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Testimony prepared for the House Committee on Small Business for a hearing on ‘Prices on the Rise, Examining the Effects of Inflation on Small Businesses’

Testimony • By Josh Bivens • June 7, 2023

EPI's Josh Bivens appeared as a witness and submitted the following written testimony before the U.S. House Committee on Small Business, on Wednesday, June 7, 2023 at 2:00PM, for a hearing titled "Prices Are On the Rise: Examining the Effects of Inflation on Small Businesses"

Chairman Williams, Ranking Member Velázquez, and distinguished Members of the Committee: Thank you for inviting me to testify at this hearing. My name is Josh Bivens and I'm the Chief Economist and Research Director of the Economic Policy Institute (EPI). EPI is a non-profit, non-partisan think tank that uses the tools of economics to identify policies than will boost the living standards of low- and moderate-income families, particularly through their role as workers.

I'd like to make the following points about the subjects of this hearing—inflation and its effects on small businesses.

- Inflation has been a challenge over the past two years, but inflation is not the only notable economic trend that's emerged in this time—we've also seen by far the best labor market in a generation, particularly for low-wage workers. Policy changes that are undertaken in the name of fighting inflation may threaten these labor market gains, and if inflation is poised to moderate on its own even absent these changes, then they would be pure gain for little gain.

- Inflation has not been the result of policy mistakes. Instead, it's been the essentially inevitable result of massive shocks to the economy and the long-lived—but steadily dampening—ripple effects. These shocks were obviously the pandemic and the Russian invasion of Ukraine, and the ripples were mostly about jockeying by different economic actors—corporations, workers, and suppliers—to protect their own real incomes from these shocks.

- All of this means that inflation has mostly been a *distributional* challenge—because one person's income is another person's cost, the higher costs for some have shown up as significant income gains someplace in the economy. This "someplace" has mostly been the business income of sellers—particularly corporate profits.
  - Have small businesses been able to draft in this corporate pricing power wake and charge higher prices themselves to protect their own margins? It's very hard to generalize, but it is vital to remember that lots of "small businesses" are actually incredibly rich and privileged enterprises. My guess is that these privileged businesses have largely been able to pass input price increases on and then some.
  - To the degree that some genuine Main Street small businesses have been squeezed on the input side but have been unable to pass these costs on—maybe because they are suppliers to big corporations who refuse to pay higher prices to their suppliers—this is not really a problem of inflation *per se*, it's a problem of monopoly power in markets that's been growing for years. We certainly should address this, particularly with more assertive anti-trust policy.

    - There is no labor shortage relative to pre-pandemic trends–recovery in labor supply is effectively complete.
- But, the risk to small business from an overaggressive attack on inflation that seeks to slow the economy are the same as to workers writ large–it will sacrifice the huge gains from the recovery for no real need if inflation is already normalizing (and it almost surely is).

Below I'll say a bit more on each of these.

Inflation not the only notable economic trend of recent years

This hearing is predominantly about inflation and its effects on small businesses–and inflation has obviously been a key economic challenge facing working families throughout the recovery from the recession caused by the COVID-19 pandemic. But inflation is not the only notable economic trend in recent years–and it is certainly not the only notable trend highly relevant to small businesses.

In short, this has been a remarkably rapid recovery–particularly when compared to recoveries following the recessions of the early 1990s and 2000s and the recovery from the Great Recession and financial crises of 2008. Over 13 million jobs have been added since January 2021, a rate of around 450,000 jobs per month since President Biden took office.

The pre-recession unemployment rate was reattained in essentially 2 years following the recessionary shock. It took 10 years to reattain the 4.3% unemployment trough after 2007.

Growth in hourly pay–even adjusted for inflation–has been extraordinarily strong for low-wage workers. Between 2019 and 2022 hourly real wages for workers at the 10th percentile rose by 9%. In the first three years following the business cycle peak of 2007, inflation-adjusted wages grew by just 1.1%.

