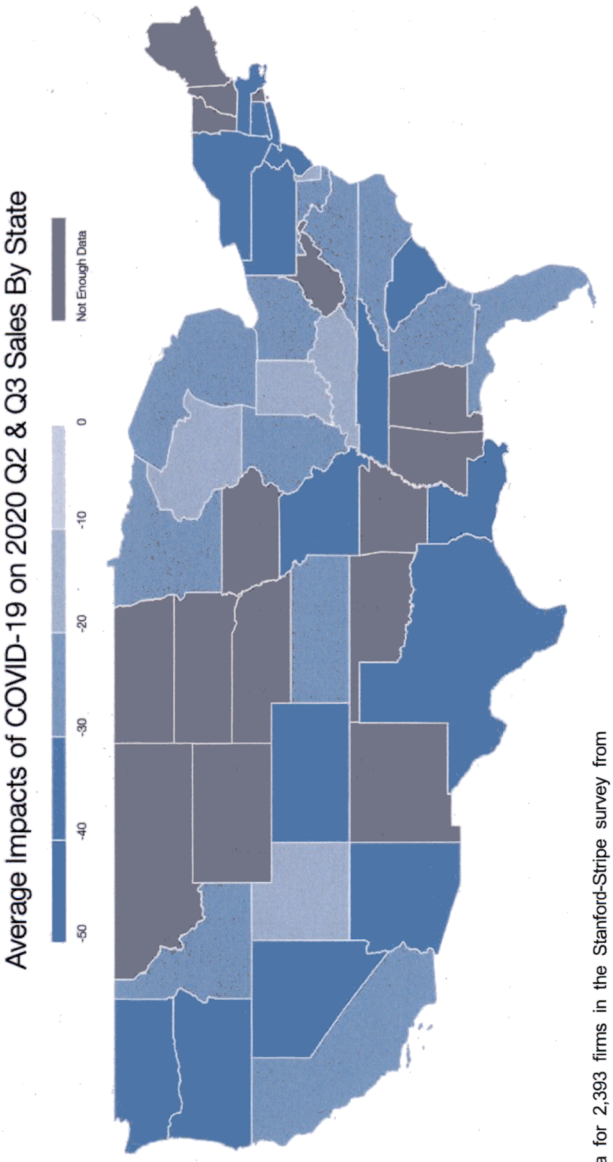
	Sales Impact	Sales Impact	Sales Impact	Sales Impact	Sales Impact
Degree Humanities & Arts	-0.111***	-0.092**	-0.074*	-0.105***	-0.056
	(0.039)	(0.040)	(0.039)	(0.039)	(0.039)
Degree Econ & Bus	-0.089**	-0.083**	-0.106***	-0.085**	-0.095***
	(0.035)	(0.035)	(0.035)	(0.035)	(0.035)
Degree Other	-0.075*	-0.056	-0.044	-0.064	-0.021
	(0.039)	(0.039)	(0.039)	(0.039)	(0.039)
Degree Social Sciences	-0.017	-0.030	0.001	-0.003	-0.006
	(0.043)	(0.044)	(0.044)	(0.043)	(0.044)
Log Employees			0.099***		0.096***
			(0.015)		(0.015)
% Rev. Online				0.002***	0.002***
				(0.000)	(0.000)
Industry FEs		Yes			Yes
Dep. Mean	-0.319	-0.319	-0.319	-0.319	-0.319
# Obs	1946	1946	1946	1946	1946

Notes: STEM is the omitted category. Data for 2,393 firms in the Stanford-Stripe survey from October-November 2020. Standard errors are robust.



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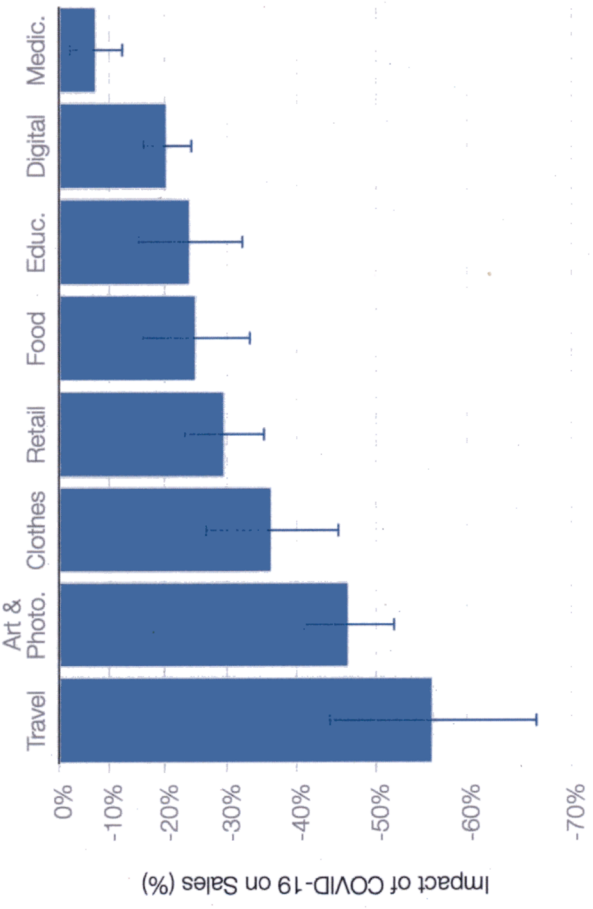
Figure A2: Average Impact of COVID-19 by State



Note: Data for 2,393 firms in the Stanford-Stripe survey from October-November 2020. States with fewer than 12 observations are marked as not having enough data.

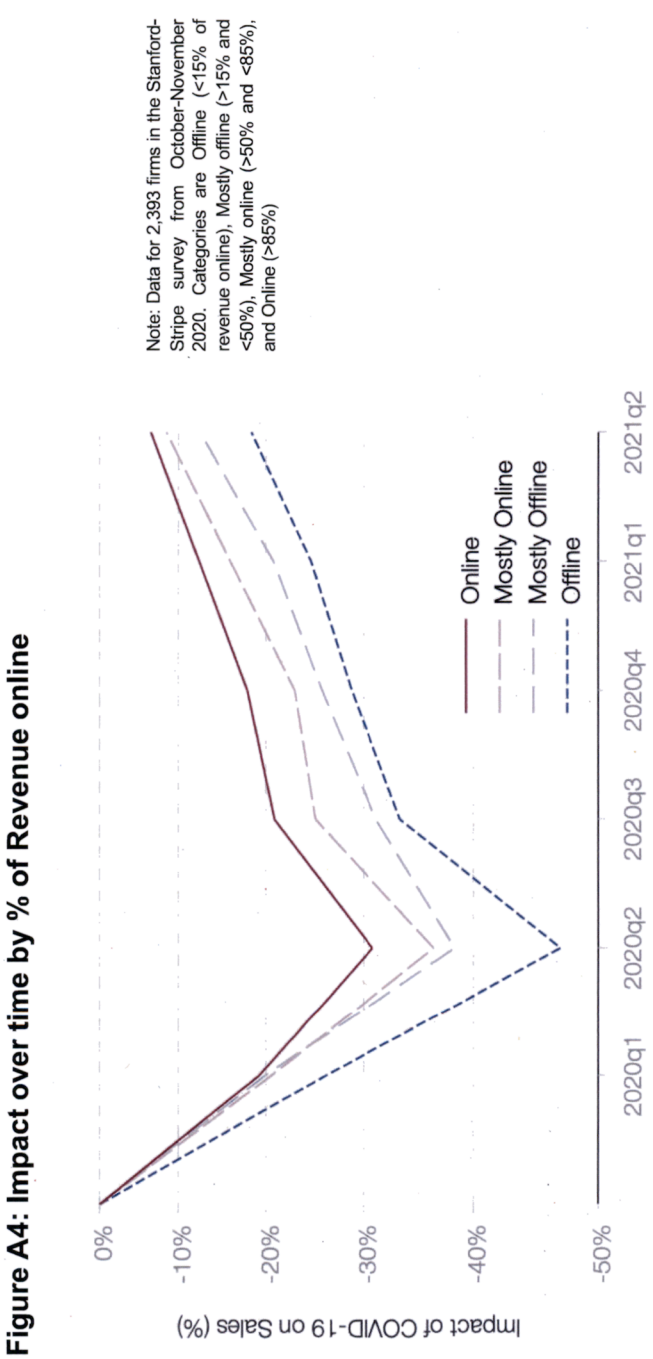
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Figure A3: Average Impact of COVID-19 By Industry



