AMERICAN ENTERPRISE INSTITUTE

Statement before the Senate Committee on Small Business and Entrepreneurship
On "Perspectives from Main Street: Covid-19's Impact on Small Business"

Covid-19's Impact on Small Business

Deep, Sudden, and Lingering

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Chairman Rubio, Senator Cardin, and Members of the Committee, thank you for the opportunity to appear before you today to discuss Covid-19's impact on small business. It is an honor.

THE ECONOMIC IMPACT OF COVID-19

To slow the spread of the novel coronavirus, states issued shelter-in-place orders beginning in mid-March that brought a large share of economic activity to a sudden halt. These orders, combined with the concern many Americans have about becoming infected by engaging in normal economic activity, have devastated the economy. The pandemic has brought the longest economic expansion since World War II to a conclusion and caused an acute deterioration in the labor market.

Consumer spending, which accounts for about two-thirds of gross domestic product (GDP), fell in March as a result of reduced demand for goods and services and businesses limiting their operations in the second half of that month. The Bureau of Economic Analysis estimates that pandemic lockdowns have reduced consumer spending by 27.8 percent, with restaurant sales dropping by 70 percent and accommodations sales dropping by 80 percent.[1] My calculations suggest that GDP as a whole has been reduced by roughly $80 billion per week because of the pandemic. The ultimate effects of the pandemic on these measures are still very uncertain, as data on spending and incomes for this spring are still incomplete.

Labor market data are more timely, and demonstrate both the suddenness of the downturn and its depths. The labor force shrunk by 8.1 million workers between February and

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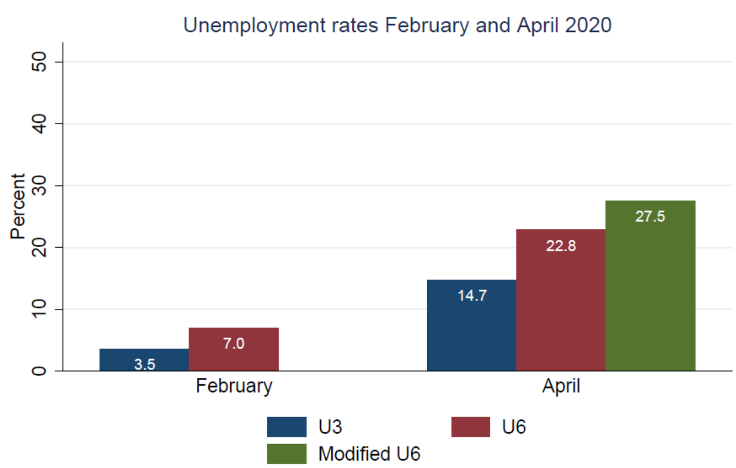
[1] Abe C. Dunn, Kyle K. Hood, and Alexander Driessen, "Measuring the Effects of the COVID-19 Pandemic on Consumer Spending Using Card Transaction Data," Bureau of Economic Analysis Working Paper Series, WP2020-5, April 24, 2020.

April, and household employment fell by 25.4 million. The unemployment rate in February stood at 3.5 percent. In two months, the rate increased by a factor of four to 14.7 percent.

This statistic alone highlights both the speed and magnitude of the decline. To understand the speed of the decline, compare a fourfold increase in two months in the unemployment rate to what happened during the Great Recession, when it took two years for the unemployment rate to double from 5 percent when the recession began in December 2007 to its peak of 10 percent in October 2009. As for the magnitude, unemployment in April was higher than in any month since the Great Depression.



Source: Author's calculations; Bureau of Labor Statistics. The Employment Situation - April 2020.

Modified U6 assumes that people in April 2020 marked "Absent from work last week" beyond the average level for 2016-2019 were unemployed on layoff.

