



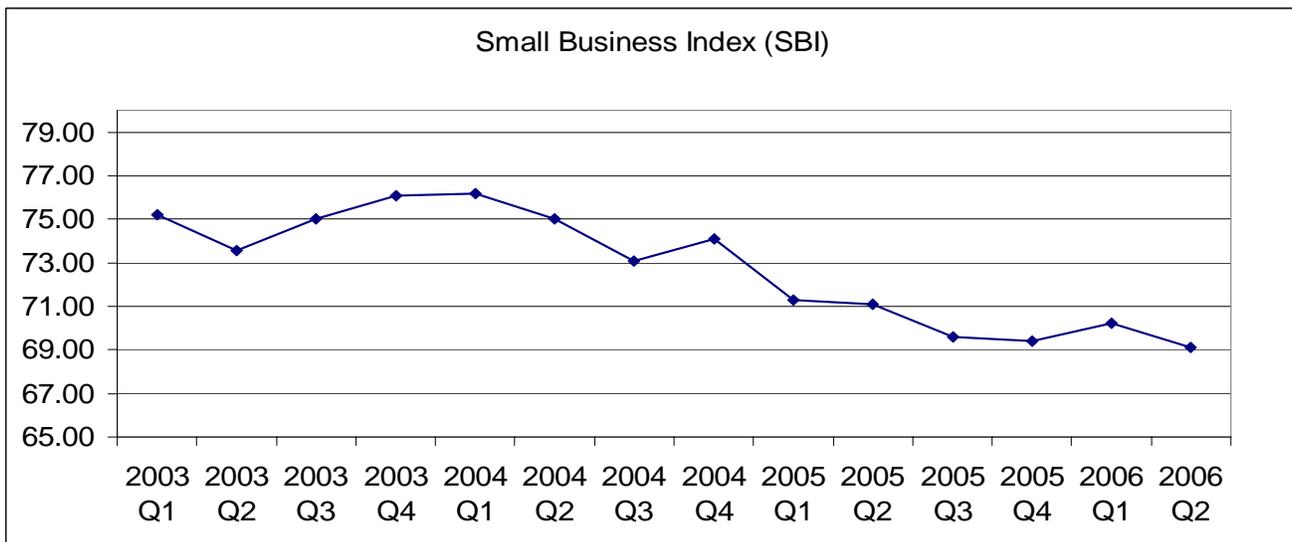
Small Business Index: 2nd Quarter 2006

Committee on Small Business

Nydia M. Velázquez, Ranking Democratic Member

In the first half of 2006, small businesses continued to face several economic challenges, due mainly to a slowing economy and rising expenses for critical resources and services. These challenges have impeded growth in the small business community, and, as we enter the latter part of the year, the small business sector has failed to gain traction and produce the high level of job creation that had been expected. This deceleration will weigh on entrepreneurs and create uncertainty in many parts of the United States.

The Small Business Index (SBI), a broad measure of the economic conditions facing entrepreneurs, declined more than one percent in the most recent quarter to a value of 69.20. The SBI for the second quarter of 2006 – which is at a nine-year low – reveals troubling signs for small businesses, which are in turn contributing to slow GDP growth and low levels of job creation. The drop-off in the SBI is driven largely by rising energy prices, increasing health insurance premiums, and higher capital costs.



The most notable, and perhaps alarming aspect of this quarter's SBI is the fact that the index remains at such a low level, demonstrating that small firms continue to face challenges on a variety of fronts. In the past, economic downturns – such as the recession in the early 1990s – were followed by times of pronounced entrepreneurial activity. The SBI and other economic indicators show that the economy has failed to approach the levels of optimism and business expansion seen in comparable periods. Recent market data suggests that the economy will continue to slow further, as GDP growth was down to 2.6 percent for the 2Q 2006 and only 92,000 jobs were created last month – well below expectations. As a result, it is probable that the SBI will maintain this downward trend over the near term.

Key Indicators Are Driving SBI's Recent Decline

The SBI declined by 1.18 percent in the most recent quarter, which is largely due to rising operating costs for small businesses. Among the cost factors that are contributing to the decline in the SBI are oil prices and interest rates, both of which have increased significantly. Rising operating costs are particularly challenging for small businesses, as many must absorb the higher costs – in order to stay competitive – without raising prices on consumers.

Recent severe price increases in oil have had a substantial effect on entrepreneurs (see chart 1). Rising gasoline prices greatly affect entrepreneurs, impeding their growth, limiting their ability to hire new employees, and stifling innovation. While gas prices have come down in recent months, this effect must be put in relative terms as the prices had risen by record levels in the past year. This has had the two-fold effect of creating uncertainty in industries that heavily rely on gasoline, while keeping input costs at relatively high levels.