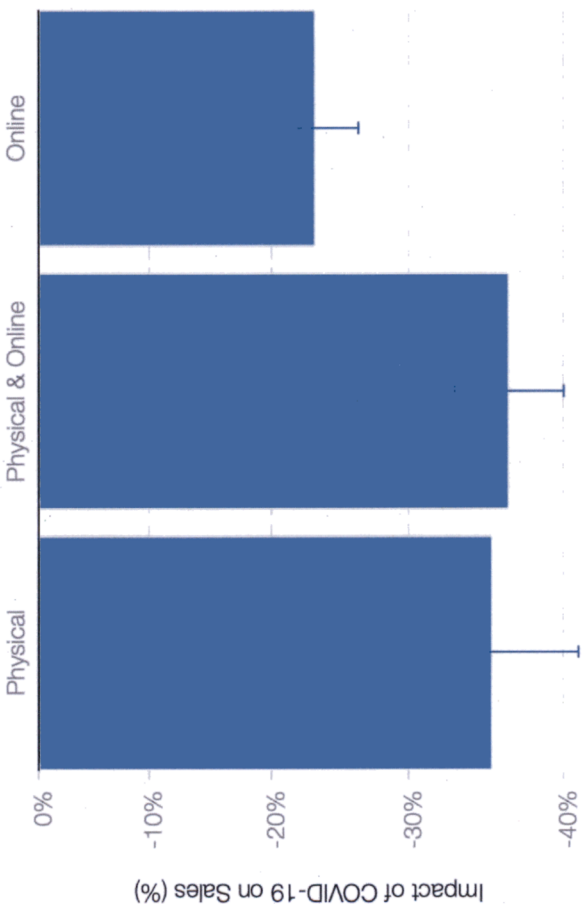
Note: Data for 2,393 firms in the Stanford-Stripe survey from October-November 2020. Figure shows the impact on 2020 Q2 and Q3 sales

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Figure A5: Average Impact of COVID-19 By Online Vs. Offline

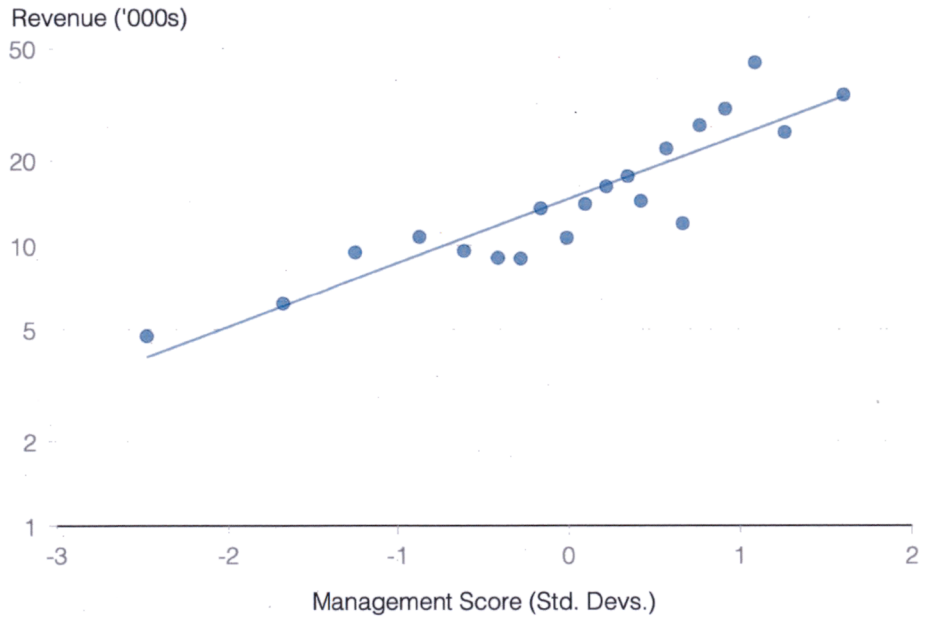


Note: Data for 2,393 firms in the Stanford-Stripe survey from October-November 2020. Figure shows the impact on 2020 Q2 and Q3 sales

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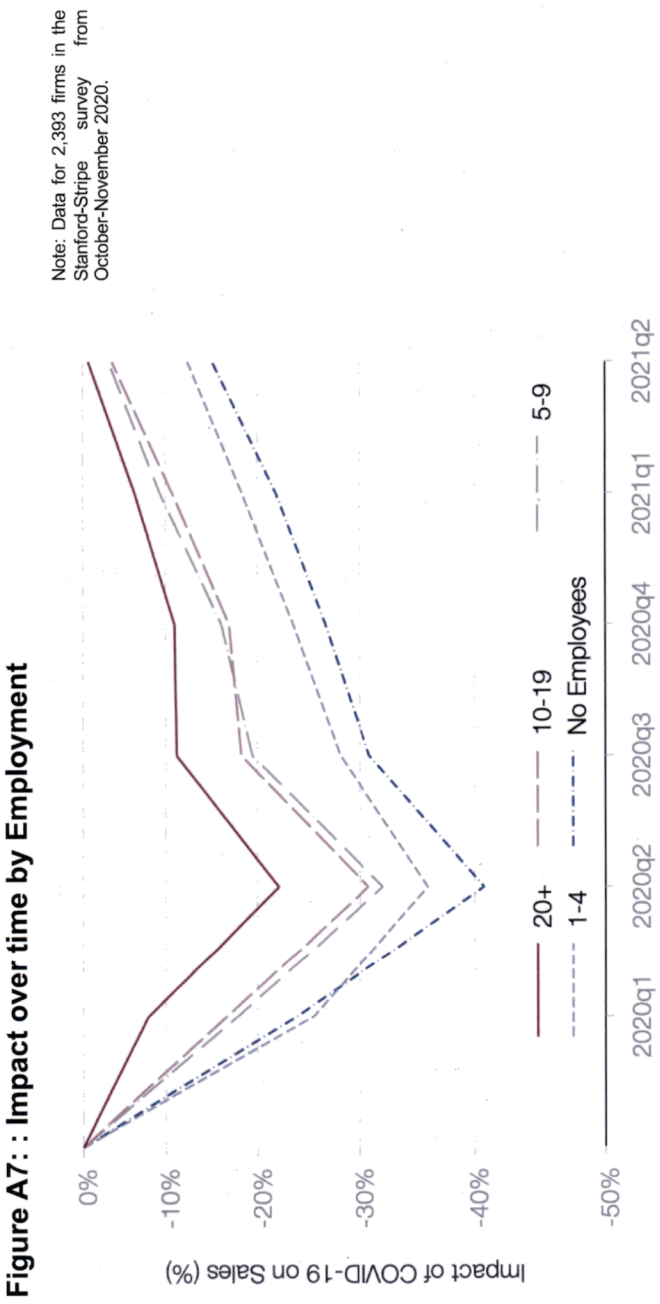
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Figure A6: Better Managed Firms are Bigger