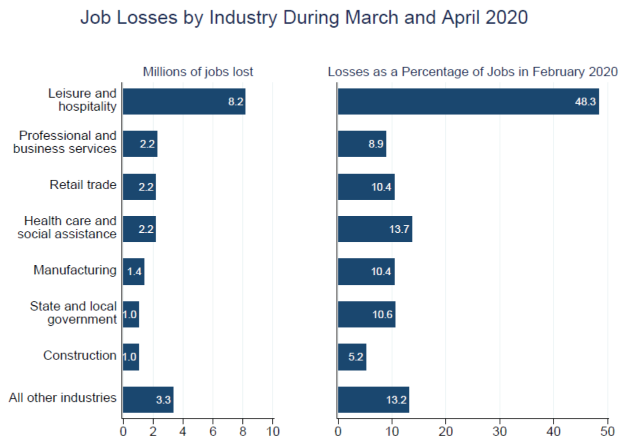
Broader measures of unemployment tell the same story. The broadest measure produced by the Bureau of Labor Statistics (BLS) includes unemployed workers, people who are neither working nor looking for work but who want a job and have been in the workforce recently, and people who want full-time work but had to settle for part-time work. By this measure, 22.8 percent of the workforce was unemployed in April, up from 7 percent in February. I have calculated a modified version of this broader rate, including workers who likely should have been classified as unemployed but who were incorrectly classified as absent from work. By this measure, 27.5 percent of workers are unemployed or underemployed — over one-quarter of the workforce.

COVID-19'S IMPACT ON SMALL BUSINESS

Small businesses have been hit very hard by the shutdown orders and decreased demand due to concern about the coronavirus. Many small businesses operate with low profit margins, making it difficult to absorb a large decline in revenue sustained over several months. Cash buffers can allow business operations to continue in the absence of revenue. Research by the J.P. Morgan Chase Institute shows that 50 percent of small businesses have fewer than 15 days of cash liquidity, and only 40 percent of small businesses had more than three weeks of a cash buffer.[2]

Small businesses in the services sector have likely been harder hit than manufacturing firms because they face a permanent revenue loss from a long shutdown. Manufacturing companies will suffer due to a decline in the demand for goods and disruptions in supply chains. But unlike manufacturing firms, which may return to partial operations with a partial backlog of orders, services-sector losses will (mostly) never be made up. For example, households will not eat twice as many meals at restaurants in the month of July because they could not eat any meals out in the month of April.

[2] Diana Farrell, Chris Wheat, and Chi Mac, "A Cash Flow Perspective on the Small Business Sector," J.P. Morgan Chase Institute, May 2020.

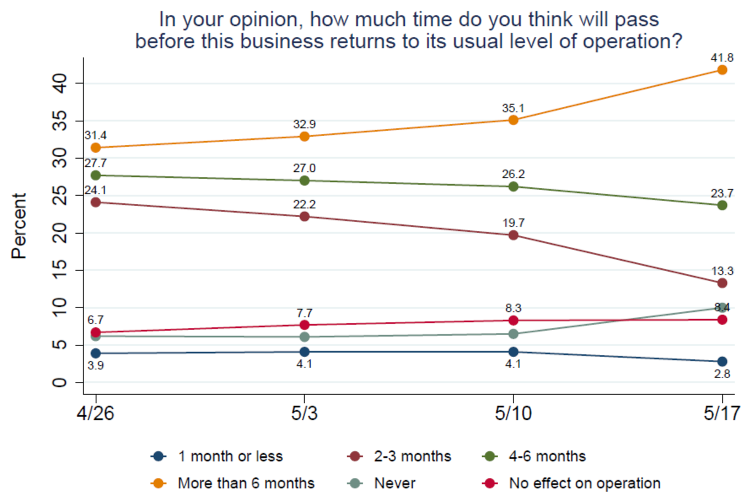


Source: Author's calculations; Bureau of Labor Statistics. The Employment Situation - April 2020.

The chart above breaks down job losses by industry, using data from BLS's Current Employment Statistics Survey. These data are for the labor market as a whole, and not only small employers. They highlight that sectors with a large degree of in-person interaction and with many small employers have been hardest hit by the pandemic. For example, the leisure and hospitality sector lost 48.3 percent of its February employment in March and April, and retail lost 13.7 percent.

To understand more of the pandemic's impact on small businesses specifically, I turn to the new Small Business Pulse Survey from the Census Bureau, a weekly email survey designed to provide information on the challenges facing small businesses due to the Covid-19 pandemic. The survey began on April 26, and is scheduled to run through June 27, providing nearly real-time updates on the changing condition of small businesses across states and industries.