Since the recovery from the COVID-19 recession began in the third quarter of 2020, gross job gains have outpaced gross job losses in the Business Employment Dynamics (BED) data by more than 5 million. A third of these net job gains have been in businesses with less than 50 people – a bit higher than the average share of net job creation that could be accounted for by small businesses in the two years before the pandemic hit. In 2021 and 2022, 10.5 million applications to start new businesses were filed, the highest two years on record. Work from the Federal Reserve finds that these applications have turned into new establishments and new hiring.[1]

All of these salutary economic trends have been supported by Biden administration efforts, including but not limited to the rapid recovery ensured by the American Rescue Plan (ARP). Additional efforts for small businesses have included expanded access to capital through small business lending and investments in support services for small businesses. [2]

Inflation was not the result of a policy mistake–it was the inevitable result of mammoth global shocks and their long-lived–but dampening-ripples

In early 2021, debate raged about the potential economic effects of the American Rescue Plan (ARP). The ARP, passed in early 2021, was explicitly designed as fiscal stimulus, with large and front-loaded transfers to households as its centerpiece, along with substantial aid to state and local governments.[3]

It is worth remembering the macroeconomic situation at the time of this debate. Of the 22 million jobs lost due to the COVID-19 shock, barely half had been recovered by December 2020, leaving the economy more than ten million jobs below pre-recession levels. This was a larger jobs gap than we had at the trough of the Great Recession and financial crisis of 2008-2009.

Further, the recovery that had begun in May 2020 was flagging. Monthly job gains had been getting smaller and smaller since September of that year, and December 2020—the last month's data informing the meat of the debate over the ARP—saw outright job losses again.

Hence, the decision to go for a large fiscal stimulus was very well founded in the evidence.

Some critics of the ARP worried about its potential effect on inflation, as it was argued that the ARP would push gross domestic product (GDP) well over the economy's long-run potential to deliver, hence causing inflation. In this story, a positive "output gap" with actual GDP far exceeding the economy's long-run potential should have appeared in the data. Yet both real GDP and estimates of potential GDP today sit almost exactly where pre-pandemic forecasts predicted they would be in 2023 – and these forecasts included no indication of inflation. If the economy is not trying to produce more than it is capable of relative to pre-pandemic forecasts, it is hard to see where the heat that is generating inflation is coming from.

Reasonable estimates of potential GDP that account for the damage done by the pandemic were also slightly below pre-pandemic trends, but the size of the resulting output gap was utterly *un*remarkable—totally in line with recent past episodes that saw larger and more sustained gaps without generating any inflation at all.

Another piece of evidence against this simple overheating view comes from international data. Inflation—even outside of food and energy prices—has clearly been global. Every single advanced economy has seen inflation accelerate relative to pre-COVID trends, and most of these countries have seen a large acceleration, whether or not they used large stimulus programs. Some have argued that this just means that every single other advanced country replicated the U.S. "mistake" of overheating their economies. But this would suggest that the extent of inflationary acceleration should be correlated with reductions in unemployment—for overheating to take hold, it must run through labor market tightening. Yet across countries, there is no correlation at all between the reduction in unemployment and the acceleration of inflation in recent years.

Finally, key aspects of the labor market show little conventional signs of heat. One of the most reliable empirical relationships in modern business cycles is that low and falling unemployment (i.e., an economy that is "heating up") pushes *up* the share of corporate-sector income claimed by workers (rather than capital owners). Yet the labor share fell sharply and has remained depressed all through the recent inflationary surge.[4]

Shocks and ripples

If inflation was not driven by macroeconomic overheating, what's the alternative account? Extreme sectoral shocks kicked off large—but steadily diminishing—ripple effects. In this "shocks and ripples" account, if shocks relent, then inflation will normalize—even if it will take some time.

