CAN U.S. COMPANIES COMPETE GLOBALLY USING AMERICAN WORKERS?

FULL COMMITTEE HEARING

OF THE

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HOUSE OF REPRESENTATIVES

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HEARING ON: CAN U.S. COMPANIES COMPETE GLOBALLY USING AMERICAN WORKERS?

WEDNESDAY, JANUARY 21, 2004,

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS
Washington, D.C.

The Committee met, pursuant to call, at 10:06 a.m. in Room 2360, Rayburn House Office Building, Hon. Donald Manzullo presiding.

Present: Representatives Manzullo, Velazquez, Bartlett, Millender-McDonald, Udall, Chabot, Ballance, Christensen, Akin, Napolitano, Bordallo, Majette, Bradley, Beauprez.

Chairman MANZULLO. The Committee meeting will be called to order. While we have good news about an improved economy, we continue to have not so good news about Americans losing jobs to foreign competition.

As a capitalist and as an ardent free trader, I can say with conviction that competition is good. It makes us a better nation, while improving the economies of those nations against which we are competing.

There is a false argument, however, that anyone who dares question what is happening with off-shoring or the decimation of domestic manufacturing is somehow protectionist, as if there are no shades of gray between the two extremes of pure protectionism and no holds barred free trade.

It is my contention that one of the key issues hidden from this debate is the tremendous pressure Wall Street puts on corporate America. I think if we peel back the onion, we will find that companies are unduly forced into doing anything and I mean anything, to drive up stock values in order to make their quarterly estimates.

The decision to manage a company by managing stock price has monstrous effects on everyday America. For example, companies are shutting down entire domestic supply chains for the lure of cheaper labor overseas.

I am not against international trade, but neither do I support the wholesale abandonment of small businesses by big multinationals. By looking long-term as opposed to short-term, I believe companies can put America's jobs first and still win in the global marketplace.

Legislation is surely not the answer. There has to be a change in corporate culture and thus this hearing this morning.

I realize we are dealing with highly competitive nations like India and China. The problem is we are giving away the store without giving up much on their end. India has one of the worst trading records with the United States. China simply refuses to comply with WTO obligations and we still keep the door open.

What is interesting is that the semi-conductor industry is complaining that China is forcing them to give up technology secrets if they want to do business in China. What they are afraid of, what they know to be true, is that the Chinese companies will steal their intellectual property and the Chinese government will do nothing about it.

We are not talking about manufacturing employment being in a decline because of better machinery. That is the classical definition of productivity. In fact, according to sources in the tooling industry, only about one-quarter of the productivity increases can be attributed to new machinery. The rest is off-shoring and the incorporating of cheap, foreign components with American components to come up with higher productivity.

If the argument is that companies cannot be profitable using Americans, why are companies like IBM still sending jobs overseas, when they have had strong profits?

In Monday's issue of the Wall Street Journal, a copy of which is on the table, it is reported that IBM plans to ship thousands of high paying programming jobs to China, India and Brazil. They even tell their managers not to be "transparent regarding the purpose or intent" of the off-shoring decision and cautions that the "terms on-shore and offshore should never be used". It is a startling and revealing article.

That is not the worst of it. The poke in the eye is that IBM will have some of the foreign programmers come to the U.S. for on-the-job training by the very people whose jobs they will take over.

I.B.M.'s chief financial officer said, "Competitive price pressures in computer services are holding down profitability". Well less than a week ago, IBM announced a 41 percent increase in fourth quarter earnings per share the same period in 2002. They had a 42 percent increase in income compared to the same period a year ago.

What about the CEO's exuberance in stating, "This was a very good quarter for IBM and an encouraging end to a year in which we steadily gained momentum and posted record revenues. Our pretax earnings per share were up double digits for 2003 and we ended the year with more than 7.6 billion in cash"?

Is this what the IBM CEO meant when he said price pressures are holding down profitability? I cannot say he is blowing smoke, but it sure is an interesting definition of profitability.

What is remarkable is that the National Science Board and the High Tech CEO Policy Group recently warned that the economic vitality of America is threatened by a lack of U.S. graduates in science and engineering. My question is: How can you get students excited about science and engineering when they see those same jobs be moved overseas for a fraction of the price?