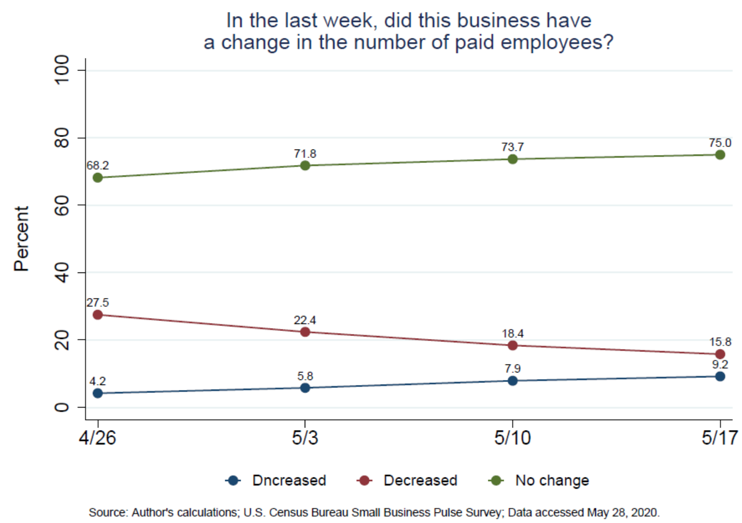
The target population for the survey is nonfarm, single-location businesses with at least $1,000 in earnings and between 1 and 499 employees. The survey is designed to be representative of this population of small businesses, with the exception of a few industries, including agriculture, railroads, religious organizations, funds and trusts, and certain government entities.[3] The survey contains questions about overall well-being, changes to operations and finances, and other challenges resulting from restricted economic activity, as well as expectations for when operations will return to normal.



Source: Author's calculations; U.S. Census Bureau Small Business Pulse Survey; Data accessed May 28, 2020.

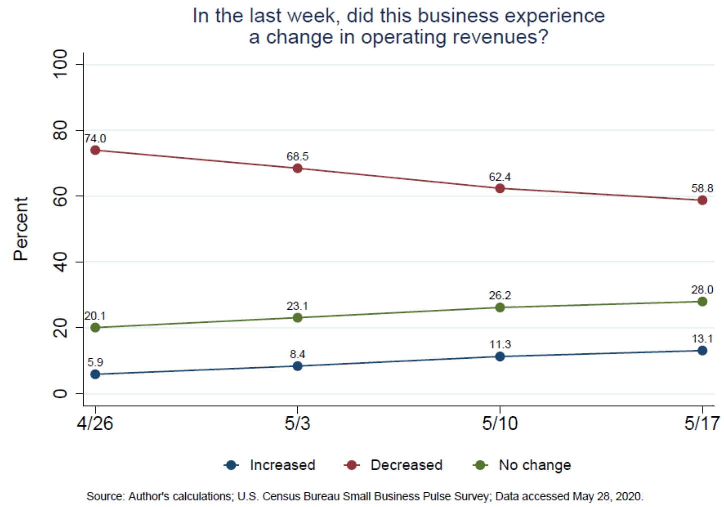
The survey shows that the expectations of small business owners are souring, with the share of owners who expect it to take longer than six months for a return to normal increasing significantly, as the chart above shows. Correspondingly, respondents are much less likely to report a return to normal in less than three months.

[3] The Census Bureau used administrative records from the April 2020 Business Register to identify roughly 885,000 active businesses with a single email address that met these criteria. These businesses were divided into nine groups with similar size and geographic characteristics, and roughly 98,000 businesses receive the survey each week. This coverage is designed to produce detailed weekly data by industry and state and data for the 50 largest metropolitan statistical areas.



The survey asks respondents if, in the last week, the business had a change in the number of paid employees. The results are somewhat encouraging. In late April, 27.5 percent of firms decreased employment in the last week, and only 4.2 percent increased employment. In mid-May, 15.8 percent decreased employment, and 9.2 percent increased the size of the workforce. These are trending in the right direction.