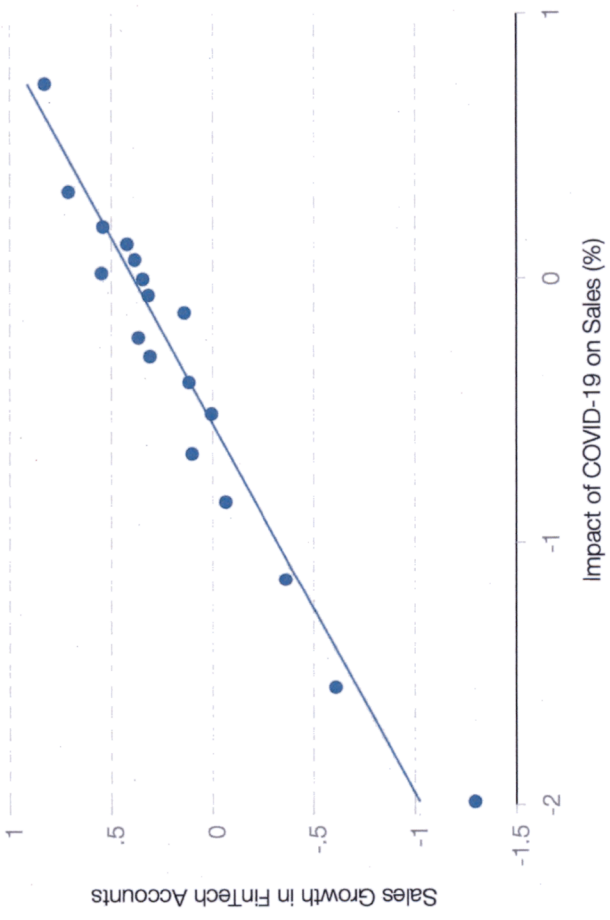
Notes: 2,207 survey responses from the second wave of the Stanford-Stripe Study of Internet Entrepreneurship. The management scores are based on the Bloom et al. (2019) management scoring approach applied to this sample of firms.

Figure A7: : Impact over time by Employment



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Figure A8: Reported Impact of COVID-19 Correlates with Sales Growth



Note: Data for 2,393 firms in the Stanford-Stripe survey from October-November 2020. Figure shows the impact on 2020 Q2 and Q3 sales plotted against the average growth of transactions revenue in Fintech between 2019 Q2 and Q3 vs 2020 Q2 and Q3.

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Figure A9: Reported Impact of COVID-19 Correlates with Sales Growth

We would like you to consider the recent impact of COVID-19 in the following questions.

What was the impact of COVID-19 on your firm's sales revenues over:

	Lower	No Effect	Raise
Quarter 1, 2020 (Jan. 2020 - Mar. 2020)?	○	○	○
Quarter 2, 2020 (Apr. 2020 - Jun. 2020)?	○	○	○
Quarter 3, 2020 (Jul. 2020 - Sep. 2020)?	○	○	○

By what percentage did the impact of COVID-19 **lower** your firm's sales over **Quarter 1** (January 2020 through March 2020)? *Must be between 0% and 100%.*

[ ]%

By what percentage did the impact of COVID-19 **lower** your firm's sales over **Quarter 2** (April 2020 through June 2020)? *Must be between 0% and 100%.*

[ ]%

By what percentage did the impact of COVID-19 **lower** your firm's sales over **Quarter 3** (July 2020 through September 2020)? *Must be between 0% and 100%.*

[ ]%

Table A1: Response rates by Firm Characteristics

	Survey Not Completed.		Survey Completed			
	Mean	Std. Dev.	Mean	Std. Dev.	t-stat	Norm. Diff.
Email Confirmed	0.87	-0.34	0.9	-0.29	7.52	0.11
Small	0.28	-0.45	0.34	-0.48	9.21	0.14
Large	0.36	-0.48	0.37	-0.48	1.16	0.02
Funded	0.36	-0.48	0.28	-0.45	-10.7	-0.16
Log Age	6.38	-0.95	6.32	-0.96	-3.53	-0.06
Log Revenue 2018	9.97	-2.79	9.71	-2.45	-5.5	-0.1
Log Revenue 2019	9.63	-3.22	9.48	-2.75	-3.29	-0.05
Sole Prop	0.29	-0.45	0.36	-0.48	9.34	0.15
Partnership	0.01	-0.11	0.01	-0.11	0.73	0.01
LLC	0.31	-0.46	0.32	-0.47	1.41	0.02
Corporation	0.36	-0.48	0.29	-0.46	-9.69	-0.15
Non-Profit	0.02	-0.15	0.01	-0.12	-4.96	-0.07
Observations	21184		5219			

Notes: Data from full-sample 26,403 firms in the Stanford-Stripe.

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March 9 2022

The Honorable Nydia Velázquez
Chairwoman
Committee on Small Business
U.S. House of Representatives
Washington, DC 20515

The Honorable Blaine Luetkemeyer
Ranking Member
Committee on Small Business
U.S. House of Representatives
Washington, DC 20515

Dear Chair Velázquez and Ranking Member Luetkemeyer,

Thank you for the opportunity to provide Public Citizen's views on the beneficial impacts of regulations for small businesses and to correct numerous false and misleading claims from the minority witness during your committee's recent hearing entitled "Competition and the Small Business Landscape: Fair Competition and a Level Playing Field," which was held on March 1.

The committee should be applauded for holding this hearing and focusing its attention on the true cause of the decreasing number of small business in this country: increasing corporate concentration by big business due to decades of lax antitrust enforcement by government authorities. Unfortunately, some experts continue to blame federal regulations as the primary threat to small business in false and misleading fashion. Yet, there is virtually no empirical evidence to support such claims.

