

**Congress of the United States
U.S. House of Representatives
Committee on Small Business**

Hearing on Impacts of Sequestration on Small Business

Testimony By

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The Economic Impacts of Sequestration on Small business

Total GDP and Job Impacts of Sequestration

The economic impacts of sequestration, as imposed by the Budget Control Act of 2011 (BCA), have been analyzed and found to be large and significant. I prepared a report entitled “The Economic Impact of the Budget Control Act of 2011 on DOD and Non-DOD Agencies” (July 17, 2012) that measured these impacts building on previously analyses prepared by the Congressional Research Service and the Congressional Budget Office. These analyses establish the magnitudes of these economic impacts across both the public and private sectors inclusive of large and small businesses. These total impacts can be summarized as follows:

With spending reductions totaling \$115.7 billion in FY 2013 from FY 2012 authorized levels for DOD and Non-DOD agencies—\$56.7 billion and \$59.0 billion respectively—U.S. gross domestic product growth projected for 2013 would be reduced by \$215.0 billion erasing approximately two-thirds of the currently projected gains in GDP for next year. While the U.S. economy is struggling to sustain its recovery and any sudden loss of economic activity of this magnitude could derail its fragile performance, the loss of jobs associated with these spending reductions would have far reaching implications. My analyses of the BCA of 2011 spending reductions found that these federal spending cutbacks would generate 2.1 million job losses nationwide.

The direct job losses resulting of sequestration would total 746,222 and consist of: (1) federal workers whose jobs would be lost due to reductions in agency payroll

and (2) employees of federal contractors whose employment depends directly on the federal contracts that would be terminated.

These federal contractors support a large number of subcontractors, suppliers and vendors. As a result, the spending reductions directly impacting the prime contractors would result in the loss of 432,978 additional jobs in both the supply chain and in businesses that otherwise depended on indirect transactions supported by federal contract awards.

The loss of these jobs and their payrolls would reduce consumer spending, the loss of which would impact every sector of the economy and their respective businesses across the country. These are the businesses and workers that depend on the spending of payroll of the jobs lost to sequestration and are principally found in retail, restaurant, health care, education, personal services, construction, housing, and local government sectors. These sectors would lose 958,508 jobs as a result of sequestration.

Table 1 below identifies these job losses by source and type.

Table 1

Employment Impacts of the Budget Control Act of 2011 in 2013

Type of Job Loss	Spending Reductions		Total
	DOD	Non-DOD Agencies	
Direct Job Losses	325,693	420,529	746,222
Federal Jobs	48,147	229,116	277,263
Contractor Jobs	277,546	191,413	468,959
Indirect Job Losses*	282,426	150,552	432,978
Induced Job Losses**	482,240	476,268	958,508
Total Job Losses	1,090,359	1,047,349	2,137,708

Source: "The Economic Impact of the Budget Control Act of 2011 on DOD and Non-DOD Agencies," by Stephen S. Fuller, Ph.D. (July 17, 2012).
 *suppliers and vendors and sub-contractors dependent on federal contractor spending; **jobs supported across all sectors supported by payroll spending by federal workers and employees of federal contractors losses due to federal spending reductions in FY 2013.

The significance of these job losses is seen in their impact on the unemployment rate. The addition of these laid off workers to the unemployment rolls would add an estimated 1.5 percentage points to the current unemployment rate, increasing it to 9.5% if the current rate holds to into 2013.

Collateral Impacts of Sequestration

Sequestration would generate other impacts than those directly linked to reductions in federal payroll and procurement outlays. These impacts would result from the reaction of businesses and individual consumers to the increased uncertainty generated by the national economy's declining performance in response to sequestration. Some of these economic impacts would be driven by behavioral factors—the loss of consumer confidence may suppress spending especially spending requiring credit such as for autos and housing, personal saving may increase taking further disposable income out of the economy, business investment and private sector hiring may be dampened as a result of increased uncertainty all contributing to further weakening of the economy's performance. These and other collateral impacts will enlarge the negative consequences of the initial federal spending reductions and contribute to further deepening a potential economic contraction in 2013 thereby extending its duration and increasing its magnitude.