Trends over the past month in hours worked by paid employees corresponds to employment trends. Hours increased for 11.9 percent of businesses in mid-May, up from 5.6 percent in late April. One-third of businesses reduced hours in mid-May in the last week, down from half in late April.



If businesses are increasing their payrolls at greater rates (and decreasing them with less frequency), you would expect their revenues to be improving. The Census survey shows exactly this. By the middle of May, the share of businesses reporting revenue increases in the last week more than doubled from late April, rising to 13.1 percent of firms. The share of firms reporting revenue declines in the previous week dropped by 21 percent over this period, falling to 58.8 percent from 74 percent.

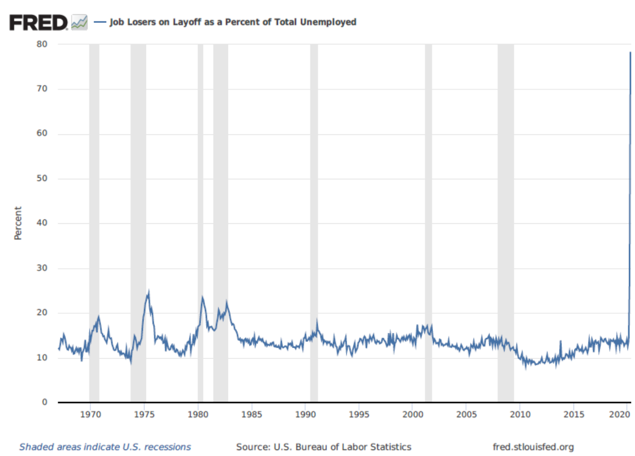
What is the overall takeaway? I draw two conclusions: The picture is both dire and improving. A situation in which revenue and employment declines are this widespread represents a national emergency, even though the small business economy is making considerable strides in recent weeks.

THE PANDEMIC RECESSION IS NOT A NORMAL DOWNTURN

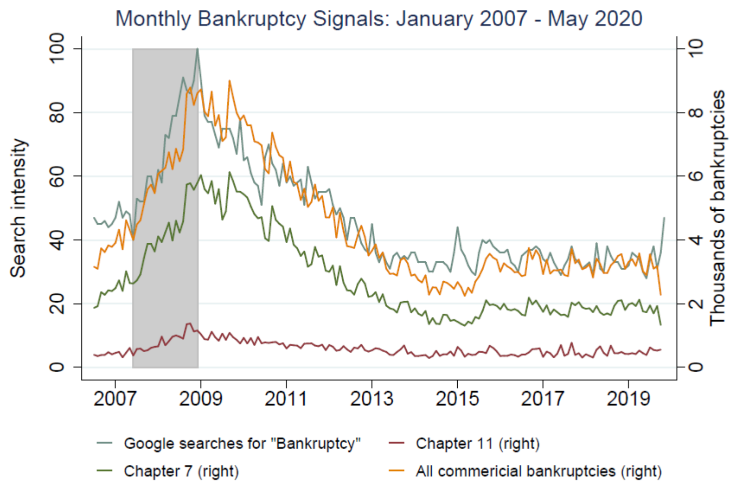
Recent recessions have been caused by imbalances in the economy — e.g., bubbles in the housing and tech sectors and excessive leverage in the financial system. Those recessions were followed by slow recoveries in part because the underlying structural problems with the economy needed to be corrected.

In contrast, the economy was in great shape as recently as February of this year. The goal of social distancing was to freeze the economy in place to slow the spread of the virus, and then to “turn” the economy “back on” this summer. Since the economy was in great shape when it was frozen, the recovery from the freeze should be relatively rapid.

This is, of course, a simplification. But one indication that this may be a reasonable simplification is the widespread use of temporary layoffs by firms. The chart below shows unemployed workers on temporary layoff as a share of all unemployed workers. The chart demonstrates the unusual nature of the current recession.



Things may not be as simple as the “turn off the switch, turn on the switch” model suggests. Although states have partially reopened, it is not clear how quickly their economies will return to normal if people are concerned about contracting the virus, or if the virus flairs up again in the fall. To the extent that people’s preferences have changed — e.g., if fewer people prefer to go to dinner and a movie and more people prefer to have takeout delivered and stream a movie at home — then some industries will shrink and some will expand relative to where they were in February. This process would require workers to change industries, as well. The reallocation process these changes would require would take time, and many unemployed workers currently on temporary layoff may never return to their previous employer. Still, there is reason for cautious optimism that the labor market recovery from the pandemic will be quicker than has typically been the case.