The shocks are fairly obvious: The pandemic led to a historically sharp reallocation of spending away from face-to-face services and toward goods consumption and residential investment. Simultaneously, the pandemic introduced huge snarls in global supply chains that need to function smoothly to meet demand for goods and materials used in residential investment. These extreme shocks to both sectoral demand and supply was *the* spark to inflation in 2021. In 2022, the Russian invasion of Ukraine added another, more familiar shock to energy and food prices.

Proponents of the macroeconomic overheating view often refuse to acknowledge that sectoral shocks that lead to large changes in *relative* prices (i.e., prices for specific goods and services) can cause overall inflation. Their reasoning is that if, say, gas prices rise by 50 percent in a short period, then this should lead to a near-immediate reduction in demand for other goods and services that forces down their prices, leaving overall inflation unaffected. There's some logic to this, but the time span in which this kind of countervailing demand reduction happens following sectoral price shocks is *far* longer than they think—measured in years, not months. In short, thinking that sectoral shocks can have profound implications for inflation is not a simple failure to understand macroeconomics. James Tobin, perhaps the greatest macroeconomist of his generation, wrote in 1972 that:

> "dispersion is inflationary … the rate of wage inflation will depend not only on the overall dispersion of excess demands and supplies across markets but also on the particular markets where the excess supplies and demands happen to fall. An unlucky random drawing might put the excess demands in highly responsive markets and the excess supplies in especially unresponsive ones."

Ripples that were surprising—but likely to decline without high interest rates

These sectoral shocks led to more persistent effects on inflation than many anticipated in part because of a key ripple effect—nominal wage growth accelerated noticeably in late 2021 and early 2022. This nominal wage acceleration did not provide the initial impetus to inflation—the pandemic and war shocks did that. Further, while nominal wage growth accelerated relative to pre-pandemic levels, it remained slower than overall inflation and so actually muffled rather than amplified the inflationary shock.

Essentially, the pandemic and war shocks to prices sent economic actors—firms, workers, and consumers—scrambling to protect their own real incomes from higher costs. As nonlabor costs rose due to pandemic and war shocks and pushed up prices, workers tried to protect their real (inflation-adjusted) incomes by demanding higher nominal wages. Firms in turn tried to keep their own profit margins intact or even to opportunistically raise them. This cascade of higher nominal wage demands and profit margin hikes intensified the inflationary effect of the initial shocks and made them more persistent.

Nominal wage acceleration did keep inflation higher than it would have been had wage growth not budged from its pre-pandemic pace. But even if nominal wage growth had not quickened at all, we still would have had a burst of inflation over the past two years. The reduced inflation that could have been "bought" by keeping unemployment higher and nominal wage growth lower in 2021 and 2022 would have been relatively small—and the price of this slightly slower inflation would have been even larger declines in real wages for working families than we have seen. In short, given the incredibly binding constraints put on the range of economic choices by the pandemic distortions and the Russian invasion of Ukraine, choosing to tolerate some inflation as the price of engineering a remarkably fast recovery was the right thing to do.

Inflation has been mostly a distributional challenge–sellers have done well

There are times when inflation really can be driven by *most* incomes in society rising at mostly the same pace. In this case, inflation is distributionally neutral, but there's also no "real" cost. For example, if inflation accelerates from 0% to 4%, but nominal wage growth accelerates from 2% to 6%, real wages haven't been harmed (they grow at 2% in either case). The inflation we have seen since 2021 has not been distributionally neutral. Prices and incomes for low-wage workers, middle-wage workers, high-wage workers, and profits have not moved in lockstep but have seen very different rates of growth.

Most striking is the role of corporate profits in starting and sustaining inflation since 2021. **Figure A** below shows one measure of profit "mark-ups" in the non-financial corporate (NFC) sector of the U.S. economy. We look at this sector because it has rich and timely data coverage. Mark-ups are essentially profits earned per unit of output divided by labor and non-labor costs.