The National Science Board further concluded that U.S. strength in education and innovation is threatened by two major trends. First, global competition for science and engineering talent is intensifying. Second, the number of U.S. born graduates in these fields is likely to drop. I must add a third, the number of foreign born graduates from U.S. institutions going back home was increasing.

So what does all this have to do with corporate earnings management? I think they are all connected to decisions made in the board room to find that extra penny per share at all and any costs.

It is my hope that our distinguished panel of experts can shed some light on how companies can compete in the global market using American workers.

For the purpose of the hearing, we have set it forth in two distinct panels. The first panel is dealing with essentially employees as human capital. It is going to be a very exciting conversation taking place.

The second panel I have split off. The minority had requested a separate hearing on 7(a), and the second panel speaker is an expert on the 7(a) program that is totally unrelated to this. In fairness to the two separate topics, I have decided as Chair to split them into two separate panels.

[Chairman Manzullo's statement may be found in the appendix]

I recognize our distinguished ranking minority leader of the Small Business Committee, Congresswoman Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. Today the drive on Wall Street for short-term profits has damaged our nation's consumers, workers and local communities.

Unfortunately, such eagerness for rapidly rising profits has made headlines around the world as company after company has adopted shifty accounting techniques to appear more profitable than they actually are.

From Enron to Worldcom, the desire to satisfy shareholders has pushed these companies over the edge. These type of scandals are not directly related to small businesses, since they have occurred in large publicly traded companies, calling into question the relevance of this issue for the Small Business Committee.

Unfortunately, these type of governance issues are not solely limited to the private sector. Many times decisions that are made at the federal level serve to create the very complications that we try to stop.

An example of this is a continuing crisis in the Small Business Administration's 7(a) loan program, which goes without shift and thorough Congressional scrutiny. This issue surfaced late last month when the SBA announced that it will impose another cap on the 7(a) lending program, but this looming crisis was actually foreshadowed much earlier in the year, during a Committee hearing when both Democratic members and industry leaders indicated that the SBA's budget will clearly fall short in meeting the small business demand for 7(a) loans.

During that testimony and throughout 2003, the Bush administration maintained the program had enough funds. Then at the end of this year and to no surprise of some members on the Committee, the Bush administration announced the program ran out of money.

The root of the current crisis is the Administration's budget requests. The funding request for this important program has steadily declined from President Clinton's budget request of $11.5 billion in 2001 to the Bush administration's most recent request of $9.3 billion in 2004.

This decrease is inconsistent with the demand for 7(a) loans, which has increased to more than $12 billion in 2004. As a result of this inadequate budget request, the stage was set for the program to collapse.

The first sign of this collapse was the Administration's December 23 announcement of a $750,000 cap on 7(a) loan size. This announcement caused a completely foreseeable run on the bank as lenders rushed their applications to the SBA for processing and approval.

As obvious as this was, the Administration was caught completely off guard. Instead of managing its operation to account for this heightened demand, the Administration made the extreme decision on January 6 to shut down the 7(a) loan program and return all pending applications to our nation's small businesses.

The Administration's current solution is hardly a solution at all. The SBA has continued its $750,000 cap on loans, banned the use of 7(a) loans in larger financing packaging and has not addressed the inequities suffered by those small businesses that had their application outright canceled.

To top it all off, it is likely the program will shut down again before the end of January. Does this sound like a solution to you? It does not to me or my Democratic colleagues on the Committee.

Small businesses in the United States drives job creation and contributes to positive economic growth. This is especially important now as recent reports confirm the economy is failing to add the number of jobs necessary to put America back to work. In fact, in December it just created 1,000 new jobs.

A real commitment from this Administration to get the small business sector is exactly what our nation needs right now. Without this, the economy will be unable to make a full recovery because small businesses will be left out in the cold. Thank you, Mr. Chairman.

[Ranking Member Velazquez's statement may be found in the appendix]

Chairman MANZULLO. Thank you very much. We have been waiting over a year for two of the three witnesses and conversations going on. I was challenged about two years ago by a CEO of a major corporation back in Rockford, Illinois to read a book called The End of Shareholder Value, Corporations at the Crossroads, by Allan Kennedy.

It has become required reading for the members of my staff and I got my personal copy autographed this morning. We have been in contact with Mr. Kennedy I believe now for about a year and a half to try to coordinate his schedule to come here and speak.

We are going to set the clock at eight minutes for each of the witnesses and I look forward to your testimony.