Additionally, the impacts of sequestration would substantially disrupt the economy as a consequence of reductions in government services from the layoffs of federal workers and curtailment of federal programs. At a minimum these disruptions would slow commerce and undermine efficiency. As some federal services would face elimination or suspension for an extended period, these disruptions could result in significant reductions of business activity and increased costs impacting exports, business travel, tourism, health and food safety, and security, and would likely extend to the public safety and education services provided by local governments.

Other costs will occur over a longer timeframe resulting from deferred or foregone innovation by both federal agencies and private entrepreneurs. These disruptions to the U.S. economy will have cumulative impacts with far-reaching and potentially more significant consequences than the initial first-year impacts. While these costs may be difficult to quantify in the short term, they need to be recognized and acknowledged before the full economic consequences of sequestration can be properly assessed.

The economic impacts of sequestration will not be distributed evenly across all states but they will impact all states. Similarly, these economic impacts will not be equally distributed across all sectors of the economy or types and sizes of businesses. Like all economic impacts, the respective hardships will be a function of the businesses' or workers' abilities to absorb the costs and shift into more promising ventures and occupations. Small businesses and their workers will be especially vulnerable to both the initial economic impacts of sequestration and the consequences of these initial impacts as they affect their abilities to reposition themselves in a national economy struggling to regain traction in a weak global economy.

The Economic Impact of Sequestration on Small Businesses:
By the Numbers

The impact of the BCA of 2011 on both the public and private sectors, with the projected loss of 2.1 million jobs in FY 2013, will have a significant effect on small businesses and their employees. Workers in small businesses would suffer more than fifty percent (51.6%) of the projected job losses due to the spending reductions mandated by the BCA of 2011.

- DOD spending reductions would result in the loss of 520,398 jobs in small businesses accounting for 50.2 percent of all private sector job losses generated by mandated cutbacks under sequestration; and,
- Non-DOD agency spending reductions would result in the loss of 435,782 jobs in small businesses accounting for 53.4 percent of all private sector job losses generated by mandated cutbacks under sequestration.

Table 2

Summary of the Employment Impacts of the
Budget Control Act of 2011 on Small Businesses, FY 2013

Sources of Impact	Federal Spending Reductions		
	DOD	Non-DOD Agencies	Totals
Direct Federal Contractor Job Losses*	81,552	76,047	157,598
Percent of All Federal Contractor Job Losses	29.9	40.1	34.1
Total Small Business Job Losses**	520,398	435,782	956,181
Percent of all private sector job losses	50.2	53.4	51.6

Sources: GMU Center for Regional Analysis and Chmura Economics & Analytics. *See Table 3 for state-by-state distribution of direct jobs losses by small businesses; **see Table 4 for state-by-state distribution of total job losses by small businesses.

Small businesses will be impacted by the immediate reductions in federal procurement spending resulting from sequestration (direct impact), as

subcontractors, suppliers and vendors (indirect impacts), and as businesses supporting the retail and consumer service needs of the workforce (induced impacts) that would experience layoffs and the loss of labor income due to sequestration. This latter class of small businesses would span the economy although would be concentrated in retail and consumer service sectors and be located throughout shopping districts and small communities across the country.

The direct impacts on small businesses from sequestration—small businesses that are federal contractors—would result in the immediate loss of 157,599 jobs representing 34.1 percent of all federal contractor jobs (462,211 jobs) lost under sequestration. That this percentage is less than the 51.6 percent of the total job losses that small businesses would experience from sequestration (direct, indirect and induced) underscores the vulnerability of small businesses to these spending reductions. Many small businesses are subcontractors, suppliers and vendors to larger-scale businesses that are the prime federal contractors. As such, these subcontractors, suppliers and vendors are at the mercy of their primes and the acquisition-policy adjustments these large businesses may implement in response to changes in their backlog, profitability, or business outlook. These subcontractors, suppliers and vendors have little recourse when their contracts with their primes are scaled back or terminated; in fact the suppliers and vendors may not even know that their business is linked to a federal contract that could be canceled due to something called “sequestration.”