In fact, the studies cited by Mr. Douglas Holtz-Eakin in the hearing have been thoroughly debunked and formally disavowed by the entity that commissioned them,[1] the Small Business Administration's Office of Advocacy (SBA Advocacy). Shockingly, even after disavowing the study that it commissioned, SBA Advocacy attempted once again in 2018 to issue a contract to the same researchers of the disavowed study, Mark and Nicole Crain, for a similar study on the costs of federal regulation.[2] Fortunately, SBA Advocacy was forced to cancel the contract after media reporting exposed the commissioning of a new report by the same discredited researchers. While this prevented another misleading study on the purported costs of federal regulations on small business from further polluting the debate around the impact of federal regulations on small business, SBA Advocacy was not able to recoup the first half of the contract that was paid to the Crains resulting in wasteful spending of taxpayer funds.[3] Fundamental problems continue to exist at SBA Advocacy that require oversight and attention from your Committee as detailed below.[4]

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[1] https://www.sba.gov/advocacy/impact-regulatory-costs-small-firms
[2] https://sensiblesafeguards.org/sbafakenews/
[3] https://www.sbc.senate.gov/public/_cache/files/1/0/101f240e-caf7-4226-a5d3-cebcb9544f44/1BD62DDEB15625DC5810E412E3F879FC.shaheen-heitkamp-letter-to-sba-office-of-advocacy-12.22.17.pdf
[4] See Richard Parker, *The Faux Scholarship Foundations of the Regulatory Rollback Movement*, Ecology Law Quarterly (2019) available at https://opencommons.uconn.edu/cgi/viewcontent.cgi?article=1426&context=law_papers for a comprehensive debunking of the SBA Advocacy Report and other misleading studies cited to criticize the impact of federal regulations.

Indeed, the available credible evidence shows that there is **no** harmful impact on small business from federal regulations. The leading study, entitled "Is regulation to blame for the decline in American entrepreneurship?"[5], analyzed small business creation across multiple industry sectors, including those that are both highly regulated and less regulated, and concluded that the decline is small business creation is widespread across all sectors no matter the level of regulation. Thus, the study definitively answers the question posed in its title with an emphatic "no." It is worth noting that one of the authors of the study, Alex Tabarrok[6], is a noted economist with the conservative Mercatus Center at George Mason University which describes itself as "the world's premier university source for market-oriented ideas."

The committee's view of whether and how federal regulations impact small business must be informed by facts and evidence, not anecdotes and talking points from those ideologically opposed to regulation. The danger goes beyond just misinforming and misleading the public. If members of the committee approach this issue with the fundamental assumption that federal regulations only hurt, and never help, small business, it will be blind to the clear evidence that numerous regulations are directly intended to help small business.

For example, there are currently two rulemakings that agencies are promulgating that will directly benefit small business if finalized. First, the US Department of Agriculture (USDA) is taking long overdue action[7] to level the playing field for small chicken farmers that are being harmed and abused by monopolistic practices by large corporate meatpackers that have a stranglehold on the poultry market. If finalized, these USDA regulations will protect small business from larger competitors that are abusing their market power.

Second, the Consumer Financial Protection Bureau (CFPB) is finally implementing a rule more than ten years after it was mandated in the Dodd-Frank financial reform law to require banks to provide data on lending patterns to women and minority-owned small businesses.[8] There is strong and clear evidence showing that women and minority-owned small businesses receive fewer and less favorable loans than their small business peers. Thus, this rule will directly benefit small businesses owned by women and minorities. These are just two examples of many rules that will improve the climate for small business owners.

One would expect that SBA Advocacy, which claims it advances the interests of small business, would be supportive of both rules and engaging the small businesses that benefit from both. Unfortunately, that is hardly the case. In fact, according to a search of its website, SBA Advocacy has never issued a public comment letter in support of regulations that protect small chicken farmers from the large corporate meatpackers. Even worse, SBA Advocacy included no women or minority owned small businesses in its small business review panel regarding the upcoming CFPB rule.[9] Instead, SBA Advocacy only heard from lenders and financial institutions that would comply with the rule. It is no surprise then that SBA

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[5] https://academic.oup.com/economicpolicy/article/33/93/5/4833996?login=true#109966346
[6] https://mason.gmu.edu/~atabarro/
[7] https://www.usda.gov/media/press-releases/2021/06/11/usda-begin-work-strengthen-enforcement-packers-and-stockyards-act
[8] https://www.consumerfinance.gov/about-us/newsroom/cfpb-proposes-rule-to-shine-new-light-on-small-businesses-access-to-credit/
[9] https://files.consumerfinance.gov/f/documents/cfpb_1071-sbrefa-report.pdf

Advocacy issued a comment letter to CFPB that largely parroted the views of financial institutions and lenders while ignoring the benefits of the rule to women and minority-owned small businesses.[10]

This follows a long-standing pattern at SBA Advocacy of ignoring certain small business viewpoints, namely those that support federal regulations, while favoring other small business viewpoints, namely those that oppose federal regulations, in unbalanced and asymmetric fashion. A 2019 Senate small business committee hearing on the Reauthorization of SBA Advocacy is a case in point. At the hearing, small business owner Rick Baumann, who owns Murrells Inlet Seafood in South Carolina, testified[11] that while he strongly opposed efforts at the time to massively expand offshore drilling in the Atlantic Coast due to the potential for oil spills that would destroy his business, his views were never solicited by SBA Advocacy. Not surprisingly, SBA Advocacy ignored his and thousands of other coastal businesses concerned about the expansion of offshore drilling by strongly supporting the Department of Interior's plan to expand offshore drilling.

This is hardly an isolated case. Currently, the Environmental Protection Agency (EPA) is developing regulatory protections for many communities across the country contaminated by two toxic chemicals, PFAS (also known as "forever chemicals)[12] and Ethylene Oxide.[13] Both chemicals are highly carcinogenic but have gone unregulated for too long despite clear evidence showing the threat they pose to public health. As EPA has begun the rulemaking process to regulate and protect the public, particularly those communities with the highest contamination levels, SBA Advocacy has enlisted small businesses to participate in small business review panels. Predictably, there is no evidence whatsoever that SBA Advocacy has reached out to any small businesses that support increased regulation of these toxic chemicals, particularly small businesses in those communities that are most impacted.

SBA Advocacy is in dire need of deep and fundamental reforms to ensure that it is listening to all small businesses and not just those opposed to federal regulation. Public Citizen urges this committee to conduct robust oversight of SBA Advocacy to ensure that is using its authorities under the Regulatory Flexibility Act in a fair, neutral, objective, and balanced manner in addition to examining how increasing corporate concentration by big business hurts small businesses across the country. Please contact me at anaran@citizen.org for any additional information or questions.

Sincerely,



Amit Narang, Regulatory Policy Advocate
Public Citizen

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[10] https://cdn.advocacy.sba.gov/wp-content/uploads/2022/01/20105345/FINAL_CFPB-Small-Business-Lending-Data-Collection-for-Filing_1.6.22.pdf
[11] https://www.sbc.senate.gov/public/_cache/files/a/2/a299499f-2e05-45e4-9754-b9df51209803/F27DB29849E78A35EE848612688BDADC.baumann-testimony.pdf
[12] https://www.epa.gov/pfas
[13] https://www.epa.gov/hazardous-air-pollutants-ethylene-oxide

SBE COUNCIL
Small Business & Entrepreneurship Council

March 1, 2022

The Honorable Blaine Luetkemeyer
Ranking Member
Committee on Small Business
U.S. House of Representatives
Washington, D.C. 20515

Dear Ranking Member Luetkemeyer:

I am writing to express the views of the Small Business & Entrepreneurship Council (SBE Council) with regard to today's Committee on Small Business hearing, "Competition and the Small Business Landscape: Fair Competition and a Level Playing Field."