Between 2004 and the 2Q 2006, the prime rate doubled, increasing from 4 percent to 8 percent (see chart 2). As a result, entrepreneurs are less able to secure affordable capital, which in turn constrains their growth and reduces their profitability. According to a study by NFIB, the availability of loans and expected credit conditions among small business owners are at 6 year lows.

Chart 1: Price, Barrel of Oil¹

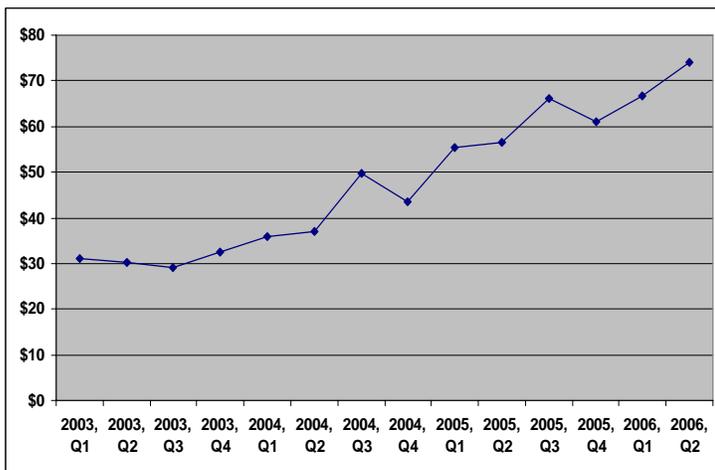
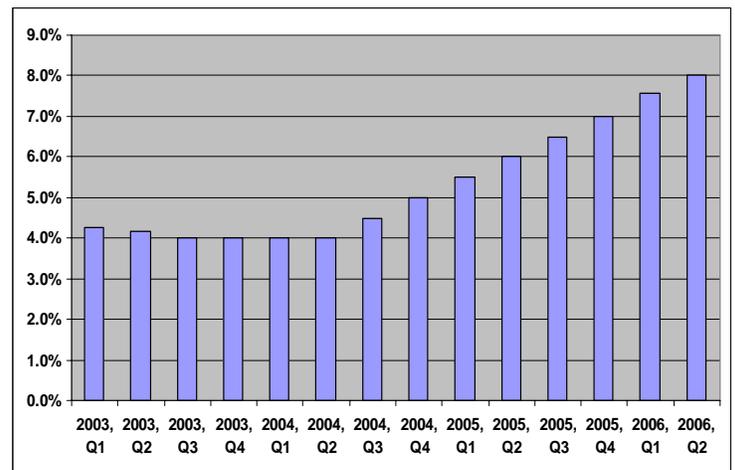


Chart 2: Prime Interest Rate²

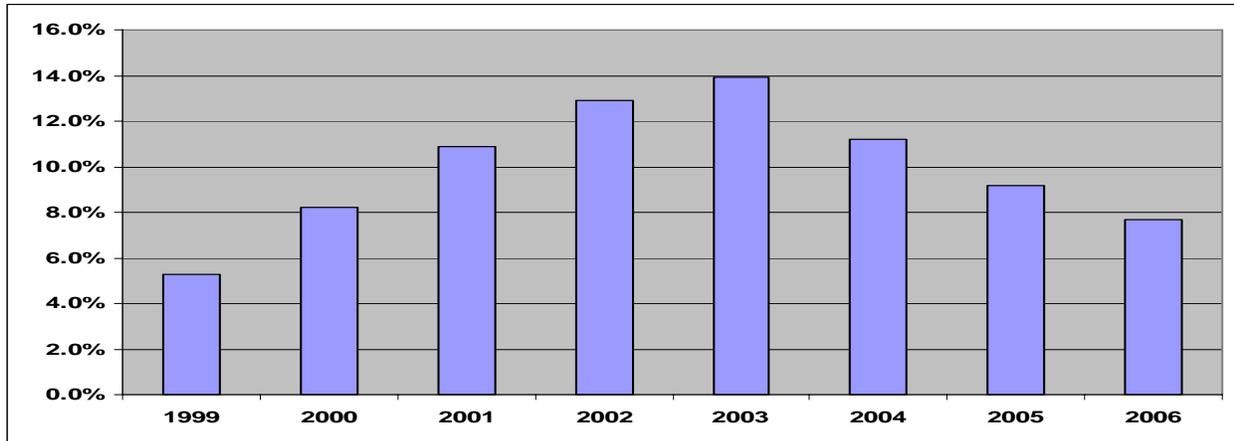


¹ Light Sweet Crude, Contract #1, U.S. Energy Information Administration, September 2006.

² Economic Indicators, Council of Economic Advisors, September 2006.