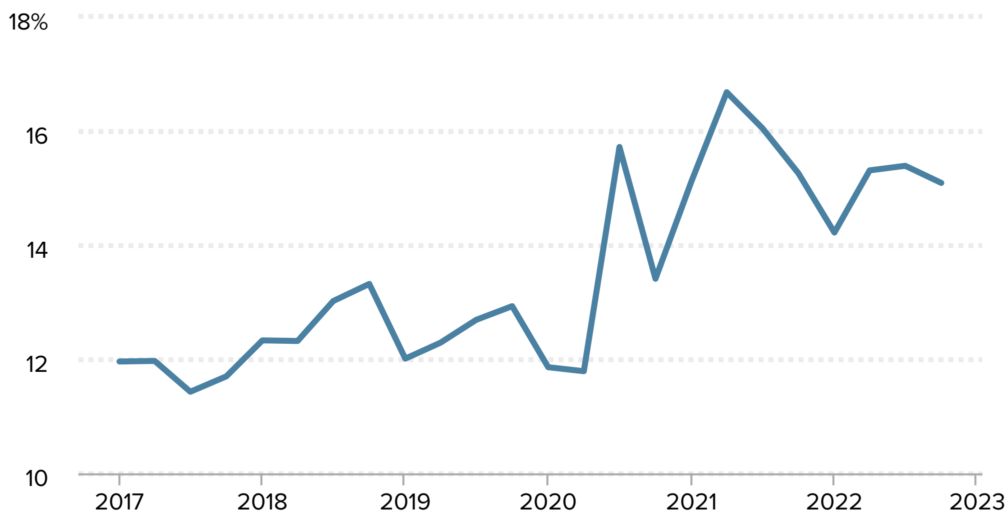
When these profit markups rise, the result is increasing prices for consumers (inflation). The very large spike in the beginning quarters of the COVID-19 recovery is clear. Since then, mark-ups have come down a little, but remain extremely elevated relative to historic norms. Many (including me) had hoped these high mark-ups would relent sooner and provide more relief from too-high inflation by now, but it has not yet happened in a serious way.

Figure B shows the contribution of profits, labor costs, and nonlabor costs to growth in NFC prices between the beginning of the COVID-19 recovery (the second quarter of 2020)

Figure A

Profit markups spiked during COVID-19 economic recovery

Profits per unit of output divided by unit labor and unit nonlabor costs in the NFC, 2017–2022



Source: Bureau of Economic Analysis (BEA) National Income and Product Accounts (NIPA) data, Table 1.15.

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and the end of 2022. Measuring since the last business cycle peak (the fourth quarter of 2019) does not change this story radically.

In normal times, corporate profits contribute about 13% to prices. Between the second quarter of 2020 and the end of 2022, they have instead contributed more than a third of price growth, or more than twice as much as they normally do. This contribution was larger in previous quarters, which means the slight decline in mark-ups shown in **Figure A** has put a small bit of welcome *downward* pressure on inflation in recent quarters. But there remains a long way to go before profits are back to normal, and this profit normalization drive even more disinflation.

Have small businesses also been able to increase their profit margins due to pandemic and war distortions?