For 28 years, SBE Council has worked on a range of policy initiatives to strengthen the environment for strong startup activity and small business success, and we believe intrusive government policy is what gets in the way of healthy entrepreneurship and business entry. When government, at any level, makes it difficult and costly to start and grow a business then entrepreneurship and competition suffer. Rather than look at ways that government should micromanage the economy or certain sectors to bolster competition, elected officials and policy makers need to be looking at ways to bring down government-imposed barriers like regulation and high taxes that dissuade entrepreneurial activity and therefore competition.

Entrepreneurs See Opportunity

As noted by the majority in a memo about today's hearing, there is a strong uptick in entrepreneurial intention as embodied by the higher number of new business registrations in 2020 and 2021.

The actual data belies the premise that markets are inaccessible and that a few big companies monopolize key sectors, which is the rationale behind President Biden's Executive Order on Competition and the legislative activity on Capitol Hill aimed, for example, at reining in 'big tech.'

According to the U.S. Census Bureau, 5.4 million people filed business applications to start new businesses in 2021, an increase of 53% from 2019 and the most of any year on record.

This upsurge began in 2020, and there seems to be no slowing down, as more than 430,000 individuals applied for business applications in January 2022.

Moreover, sectors identified in business applications are broad-based – across all major industries – with the top five being transportation and warehousing; retail trade; accommodation and food services; administrative and support; and other services.

It is vitally important that government leaders understand why this entrepreneurial upsurge is happening, and more importantly encourage it to unfold. After all, applying for a business application is merely the first step in launching a business and missteps by government that discourage the new entrepreneurs will undermine U.S. economic recovery and a vibrant, competitive economy.

Only a fraction of those applying for business applications will move forward, according to Census Bureau data.

Out of the total business applications filed in January 2022 (430,411), it is estimated that only 31,287 businesses will actually form over the course of a year, and 40,433 will form over two years. So, government actions need **to focus on encouraging new businesses to fully form,** not dissuading entrepreneurs from launching their businesses by erecting new and costly regulatory barriers or higher taxes.

Our economy needs these new risk-takers to succeed to help replenish the countless number of businesses that closed or shrank during the pandemic shutdowns. These new entrepreneurs are seeing vast opportunities in the transformed economy - a vibrant and competitive one - which is quite different than the inaccessible and restricted business environment described by President Biden or members of Congress who are working to advance intrusive government regulation and punishing actions in the name of promoting competition.

Technology and Digital Tools are a Dynamic Force for Entrepreneurship

New entrepreneurs are seeing opportunity due to the widespread adoption of innovative technologies, and they are tapping into free or affordable digital tools to access the massive consumer marketplace.

The transformation in retail, for example, a sector where we see high levels of business entry, driven by online engagement and the transformation to digital are requiring small **and large businesses** alike to methodically evolve in order to cater to the wide mix of shopping preferences and consumer needs. Most consumers have increased their use of digital tools – honed during the pandemic - to fully support (not replace) their physical shopping trips.

New studies by Deloitte for the Computer and Communications Industry Association (CCIA) on small and mid-size businesses (SMBs) reveal the reality and positives of this evolving dynamic. The reports are must reading for Members of Congress who are working to impose new regulations on America's technology leaders, **as the legislation being pushed will actually harm the SMBs** that are using an array of tech tools and platforms to reach and serve

consumers. These various bills will harm consumers and small businesses by disallowing conveniences they enjoy and have come to depend on. If that isn't enough, **legislation would also undermine** America's startup ecosystem, and the investment and innovation that leads to more beneficial products and services for consumers. This is not what our economy needs as it works to recover from the pandemic and navigate the crushing impact of inflation.

As noted by CCIA **in a press release about the studies:**

"The rapid growth of omnichannel retail has allowed both SMBs and large national retailers to find synergies between their physical and digital channels, adding further value to physical stores. The survey finds that consumers are seamlessly using both digital and in-person retail options, more often than not within the same journey, to find the products they want, at the best price, and with a fulfillment method most convenient to them. **The research supports the idea that consumers don't think of shopping in segmented terms of online and offline.**"

For example, **according to the key takeaways provided by CCIA**, SMBs have positively responded and are continually innovating to meet consumers where they are, how they want to be served, and are able to do so because of tech tools:

• SMBs are taking advantage of the omnichannel fulfillment option and leveraging their physical stores: 61% offer buy online, pick up in-store, and 50% offer buy online, same-day curbside pickup.

• 99% of SMB retailers use at least one digital tool or marketplace, including retailers who only sell via physical stores. Digital tools have lowered barriers to entry, allowing SMBs to reach consumers far beyond their physical location or hometown.

• Among the SMB retailers who are currently selling online, they're using a variety of digital touchpoints; 70% are using more than one: 39% are using two and 31% use three or more.

• 27% of online sales were fulfilled at the physical store in 2021, up from 21.7% in 2020, demonstrating the importance of physical retail.

Especially over the past 10-15 years, retail has dramatically evolved. It will continue to do so because of innovative entrepreneurs and technology. Again, consumers and entrepreneurs are greatly benefiting in this dynamic sector. Some in Congress see boogeymen, while consumers and small business owners see efficiencies, conveniences, competition and opportunity.

Sound Policy, Not More Government

If the Administration and Congress want to help small businesses compete, and for entrepreneurs to launch and succeed in their new business endeavors, legislation and policies must address their pain points: inflationary pressures, supply chain disruptions, labor shortages, high health care costs, and an uncertain economy in general. As we've seen over the past year, the more government intervenes through increased regulation or the threat of higher taxes, the worse these problems have become.

Small businesses and entrepreneurs need policy stability and less government, and SBE Council urges the pursuit of the following simple principles by the Administration and Congress:

- Lower taxes and tax simplification.

- Emphasize regulatory relief, not imposing additional regulatory burdens.

- Strengthen access to global markets through trade agreements.

- Address high health coverage costs and lack of access through more affordable options, which means regulatory modernization (not more regulation or price controls.)

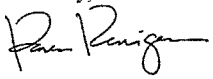
- Smart monetary policy is critical.

- Encourage workforce entry and training and address immigration reform.

SBE Council looks forward to our work with the Committee and all members of Congress in pursuing these sound policy objectives. Again, strong entrepreneurship and business growth hinge on pro-small business policies, and that means government restraint and modernizing the systems or regulations that prevent businesses from starting or successfully launching in the first place.

Thank you for the opportunity to provide comments today, and for your strong support of America's small businesses and entrepreneurs.

Sincerely,



Karen Kerrigan
President & CEO

cc: Chairwoman Nydia Velazquez
Members of the Committee on Small Business

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(703)-242-5840 •www.sbecouncil.org •@SBECouncil

Protecting Small Business, Promoting Entrepreneurship

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SOCIETY OF COMPOSERS & LYRICISTS

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February 3rd, 2022

Nydia M. Velázquez, Chair
House Small Business Committee
2302 Rayburn House Office Building
Washington, DC 20515

Blaine Luetkemeyer, Ranking Member
House Small Business Committee
2230 Rayburn HOB
Washington, D.C. 20515

Re: The Power, Peril and Promise of the Creative Economy

Dear Chair Velázquez and Ranking Member Luetkemeyer:

The **Society of Composers & Lyricists** (SCL) is the premier US organization for music creators working in all forms of visual media, including film, television, video games, and musical theatre. It has a membership of over 2,400 professional composers and lyricists and is a founding co-member— along with Songwriters Guild of America (SGA) and other independent music creator groups -- of Music Creators North America (MCNA).