Approximately 1.4 million indirect and induced private sector jobs—jobs of businesses that are subcontractors, suppliers and vendors, or jobs dependent on the spending of federal and contractor payroll—would be lost due to federal spending reductions with almost fifty-eight percent (57.7%) of these jobs losses coming from small businesses. Small businesses and their workers are particularly vulnerable to these indirect and induced impacts that would undermine these firms’ viability and threaten their survival even though many are not even doing business with the federal government.

The Economic Impact of Sequestration on Small Businesses:
The Collateral Impacts

That small businesses are more vulnerable to changes in the economy than large businesses is well established in the literature. Among the factors explaining this greater vulnerability is their more limited access to financial resources, their greater dependency on fewer product and service lines of business, their smaller business backlogs, the more limited adaptability of their workforce, and the smaller margins of their economies of scale.

The measurements of job impacts associated with sequestration calculate only the job-equivalent of the direct spending reductions and their subsequent impacts on the economy due to the loss of federal spending or its payroll effects on consumer purchasing power. What is not included is any consideration for the induced

failures of small businesses from the partial losses of federal contracts or subcontracts.

While large firms may suffer financial losses as a result of a federal contract cancelation, these firms have sufficient scale of operations to survive through adjustments to their variable costs and most are able to absorb losses over the period required to adjust their business base, downsize, right size or re-position to regain profitability. A typical strategy of prime contractors when experiencing a reduction of contracting or business slowdown is to bring work that had been subcontracted to outside firms back into the base firm. Large businesses have the ability to re-absorb business from their subcontractors and other suppliers and vendors where this capability is less likely among small businesses. The fact that small businesses are more likely to be subcontractors and constitute a greater percentage of businesses impacted by the indirect and induced impacts of sequestration makes them more vulnerable to the predictor business strategies of larger prime contractors.

Small businesses are less able to sustain themselves when they experience a loss of a contract, either as a prime or subcontractor. Due to the narrower economies-of-scale that characterize the operations of most small businesses, the loss of even a small portion of their projected backlog or the cancelation of a contract could result in these firm's becoming unsustainable. Small businesses typically do not have the financial resources to sustain unprofitable operations for a sufficiently long period to permit restructuring and alternative product or market development.

The same dilemma facing small businesses with their limited resource base that makes adjusting to an abrupt change in business volume applies to their workers. Employees in small businesses may be more specialized or less networked than employees in large businesses thereby making their re-employment more challenging than for employees working in large businesses experiencing cutbacks or cancelations of federal contracts. These workers in larger businesses may have the opportunity for reassignment to another division in the same company when the contract they have been working on is canceled. Additionally, transfers within these companies to other locations may also re-employ some of these workers. And, larger firms tend to be located in larger economies that may offer more opportunities for re-employment. Small businesses and their workers are more vulnerable to cutbacks and the consequences can cascade beyond the immediate impacts accounted for by the econometric models.

Conclusions

The size and specialized nature of small businesses make them more vulnerable to sequestration than large businesses. As a result, small businesses will bear a disproportional impact of the federal spending reductions under sequestration. While these impacts can be measured in the loss of jobs by small businesses that are prime federal contractors (34.1% of all prime federal contractor job losses), small

businesses that are subcontractors, suppliers and vendors and whose existence depend on consumer spending that would be negatively impacted by the losses of labor income resulting from sequestration, would account for 57 percent of the associated job losses across the country. Not only will small businesses shoulder a disproportional share of the jobs losses attributable to sequestration but their ability to survive these losses and remain viable further challenges the efficacy of sequestration.

Table 3

State Employment Impacts on Small Businesses
of the Budget Control Act of 2011 in Fiscal Years 2012 and 2013

	Small Business Job Losses, DOD Cuts	Small Business Job Losses, Non-DOD Cuts	Total Small Business Job Losses
Alabama	12,812	4,965	17,777
Alaska	2,813	1,880	4,692
Arizona	16,823	5,801	22,623
Arkansas	1,719	2,308	4,027
California	64,532	37,553	102,085
Colorado	8,802	10,036	18,838
Connecticut	17,292	2,377	19,668
Delaware	31	889	920
District of Columbia	7,240	46,700	53,940
Florida	20,000	15,626	35,626
Georgia	13,177	11,194	24,371
Hawaii	3,750	1,178	4,928
Idaho	469	3,923	4,392
Illinois	11,094	12,653	23,748
Indiana	7,135	3,741	10,877
Iowa	2,500	2,446	4,946
Kansas	2,969	3,193	6,162
Kentucky	8,125	4,835	12,960
Louisiana	9,010	3,975	12,985
Maine	2,031	1,253	3,285
Maryland	18,802	31,373	50,175
Massachusetts	19,792	7,917	27,709
Michigan	6,458	7,356	13,814
Minnesota	2,344	4,628	6,972
Mississippi	2,500	2,677	5,177
Missouri	16,042	7,273	23,315
Montana	468	1,691	2,159