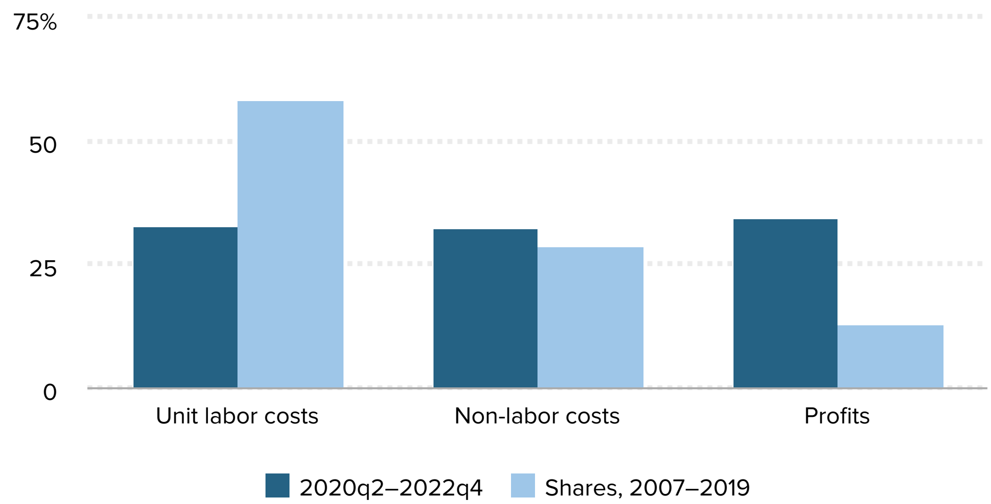
Much of the income earned by small businesses is classified as "proprietors' income" in by the National Income and Product Accounts (NIPAs)—the statistical backbone of the U.S. economy. Before looking at aggregate trends in this measure, it is vital to note that many firms that get classified as small businesses or included in proprietors' income are actually extraordinarily privileged and rich enterprises.

For example, as Smith, Yagan, Zidar and Zwick (2020) note—"*More than 69 percent of the top 1 percent of income earners – and more than 84 percent of the top 0.1 percent of income earners accrued some pass-through business income in 2014, the most recent*

Figure B

Corporate profits contributed disproportionately to price growth in the COVID-19 economic recovery

Share of NFC price growth accounted for by unit labor costs, non-labor costs, and profits, 2020q2–2022q4 and shares of each between 2007–2019



Source: Bureau of Economic Analysis (BEA) National Income and Product Accounts (NIPA) data, Table 1.15.

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year for which complete data are available."[5] Pass-through income is essentially all business income earned by entities that are not traditional C-corporations (ie, corporations that pay federal taxes at the enterprise level). Further, these same authors estimate that half of the post-1979 doubling of the share of total national income claimed by the top 1 percent can be accounted for by rising pass-through business income. In short, small businesses are an even more-varied and unequal set of economic actors than any other in the U.S. economy.

In the aggregate, proprietors' income has lagged overall domestic income growth since the last business cycle peak in the last quarter of 2019 – growing at a 4.6% annualized rate in nominal terms compared to over 5.6% for overall domestic income. But, proprietors' income growth lagged even worse in the last 2 years before pandemic – growing at just an annualized rate of 3.2% between 2017 and 2019, compared to 4.5% growth in overall domestic income. In short, there is little evidence that any economic development – inflation or anything else – has severely affected the relative performance of the sector that small business incomes appear in since 2020.

Many genuine small businesses surely find themselves facing rising input cost pressures. The huge increases in corporate prices, however, should have given many of these smaller businesses some elbow room to raise their own prices to deal with some of these more expensive input costs. In cases where small businesses work as suppliers for larger corporations, and these corporations have held the line on what they will pay their suppliers, this is obviously a huge source of pressure for the smaller businesses – but its root cause is the asymmetry in market power, not inflation per se. This asymmetry in market power that allows “lead firms” to pressure their own suppliers and starve them of opportunities is a real problem in the U.S. economy in recent decades.[6] It should be met primarily with enhanced anti-trust efforts that put market power in labor markets and supplier markets on the same footing as power in product markets. The Biden administration’s Federal Trade Commission (FTC) and the Anti-Trust division of the Department of Justice have made admirable steps in this regard.

There is no labor shortage

There has been a consistent complaint by business over the course of the recovery over labor shortages. For short periods in some sectors since the recovery from the COVID-19 recession began, there did indeed seem to be some labor shortages which were relatively quickly alleviated by raising wages. But by now, there is no evidence at all of any economy-wide labor shortage relative to pre-pandemic trends. The level of employment and the labor force participation rate are higher than what the CBO projected in February 2021, before the American Rescue Plan took effect. Further, these are both higher than what the CBO projected in early 2020, before the Covid pandemic.