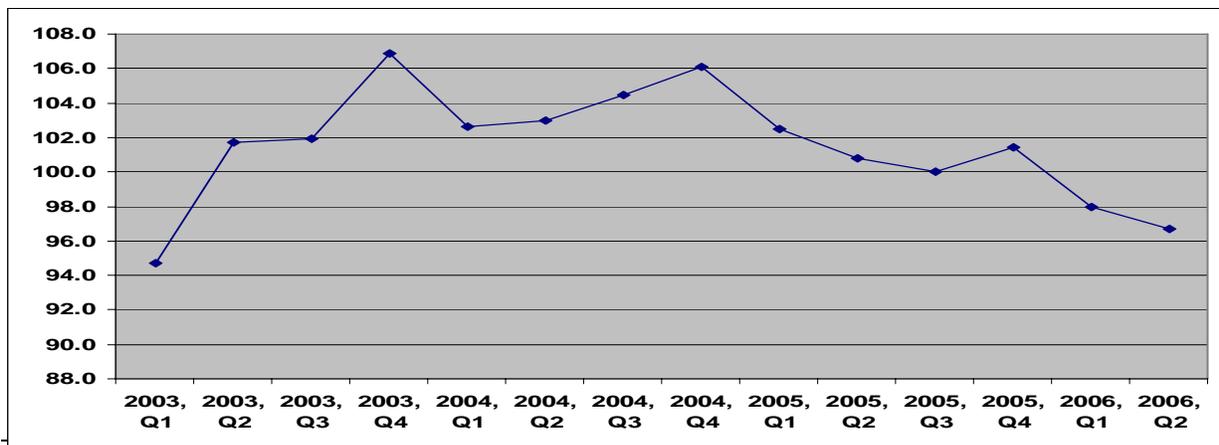
Health care costs for small businesses have risen at twice the rate of inflation (see chart 3). For small firms, providing their employees with health care is a significant expense. The effect has been that many employers are passing on the costs to their employees or they are dropping coverage altogether – neither being a desirable solution. The nearly 80 percent rise in premiums over the past six years is largely due to the failure to implement a comprehensive health care policy, including the creation of more options for small employers.

Chart 3: Annual Percent Change in Cost of Health Insurance Premiums³



For the 2Q 2006, the NFIB Optimism Index is at a three-year low, reflecting the uncertainty that small business owners have about the economy (see chart 4). According to the NFIB, firm owners' outlook for general business conditions have worsened substantially, as weaker job creation plans, lower inventory investment expectations, and lower sales projections were reported. As a result of the expected economic slowdown, many businesses are scaling back their hiring.

Chart 4: NFIB Optimism Index⁴



³ Kaiser Family Foundation, Annual Survey, 2006.

⁴ National Federation of Independent Businesses, September 2006.

Small Business Index Economic Indicators

The House Small Business Committee created the SBI to track the economic conditions facing small businesses. The index is updated regularly and is based on the following 17 economic indicators:

Balance of Trade represents the net amount of domestic international trade.

Commercial and Industrial Loans and Leases reflect the amount of business lending by commercial banks.

Federal Budget Surplus or Deficit represents the net amount of federal government outlays and receipts.

The cost of health care insurance premiums represents the price companies pay for providing health care to their employees.

Manufacturers' New Orders represent the amount of orders for durable and non-durable goods placed with domestic manufacturers, the majority of which are small businesses.

Natural Gas Costs are the average monthly price of natural gas sold to consumers in the United States.

NFIB Small Business Optimism Index is a composite measure of ten qualitative small business survey indicators and generally reflects small businesses' views of the economy. The index is based on monthly surveys of NFIB members.

Net Farm Income is a measure of the financial condition of the farm industry. It reflects the farm income received from the sale of livestock and crops, as well as payments from the government less the production expenses.

Number of Unemployed represents the number of individuals without jobs, indicating the level of small business economic activity.

Oil Costs pertain to the sweet crude oil prices as measured in U.S. dollars per barrel.

Prime Rate is the interest rate charged by banks to their most creditworthy customers. Interest rates on small business loans are generally tied to the prime rate.

Producer Price Index (PPI) measures the average change over time in the selling prices received by domestic producers for their output.

Regulatory Costs represent the total number of final regulations issued each year. This measure is used as a general indicator for small business regulatory burden.

Total small firm cost for retirement and savings represent the costs for small businesses to provide employee pension benefits per working hour.

Russell 2000 Index represents the 2,000 smallest companies in the Russell 3000, a broad based index that represents approximately 98% of the value of what is invested within the U.S. equity market.

Total Employee Compensation accounts for what small businesses spend on employees for each hour worked. This number represents the compensation for companies that have 99 employees or less, and is a combination of salary, benefits, and government paycheck requirements.

Venture Capital reflects the amount of equity investment in private companies, the majority of which are small businesses.