Mr. Kennedy, if you want to pull the mike closer to you and push it down just a little bit there I think we might get a little bit better resonance.

Mr. KENNEDY. Fine.

Chairman MANZULLO. When you see the clock getting yellow, you have got about a minute to go more or less, but do not let it intimidate you. My understanding is that there will be no votes until at least past noon. So we should be in good shape on time. We look forward to your testimony.

STATEMENT OF ALLAN KENNEDY, WRITER/RESEARCHER/ MANAGEMENT CONSULTANT

Mr. KENNEDY. First of all, thank you Chairman Manzullo and Ranking Member Velazquez and other members of the Committee for inviting me here. It is really an honor to testify in front of Congress and I appreciate it.

My name, as you know, is Allan Kennedy. I am testifying as an individual. I have no affiliations with anyone. My background is I spent about 30 to 35 years as a management consultant, primarily to big business.

Of course while I was doing that, I was running a small business called A Consulting Business and for a while I ran a software company. I have had a foot, therefore, in both big and small business for a number of years.

I do bring a bias to the table, even though I do not represent anyone. I really care passionately about the future of business, big and small. I think it is the engine that makes for a better life for all people in America and it is really critically important to get it right. That is why I wrote the book and that is why I am testifying today.

So let me briefly skip over some of the background and then end hopefully with some comments about things I think can be done. I do not have any easy answers, but I think there are steps that can be taken in the right direction.

First of all, the phenomena of the short-term orientation of large corporations or big business needs to be put in context and the most important part of that context is that big business all started as small business. Companies do not just grow up as big businesses. They are almost all family enterprises originally or quasi-family enterprises that just were successful and grew into being big businesses.

After the Second World War, a lot of people outside of a family context began to see launching a business as a darn good way to get rich. So you had a whole new set of corporations emerge, where the real intent of launching those corporations was in fact to make money. Famous names like Intel are examples of that kind of a corporation.

Along the way and certainly by the 1950's and 1960's, professional managers had for the most part replaced family members as the senior managers of these increasingly large business enterprises and of course their interest was strongly to begin to share the wealth that accrued from building the business, since they were not the founding families.

As it happens, around the end of the 1970's and the beginning of the 1980's, when buy out firms such as Kolbert Kravitz and people like that came along, they start arguing that management was not in fact pursuing adequately shareholder value. That is where the phrase began to arise.

They were not maximizing their returns to shareholders and management was not being held accountable enough to produce results. So they started putting pressure on managers, the threat of being bought out by a buy out specialist to become more accountable.

Now in response to that and in response to dramatically increased competition from overseas, most large businesses started to incorporate performance measures into their compensation to tie managers' interests more closely to the interests of shareholders.

In particular, they developed a lot of stock based compensation schemes so that managers would cash in if the stock of the corporation went up. In fact, the byproduct of those schemes, was the managers began to cash in at totally unprecedented levels, because of their stock option schemes.

By the time 2000 came around and the bubble had burst, now I should note that I wrote the book, The End of Shareholder Value back in 1998 and 1999. It was published at the beginning of 2000, so pre-bubble.

By the time the bubble burst, in fact the ethic of big business, was simply greed, get as much as you can, as fast as you can and that I think is the fundamental problem that is driving an awful lot of the problems in the business environment right now.

Why is running a business for greed dysfunctional? Well it is dysfunctional for two reasons. First of all, the incentive schemes that managers have and that they are trying to optimize with their pursuit of their own personal greed, are financially oriented and very short-term in focus.

Financially oriented, because it is easy to measure finances and short-term, because most managers have a fairly short-term perspective, unlike family members of family run firms.

Also, they are heavily influenced by the stock market and even though most of the money in the markets is institutional money, long-term pension money, money managers are motivated to beat their comparables on a quarter-by-quarter and year-by-year basis so they are very short-term oriented in their outlook and they are churning their portfolios to produce marginal gains over their competitors in the money management business, all of which increases the short-term pressure on business.

This short-term pressure leads managers to adopt techniques such as and we have all heard of them, downsizing, re-engineering, outsourcing techniques to increase the short-term earnings of the business, often at the expense, not the intended outcome, but often at the expense of the long-term viability of the business.