The number of prime-age adults (those between 25 and 54) working is not only higher than 2019 levels, it is the highest it has been since 2001. Black workers, in particular, have had historically high levels of employment in the recovery, a testament to the broad nature of this recovery. In recent months, for the first time in recorded history, the overall employment to population ratio for the Black population exceeded that of the white population. Much of this crossover was driven by differential aging trends (the white population is getting older faster and relatively more of them are crossing over retirement), but much of it is the natural tightening of racial gaps in employment that occur when the labor market is in good health.[7]

There is work that we could certainly to do to expand labor supply even further and beat past trends by supporting workers and by extension small businesses. The most obvious plank of a progressive labor supply policy that would yield big results would be a robust public investment in child care. By making high-quality childcare more affordable, we would reliably boost the labor supply of young parents–particularly women.[8]

Risks to robust recovery–and small businesses–from attacking inflation with the wrong policy tools

If one sees inflation as *ipso facto* evidence that the economy has a macroeconomic excess of demand over productive capacity, and one sees this productive capacity as relatively fixed in the short-run, the obvious policy corollary is to tamp down demand–either through contractionary fiscal or monetary policy. But if one instead sees the inflation over the past 2 years as a set of long-lived ripples stemming large pandemic and war shocks, then one would expect inflation to normalize even without sharply contractionary policy.

In recent months there has been a sharp decline in the pace of nominal wage growth even as unemployment has remained low. Further, home price declines from early and mid-2022 are just now showing up in official inflation data. In short, there is substantial reason to expect a normalization of inflation in the coming months even if we manage to keep the unemployment rate very low.

This scenario where inflation normalizes without a recession–the “soft landing”–is by far the best one for small businesses and nearly every other actor in the U.S. economy. The necessary condition for success in business–whether small or large–is a steady stream of customers. These customers will dry up if contractionary policy takes hold.

Inflation has been key challenge to the U.S. economy and its small businesses in recent years, but it remains the case that many proposed cures for this inflation would do more harm than the malady itself. Further, given the many promising signs on disinflation coming down the pike, risking a recession now by calling for ever more-contractionary monetary and fiscal policy would be akin to snatching defeat from the jaws of victory.

Notes

1. Decker, Ryan and John Haltiwanger. 2022. *Business entry and exit in the COVID-19 pandemic: a preliminary look at official data*.

2. See the fact sheet from the Biden-Harris administration here: https://www.whitehouse.gov/wp-content/uploads/2023/04/Small-Business-Report.pdf

3. This section draws on Banerjee, Asha and Josh Bivens. 2023. *Lessons from the Inflation of 2021-202?.* Economic Policy Institute.

4. See Bivens, Josh. 2023. *What Profit-Price Spirals Are Telling Us About Post-Pandemic Inflation*. Intereconomics. Volume 58(3), pp. 167-168.

5. Smith, Matthew, Danny Yagan, Owen Zidar, and Eric Zwick. 2019. *Capitalists in the Twenty-First Century*. Quarterly Journal of Economics. Volume 134(4), pp. 1675-1745.

6. See Wilmers, Nathan. 2018. *Wage Stagnation and Buyer Power: How Buyer-Supplier Relationships Affect U.S. Workers’ Wages, 1978-2014*. American Sociological Review. Volume 83(2). Pp 213-242.

7. See Bivens, Josh. 2021. *The Promise and Limits of High-Pressure Labor Markets for Narrowing Racial Gaps*. Economic Policy Institute.

8. See Bivens, Josh, Emma Garcia, Elise Gould, Elaine Weiss, and Valerie Wilson. 2016. *It’s Time for an Ambitious Investment in the Nation’s Children*. Economic Policy Institute.