At the outset, we would like to thank the House Small Business Committee for holding the January 19th, 2022 hearing titled: The Power, Peril, and Promise of the Creative Economy. We appreciate how the hearing focused on the dire impact of the COVID-19 pandemic on the arts sector and creative economy, and we support the many bills that were discussed during that hearing, specifically the Shuttered Venue Operators Grant Program (SVOG), the Performing Arts Tax Parity Act, the HITS Act, the Arts Education for All Act, the Creative Economy and Revitalization Act, and the 21st Century Federal Writers Project.

Operating as independent contractors, audio-visual music creators are essentially small businesses. To "manufacture" our product, we need thousands of dollars of equipment housed in a specifically designed space, and the product we manufacture (i.e., the "Music") contains copyright, which then gets folded into yet another copyright (i.e., the "Program"). In the process, we engage musicians, music preparation staff, singers, recording engineers, software programmers and more.

As mentioned in the hearing, the creative economy generated approximately 4.3% of the United States' gross domestic product ($919.7 billion) in 2019, and prior to the pandemic employed almost 5.2 million workers (about 3.3% of the US workforce). As was also discussed in the hearing, with the onset of Covid-19 virtually all entertainment production of film, TV and live theatre was cancelled. As a result, our profession was decimated with employment falling by as much as 25%.

Thus, we stand in solidarity with our creative colleagues who testified January 19 and applaud them for raising critical issues. There is an important distinction, however, that we believe warrants further attention from Congress – and that is that unlike those distinguished witnesses – audio-visual music creators do not have the benefit of being members of labor unions or guilds. We believe our voices, and the unique issues we face, warrant consideration by Congress.

For this reason, we respectfully request a follow up hearing where creators of artistic works and source material presented by venues and performers alike, can elucidate how the imbalance of power negatively impacts independent contractors operating as small businesses within the entertainment industry.

Let me provide some background: since the 1976 ruling in which the National Labor Relations Board (NLRB) deregistered the Composers & Lyricists Guild of America (CLGA), removing any right to collective bargaining, US audio-visual composers' musical creations have been deemed "Works For Hire" (WFH). This action means that as a condition of engagement, composers are forced to grant producers (the Film and Television studios) ownership of the copyrights in their works. While foregoing ownership in exchange for benefits such as collective bargaining (salary, working conditions, etc.), retirement and healthcare plans, may be typical of employee status, audio-visual composers are instead classified as Independent Contractors and therefore access none of these benefits. We lose ownership of our works and lose the right to any of the standard benefits accorded to every other crew and cast member working in the audio-visual industry.

This state of affairs is fundamentally due to the imbalance in bargaining power and the legal prohibitions denying audio-visual music creators the ability to collectively ensure better treatment and terms for our work. Creative workers are the original "gig" workers—we work on a freelance basis for a defined set of employers that provide standard contracts and low pay, with no ability to negotiate better terms. Under current antitrust laws, we are prohibited from acting together, in concert, to say "no" to certain terms, secure better remuneration, or highlight bad actors. Current labor laws treat audio-visual music creators as though we are independent businesses with the ability to negotiate with the buyers of their services. But that is far from reality. The fact is that there is no meaningful two-way bargaining. The specifics may differ, but audio-visual music creators and many other creative professionals share one thing in common: we are workers with no employee protections, no benefits, no minimum wages, no ability to collect unemployment, and yet no ability to negotiate our contracts or to collectively bargain for better terms. Many do not make minimum wage and have seen massive decreases in their pay in recent years, while more and more rights are extracted so that they cannot sell them separately.

As the US transitions to more of a "gig" economy, there is an opportunity to correct practices that continue to severely impact the livelihoods of audio-visual music creators. Accordingly, the Society of Composers & Lyricists thanks the House Small Business Committee for the opportunity to submit these comments as a follow up to the January 19th hearing on the creative economy with the hope they may serve to shine some light on the audio-visual music creators'

unenviable position of having neither traditional employee rights or benefits, nor any bargaining power.

As a sector of an industry that contributes immeasurably to the cultural and economic well-being of the US, we request that the Committee continue to seek ways to assist all of those in the US creative industries, including those of us who are not able to take unified action to address unfair wages or working conditions.

Sincerely,



Ashley Irwin
President

United States House of Representatives
Committee on Small Business

Competition and the Small Business Landscape
Fair Competition and a Level Playing Field

March 1, 2022

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Chairwoman Velázquez, Ranking Member Luetkemeyer, and members of the Committee, thank you for the opportunity to submit written testimony regarding this hearing.

I am the President and CEO of the South Carolina Small Business Chamber of Commerce which I co-founded in 2000. We have over 5,000 small business supporters and provide advocacy and the state and federal level on small business issues.

I also serve on the Executive Committee for the American Sustainable Business Network and have served on the Board of Directors for this organization in different capacities since 2011.

Thank you for holding a hearing on small business and fair competition.

First let me make some general comments and recommendations before focusing on the issue of regulations.

Small businesses thrive in a free market where they are on a level playing field with competition, including competition by larger businesses.

Unfortunately, the playing field is not level regarding competition with corporations. On this issue it is important to note that the vast majority of small businesses are not corporations. We define small businesses as those with fewer than one hundred employees. These are typically sole proprietors, LLCs, and S-Corps.

Corporations in general, and multi-national corporations in particular, have competitive advantages over small businesses. not all of which are unfair or needing to be addressed by government actions.

Expert testimony has already been given on the importance of enforcing antitrust laws vigorously. So, I will not address that need.

However, let me recommend government actions in four areas which can help small businesses be more competitive with big business: employee benefits, taxation, access to capital and regulations.

Employee Benefits

- Employer-sponsored health insurance is too costly for most small businesses and is too costly for small business owners to purchase for themselves and their families. This discourages entrepreneurship and hurts small businesses with recruiting skilled workers when competing with larger businesses. The federal Health Insurance Marketplace has been a great asset to entrepreneurs wanting to start a business and existing small business owners who want employees to be healthy and more productive without incurring the cost, both premiums and administrative, of offering group health. With the temporary waving of the 400% of federal poverty level to qualify for premium assistance, more small business owners can now afford quality health insurance via the Marketplace instead of only being able to afford short-term, low-benefit plans.

  Congress should address the cost of health insurance by making the enhanced premium

assistance under the Affordable Care Act permanent so that small businesses do not have to offer health insurance to compete for labor. Congress should also address one of the main drivers of health insurance costs—prescription drugs. Proposals to cap the cost of many prescription drugs and allow Medicare to negotiate prescription drug prices should be adopted to tame the upward pressure on health insurance for the benefit of all businesses and workers.