Nebraska	1,249	1,668	2,918
Nevada	2,031	2,561	4,592
New Hampshire	1,719	1,126	2,844
New Jersey	12,136	7,388	19,523
New Mexico	2,344	9,787	12,131
New York	13,750	17,143	30,893
North Carolina	5,677	7,254	12,931
North Dakota	469	1,032	1,501
Ohio	10,156	7,957	18,113
Oklahoma	3,802	3,267	7,070
Oregon	1,406	3,755	5,161
Pennsylvania	19,063	16,025	35,087
Rhode Island	1,250	778	2,028
South Carolina	7,031	6,500	13,532
South Dakota	938	1,139	2,077
Tennessee	4,843	12,055	16,898
Texas	47,240	25,170	72,410
Utah	3,958	3,220	7,179
Vermont	1,094	736	1,830
Virginia	65,000	29,700	94,700
Washington	8,125	10,261	18,386
West Virginia	469	3,772	4,240
Wisconsin	13,177	3,722	16,899
Wyoming	312	884	1,196
Guam	1,041	204	1,245
Puerto Rico	1,041	1,272	2,312
Undistributed	12,348	17,965	30,313
Totals	520,398	435,782	956,181

Table 4

Direct Impact on Small Business Contractors (<500) Employment
of the Budget Control Act of 2011 Fiscal Years 2012 and 2013

	Small Business Direct Jobs Losses DOD Cuts	Small Business Direct Job Losses, Non-DOD Cuts	Total Small Business Direct Jobs Losses
Alabama	2,008	866	2,874
Alaska	441	328	769
Arizona	2,636	1,012	3,649
Arkansas	269	403	672
California	10,113	6,553	16,666
Colorado	1,379	1,751	3,131
Connecticut	2,710	415	3,125
Delaware	5	155	160
District of Columbia	1,135	8,149	9,284
Florida	3,134	2,727	5,861
Georgia	2,065	1,953	4,018
Hawaii	588	206	793
Idaho	73	685	758
Illinois	1,739	2,208	3,947
Indiana	1,118	653	1,771
Iowa	392	427	819
Kansas	465	557	1,022
Kentucky	1,273	844	2,117
Louisiana	1,412	694	2,106
Maine	318	219	537
Maryland	2,946	5,475	8,421
Massachusetts	3,102	1,382	4,483
Michigan	1,012	1,284	2,296
Minnesota	367	808	1,175
Mississippi	392	467	859
Missouri	2,514	1,269	3,783
Montana	73	295	368
Nebraska	196	291	487
Nevada	318	447	765
New Hampshire	269	196	466
New Jersey	1,902	1,289	3,191
New Mexico	367	1,708	2,075
New York	2,155	2,992	5,146

North Carolina	890	1,266	2,156
North Dakota	73	180	254
Ohio	1,592	1,388	2,980
Oklahoma	596	570	1,166
Oregon	220	655	876
Pennsylvania	2,987	2,796	5,784
Rhode Island	196	136	332
South Carolina	1,102	1,134	2,236
South Dakota	147	199	346
Tennessee	759	2,104	2,863
Texas	7,403	4,392	11,795
Utah	620	562	1,182
Vermont	171	129	300
Virginia	10,186	5,183	15,369
Washington	1,273	1,791	3,064
West Virginia	73	658	732
Wisconsin	2,065	650	2,715
Wyoming	49	154	203
Guam	163	36	199
Puerto Rico	163	222	385
<u>Undistributed</u>	<u>1,935</u>	<u>3,135</u>	<u>5,070</u>
<hr/> Totals	<hr/> 81,552	<hr/> 76,047	<hr/> 157,598