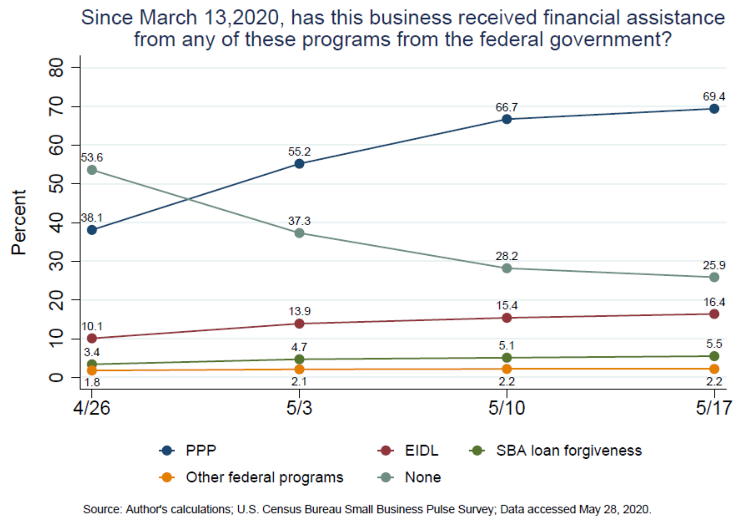


Source: Author's calculations; American Bankruptcy Institute. May 2012 and April 2020 Bankruptcy Statistics - Commercial Filings.
Search data from Google Trends accessed May 30, 2020.
Shaded area indicates recession dates.

A major concern, discussed above, is that firms, particularly small businesses, would not be able to weather the shutdown. Bankruptcy data so far do not show that businesses are closing, but filing could be a lagging indicator during this rapidly changing situation.

THE PAYCHECK PROTECTION PROGRAM

Congress enacted the Paycheck Protection Program (PPP) as part of the Coronavirus Aid, Relief, and Economic Security (CARES) Act to keep workers attached to their employers and to ensure small business continuity during the shutdown. Under PPP, small businesses take out a loan from a commercial bank for up to 2.5 times average monthly payroll costs, not to exceed $10 million. The amount of the loan spent on payroll costs (including benefits), rent, mortgage interest, and utilities during the eight-week period after the loan is originated converts to a grant — i.e., the loan is forgiven — provided that the business does not lay off workers or substantially reduce their pay. In addition, a requirement imposed by the Treasury Department and Small Businesses Administration when implementing the program requires that 75 percent of any amount of the loan that is forgiven be spent on payroll.[4]



As of May 23, 5,511 lenders have made nearly 4.4 million PPP loans totaling $511 billion. The average loan size was $116,000. Over 99 percent of PPP loans were for less than $2 million, and 79 percent were for less than $100,000. Of the total dollars lent in the program, 78.6 percent were lent as part of loans of less than $2 million.[5] As of mid-May, nearly 70 percent of small businesses surveyed were receiving financial assistance from PPP.

The ultimate test of PPP's effectiveness will be if it is shown to mitigate small business closure and support employment. It is too early to tell whether PPP is having these effects. But the magnitude of lending and the take-up rate among small businesses suggest that it is well positioned to do so. Indeed, PPP will likely be the main and most effective measure Congress has passed to address the pandemic. Between the CARES Act and the subsequent Paycheck

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[4] Michael R. Strain, "The Paycheck Protection Program: An Introduction," American Enterprise Institute, April 1, 2020. R. Glenn Hubbard and Michael R. Strain, "Building the Car While Driving It: Suggestions for Reforming the Paycheck Protection Program," American Enterprise Institute, April 15, 2020.
[5] US Small Business Administration, "Paycheck Protection Program (PPP) Report: Approvals Through 5/23/2020."

Protection Program and Health Care Enhancement Act, PPP has become the largest component of Congress' response to the pandemic recession in dollar terms to date.