- Employer-sponsored 401k plans are also too costly for small businesses to offer and thus create an unfair playing field for employee recruitment when competing against larger businesses. Congress should establish a portable employee retirement program specifically for small business. Such a federally operated 401k would give working Americans the opportunity to fund and control their own retirement plans, with or without employer contributions, and give them the independence not to be tied to an employer. An added bonus would be more American's saving for their retirement since most small businesses do not offer retirement plans.
- Most small businesses do not offer paid-family leave or paid-employee medical leave due to cost. This is yet another example of the unlevel playing field small businesses have with corporations. Congress should establish a federal small business program for these employee benefits both for the benefit of the country's workers in small businesses and for the small business owner to competed with corporations for skilled workers.

Taxation

In 2017, corporations were given a permanent 40% federal tax rate cut, ostensibly as an incentive for corporations to create jobs, pay higher wages, and invest in manufacturing. The data is clear that this did not happen. Instead, the tax-relief windfall was used to buyback stocks and pad executive compensation.

However, the dramatically lowered corporate tax rate and corporations' ability to eliminate more or even all their federal tax obligations creates an unfair advantage when competing with small businesses. Paying low or no federal taxes enables corporations to lower their prices and increase marketing budgets, both to the disadvantage of small businesses.

Congress should correct this uncompetitive advantage that it created by raising the corporate tax rate and setting a 15% minimum corporate tax.

Access to capital

Our nation is at a 40-year low in new business startups. This is an economic crisis not due to a lack of entrepreneurial interest but largely due to the continuing problem of access to capital. The dramatic drop in banks and branches since 1980 (over 70%) has contributed to this problem

However, the average small business startup loan is less than $15,000. Traditional financial institutions find startups in underserved communities, especially for entrepreneurs of color and women, as too risky and not profitable even if the loan is successful. Even Community Development Financial Institutions, which have a mission of supplying capital to underserved

communities, is reluctant to take risks financing small startup loans. Our unscientific polling of CDFIs nationally found than only about 37% were making startup loans.

Clearly, capital needs for startups and micro businesses in the nation's rural and underserved communities are not being met. As a result, the economies of these communities continue to suffer, and they remain dependent on a big corporation recruitment to create jobs. This top-down economic development approach in these communities has largely been ineffective.

Growing an underserved community through local entrepreneurship is a better, more sustainable economic development plan. Congress should enable the U.S. Small Business Administration to make direct, small loans in these communities when other financial concerns are not getting the job done.

Regulations

Since 2012, I have testified before U.S. House and Senate Committees numerous times. At every hearing we hear about the terrible regulatory burden small businesses suffer and how regulations keep small businesses from even being started.

In his direct, prepared testimony Mr. Douglas Holtz-Eakin of the American Action Forum points to long-ago studies about the regulatory burden of small businesses and polling data on how important the issue is to small businesses. I will contest both arguments.

Mr. Holtz-Eakin cites a series of research by the SBA Office of Advocacy that purports to show "small businesses bear a heavier burden from regulations than large businesses." Such research has not continued since 2010 when the Office's released a highly discredited report that was an embarrassment to the SBA. Mr. Holtz-Eakin cites no supporting research in the last 12 years to support that the small businesses are over-burdened by federal regulations.

Regarding polling, over the last 11 years small business surveys have consistently found federal regulations not to be a top concern of small businesses:

- In a 2011 survey by the American Sustainable Business Council, Main Street Alliance, and Small Business Majority only 14 percent of small business respondents flagged regulations as their largest concern.

- In May 2011, the U.S. Chamber of Commerce released a poll of small businesses, members, and non-members. When asked what the top obstacle was to hire new employees, only 8% said "too much regulation".

- In 2014, a Wells Fargo/Gallup poll of small businesses found that only seven percent mentioned regulations as being an important challenge.

- In 2020, Small business for America's Future survey of its network found that government regulations were a distant fourth top issue they wanted lawmakers to address to help small businesses.

- In October 2021, the MetLife and U.S. Chamber of Commerce Small Business Index found that inflation, revenue, and COVID safety were top concerns—not regulations.

- In December 2021, a NFIB poll of its members, employers expected to most sensitive to the issue of regulations, found that government regulations came in a distant fifth on the single most important problem.

While federal regulations are not a top concern for small businesses, the issue still continues to be a political football in Congress.

On March 29, 2017, I testified at a Senate Committee on Small Business and Entrepreneurship hearing, "Examining How Small Businesses Confront and Shape Regulations."

In that testimony I discussed the benefits of regulations to small businesses and entrepreneurship. I also addressed the concern raised by Mr. Holtz-Eakin that some small businesses have a more difficult time with regulatory compliance than larger businesses.

Below is my testimony for that Senate hearing:

Thank you, Chairman Risch, Ranking Member Shaheen and members of the committee. My name is Frank Knapp Jr. I am the board co-chair of the American Sustainable Business Council which, through its network represents over 200,000 businesses and more than 325,000 business professionals, advocates for advancing policies that support a vibrant and sustainable economy. I am also the President, CEO and co-founder of the South Carolina Small Business Chamber of Commerce, a statewide, 5,000+ member advocacy organization working to make state government more small-business friendly. Finally, over the past 26 years I have started and operated my own small businesses as well as owning and managing commercial and residential investment properties.

Thank you for the opportunity to testify today. Regulations are an important part of owning and running a small business. While most of the government regulations that affect small businesses come from local and state government, there are federal regulations that either directly or indirectly impact small businesses.

Small businesses do not resent good, well thought out regulations. In fact, polling by the American Sustainable Business Council has found that 86% believe that regulations are necessary and 93% believe their business can live with fair and manageable regulations. In fact, small and big businesses alike are living with regulations and growing. The economy is booming creating tens of thousands of new jobs every month. In my home state this past February we had the largest one-month increase in the number of people working.

Small business owners know that regulations, the rules of the game, level the playing field with big businesses and protect small businesses from unfair competition from big businesses. Regulations create opportunity for entrepreneurs and small businesses to innovate and grow by creating new products and services requiring new jobs. Small business owners care about their families, neighbors, workers, communities and environment which they want to keep safe and healthy. They understand the purpose of regulations in helping achieve these objectives.

The American Sustainable Business Council asked its members to give examples of how federal regulations have helped their businesses.

For Vincent Siciliano, CEO of New Resource Bank in California, Dodd-Frank has helped his business be more competitive with larger banks because of the new rules that have changed the overdraft products and reduced ATM interchange fees.

Fire standards for residential mattresses that required that all newly manufactured mattresses in the United States meet an open flame requirement and similar federal regulations for commercial mattresses helped Harrison Murphy, founder of the innovative textile company Ventex, grow his Virginia mattress manufacturing business.

Stephen McDonnell, founder and CEO of Applegate Natural and Organic Meats, believes that his business benefited from FDA regulation on food safety.

Ben Cohen, co-founder of Ben & Jerry's Ice Cream, says that his business almost melted in 1984 due to illegal actions of a bigger competitor. He attributes much of the success of his business to government protection from unfair trade practices.

Ally LaTourelle of Bioamber, Inc. says that the renewable chemical industry has developed because of regulations to protect the public encouraged private investment and increased consumer demand due to public awareness.

However, today we are here to examine how small businesses confront and shape federal regulations.

Let's first start with the process of how small businesses are involved in the regulatory development process.

As I mentioned, regulations can benefit small businesses. But we want them to be the least burdensome as necessary to achieve their intended goal and use common sense.

That was the purpose of the 1980 Regulatory Flexibility Act—to have federal agencies determine if a rule will have a significant impact on small businesses and, if so, engage small businesses to comment before finalizing the rule to hopefully achieve the goal of creating the least burdens on small businesses.

Then in 1996 came the Small Business Regulatory Enforcement Fairness Act. This gave small businesses even more input into the regulatory process of the Occupational Safety and Health Administration, the Environmental Protection Agency and the Consumer Financial Protection Bureau through the outreach efforts of the Office of Advocacy. Affected small businesses of proposed regulations from these agencies are to be part of a SBREFA panel to obtain their advice and recommendations with a final report of findings provided to the promulgating federal agency for making needed modifications to the final rule.

This is the process small businesses have to shape federal regulations. So how is it working?

Unfortunately, not real well.

The process to promulgate a rule in order to implement a law passed by Congress can take years—2, 5, even 10 or more—to finalize. This isn't the fault of the RFA or SEBREFA.

South Carolina passed its own Small Business Regulatory Flexibility Act 13 years ago and it has worked well. We have an all-volunteer Review Committee that looks at every promulgated state regulation to see how it might be amended to be less burdensome on small businesses. Very few problems are found and when they are the Committee has worked well with state agencies to resolve the issues.

But at the federal level, small businesses across this nation really aren't having input into the regulatory decision-making process that has been taken over by powerful, often big-business special interest groups lobbying the agencies. In addition to their Washington clout, the special interests have used the courts successfully to give us regulatory paralysis.

These efforts for the most part aren't to simply lessen a burden on small businesses. Instead they are designed to help big businesses protect themselves by stalling the regulatory process so that even good, well-thought out and needed regulations can't be successfully promulgated or at least the process delayed until a different political reality happens in Washington.

Making matters worse is the fact that the whole beneficial purpose of regulations is almost completely left out of the evaluation process by the agencies responsible for considering the impact on small businesses. I will go more into why this is a problem later.

Unfortunately the regulatory reforms being offered are not designed to make the regulatory process produce fair, well-crafted regulations in a timely fashion.

Instead proposals for reform would result instead in even more regulatory chaos.

- Federal agencies will take even longer than the current years or even decades to promulgate regulations,
- There will be even more avenues for opponents of regulations to delay regulations through litigation,
- Businesses will face even more uncertainty due to the longer time needed to promulgate regulations and increased litigation.

Now, I've only been discussing the front end of the regulatory process that gets all the attention. But it's the back end of the process that is just as important to small businesses—how small businesses interact with the federal regulations that already exist.

When a real small business has a concern about compliance with a federal regulation, they have two options for trying to get help.

First, they can contact the federal agency to ask for clarification or help in compliance.

Second, they can contact the Office of the National Ombudsman and ask for assistance in trying to resolve their regulatory issue with the appropriate federal agency.

The problem with option one is that a small business owner doesn't stand much of a chance in working with a big federal agency to get personal attention even if that agency has an ombudsman.

The problem with option two is that even though it is the much better path, the Office of the National Ombudsman is almost virtually unknown outside of the Small Business Administration where it is housed and it is tiny in terms of a federal agency.

If Congress shares the belief that regulations are needed in today's fast-changing world and it truly wants to help small businesses, here would be my recommendations—none of which require changing the RFA or SBREFA.

Balance the Balance Sheet

We have created a public impression that all regulations are evil and if we would just get rid of them the economy will thrive. That's the message the public hears but everyone here knows that regulations are needed for the benefits they yield.

So why do we never see the benefits of regulations in any agency analysis? For example the EPA and the Corps estimate that permitting costs under the WOTUS rule will increase over $19 million annually and mitigation costs will rise over $59 million. These are direct costs and some believe that indirect costs should also be reported. But there is no analysis showing how these direct costs are also direct benefits to the local economy because most of this money will be go to local small businesses for goods and services. The money doesn't just disappear. It flows through the local economy directly and indirectly.

Even the U.S Chamber and NFIB in prior testimony to Congress acknowledged that agencies are to analyze costs and benefits in the rulemaking process

However, the positive side of the ledger is always blank when the potential impacts of regulations are analyzed. The economic, health and social benefits of rules put in terms of dollars is not considered by the Office of Advocacy and the regulatory agencies. We often hear critics say that government should run like a business. Well, businesses weigh the benefits versus expenses when making a business decision. No business would invest in new equipment if all they considered was cost. Whether the absence of analyzing the benefits of a regulation in the formal process is by statute or custom, this must change if we are to get a truly accurate data for rulemaking decisions and give the public complete information about the value of regulations.

Invest in Better Outreach and Analysis

Everyone, including the critics of the rulemaking process, wants more outreach and better analysis of regulatory impact in promulgating a rule. So let's invest in that. We have essentially starved the regulatory agencies and Advocacy while at the same time wanting both to do more. But they can't. Small business outreach is primarily to Washington insiders who want to clog up the regulatory process through heavy lobbying, litigation and creating public anxiety by quoting huge bogus costs. Then the reform proposals that get the most attention fix the wrong problems and would just make more problems. The RFA process we have today simply needs more resources so it can run more effectively and efficiently. If you want agencies to cross every "T" and dot every "I" in the RFA process, give them the resources to do it so they can both perform their everyday tasks and conduct the quality rulemaking analysis and outreach we all want.

Help Small Businesses Understand the Rules and Provide Compliance Assistance

Once a rule has been promulgated and hopefully the burden on small businesses has been reduced as much as possible, the job of the federal government is not done. Small businesses need to be educated about the new rule and, when necessary, provided regulatory compliance assistance. Congress has also set up a process for this, not only within every regulatory agency, but also through the SBA Office of the National Ombudsman. Where the Office of Advocacy works on the front end of the development of significant regulations, the Office of the National Ombudsman is charged with helping small businesses on all regulation compliance on the back end. It serves as the conduit for small businesses to have their grievances about compliance problems or other issues with federal agencies heard directly by the agencies in question in an effort for successful resolution. In this way the Office of the National Ombudsman and the agencies can detect patterns of compliance problems so that the agencies can revisit rules for modifications.

This important component of the rulemaking process is woefully underfunded. The Office of the National Ombudsman relies on volunteers to help get the message out about its vital small business services. It is for the most part unknown and thus underutilized. If Congress really wants to help small businesses comply with needed federal regulations, invest more in this small business outreach, support and feedback loop.

In conclusion, the current regulatory process can produce good rules while protecting small businesses from unnecessary burdens if we provide the adequate resources for agencies to expeditiously carry out the requirements Congress has already put in place on the front end and back end of the process. Most of the regulatory reform proposals, while achieving the agenda of some seeking to delay and stop some regulations, will inevitably fail to help the vast majority of small businesses.

I strongly encourage the House to pass H.R. 4877, "One Stop Shop for Small Business Compliance Act of 2021". Enactment of the provisions of this Act would play make an important role in assisting small businesses with regulatory compliance and help them be more competitive with larger businesses.

Thank you for the opportunity to offer this written testimony.

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