Unfortunately, PPP's success has been held back by Treasury's/SBA's implementation. Treasury has not done enough to convince lenders that they would be held harmless if borrowers misrepresent themselves on their applications, despite the statute's clear intent. This has led banks to focus more lending on existing customers, potentially leaving behind many of the true mom-and-pop shops that Congress likely had in mind when creating PPP. Confusion about which borrowers Treasury would seek to audit and the conditions that would determine audits have led some businesses to return PPP loans and have discouraged other businesses from applying to the program at all. Lending under the program has slowed dramatically as a consequence of this confusion.

The 75 percent rule, which is not in the statute, is a mistake. It lessens the program's effectiveness and allows the program to benefit some small businesses over others in an arbitrary fashion. For example, a small business in a high-rent city will benefit less from PPP than businesses with lower rent payments as a share of overall expenses. Treasury justifies the rule by arguing that it keeps the focus of PPP on workers. But a business that cannot pay its rent will not be able to continue paying its workers. In a report issued last month, SBA's Inspector General concluded that the 75 percent rule "did not align with the allowable use requirements for PPP loans" in the statute.[6]

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[6] US Small Business Administration, Office of the Inspector General, "Flash Report: Small Business Administration's Implementation of the Paycheck Protection Program Requirements," May 8, 2020.

THE MAIN STREET LENDING PROGRAM

Small businesses could also turn to the Federal Reserve's Main Street Lending Program, which is open to businesses with up to 15,000 employees or 2019 annual revenues of less than $5 billion. The Treasury Department is required to approve the parameters of this program, and Congress appropriated $454 billion to Treasury as part of the CARES Act to support Fed lending under this program and several other lending programs.[7]

Treasury is not taking enough risk with that capital. Treasury has allocated $75 billion of the CARES Act's appropriation to support $600 billion in Fed lending through Main Street facilities. A 13 percent loss rate implies that Treasury intends to avoid capital losses. But if economic recovery is the goal and solvency is the problem, losses are inevitable.

Under the terms Treasury put in place for the Main Street facilities, banks must hold 5–15 percent of loans, selling the remainder to the Fed. By encouraging banks to use normal credit standards, Treasury may discourage borrowers and lenders from participating in the programs at all. It is not clear which borrowers would qualify for a loan under the Main Street facilities that would not qualify for a standard loan. Indeed, the Congressional Oversight Commission found that barely any lending under Fed facilities supported by the CARES Act appropriation has occurred.[8]

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[7] The Main Street Lending Program operates through three facilities: the Main Street New Loan Facility, the Main Street Priority Loan Facility, and the Main Street Expanded Loan Facility. Other programs backed by the CARES Act appropriation to Treasury to support Fed lending include corporate credit and municipal lending facilities.

[8] Congressional Oversight Commission, "Questions About the CARES Act's $500 Billion Emergency Economic Stabilization Funds," The First Report of the Congressional Oversight Commission, May 18, 2020.

CONCLUSION: THE NEED FOR CONTINUED SUPPORT

The economy will need fiscal policy support for quite some time. This summer and fall could witness historic annualized rates of quarterly economic growth and percentage declines in the unemployment rate, but it will take many more months of strong economic performance to return to where the economy was in February of this year. The Congressional Budget Office (CBO), for example, forecasts very strong economic growth in the second half of 2020, beginning in July. But CBO expects the unemployment rate to be 11.5 percent in the fourth quarter of 2020 and 8.6 percent in the fourth quarter of 2021.[9]

Small businesses will need support from Congress, in particular. The goal of this support should be to preserve the productive capacity of the small business sector, in large part by ensuring small business continuity and preserving the ecosystem of knowledge and relationships that drive productivity. In this way, the needs of small businesses are similar to what they were in mid-March.

At the same time, public policy should avoid impeding the process of sectoral reallocation — in which some industries shrink and others expand, and workers move across industries — and should allow small businesses to reorganize the way they produce goods and services to take into account changes in preferences, logistics, and supply chains. This represents a different challenge than Congress addressed when creating PPP. With PPP set to expire soon, the need to address that challenge is urgent.

[9] Congressional Budget Office, "Interim Economic Projections for 2020 and 2021," May 2020.