A nice example is there is a popular program called Six Sigma, which is really a quality control, quality improvement program. It is really a euphemism for cost reduction, because improved quality, quality costs less. It is the name of a famous book. Improved quality therefore streamlines operations and you can run at lower costs.

Every manager I know in big business who launched the Six Sigma program managed it by turning to the managers who were implementing Six Sigma and saying, so how much are your costs coming down? Everything translated into short-term this way cost gain.

Now why do we care if big business is being run? Why particularly in the Small Business Committee do we care if big business is being run on a short-term basis?

Well, we care because small business, first of all, is tremendously important to the economy. We all know and I do not know what the statistic is, but virtually all of the job growth in the economy comes from the small business sector.

Family firms tend not to be run for short-term profit. They tend to be run to preserve employment, often of family members and colleagues and neighbors and whatever and they are designed to build long-term wealth, which is very different from short-term profit.

Equally, unless they are ridiculously profitable, small businesses tend to be under capitalized. So anything that requires them to invest money short-term can be very problematic for a small business and you will see in a moment I will comment on why what big business is doing is creating pressure for small business in that respect, because most of what big business is demanding, which is lower costs from their suppliers, often small business suppliers.

Lower costs now requires either immediate cost reductions, which of course flies in the face of the ethic of most small businesses, which is to retain the family environment of the business and to preserve the employment of their key employees or they require new systems and procedures like the movement to just-in-time inventories on the part of big business.

Well, if you are a small business supplier, that means you have to upgrade your systems to be able to interface with big business, to be able to meet those requirements or simply the demand to lower your price in the things you are selling to big business. For example, by moving to offshore outsourcing to offshore manufacturing.

If you are a small business, the whole business of trying to open a plant overseas is a monumental problem for you. You do not have the money to be flitting off to the Far East to try to figure out how to open a plant over there.

All of these things place enormous and counterproductive pressures on small business. So the Small Business Committee has every reason to be concerned about big business' short-term focus on profits.

What is specifically wrong and what can be done to put it right? Executive compensation has gone crazy. Executive pay is driven by an artificial marketplace, because it is set by committees of boards of directors, which are mainly comprised of other senior executives. So it is a closed club.

It is a closed system, which is artificially setting the pay ever higher and if your pay goes higher, then my pay will go higher when it comes around to me. It is a non-market that has driven executive pay to levels that are just unsustainable. It is really just silly.

Now we have the means of correcting that problem. The means are in the progressive taxation system and something needs to be done to bring the pay levels back to reasonable levels.

It is totally unreasonable that a career employee, not matter how talented, I am thinking of someone like Jack Welch, who worked for General Electric, should be compensated a billion dollars for his 25 years in the company or 30 years in the company, because he was CEO at the right time and place, when a worker who spent the same 30 years at General Electric is probably struggling to make ends meet on his pension.

That does not make sense and that should be corrected by putting really punitive tax levels on over compensation. I think we could correct this problem overnight. What is over compensation? Something like a blue ribbon commission needs to define that. It is much too tough for me to define, but hundreds of millions of dollars for running a company is over compensation when you are not the creator of the company, you are just the hired manager.

Corporate governance is fouled up, because these things would not have happened to the extent they have happened, if in fact the governance of corporations had worked. There has been some progress with Sarbanes Oxley and other things, but you know the New York Stock Exchange pay package, I think I am over my time, mutual fund scandals indicate that we have not solved the problem.

The minimum thing that is needed is requiring the boards of large corporations to have representatives of all their constituencies, employees, the major communities they operate in, their suppliers, that would begin to address the problem.

I am going to skip ahead on the written testimony to just say——

Chairman MANZULLO. What I would suggest is in the time for questioning then you can bring in the last part of your testimony that talks about the small businesses and what they can do on it.

Mr. KENNEDY [CONTINUING] Will do.

[Mr. Kennedy's statement may be found in the appendix]

Chairman MANZULLO. I do not know if we have had witnesses on Capitol Hill that have made such interesting statements. As I read your book, I said, I do not know if this man is a Democratic or Republican, a Libertarian, vegetarian. I have no idea what your philosophy is, but your testimony here is as remarkable and startling as the comments that you make in the book and I want to thank you for your candor.

This leads us to our next witness I was on a plane coming home and picked up a Harvard Business Review, took a look at it and I noticed an article by Constance Bagley, associate professor of business administration at the Harvard Business School and I read the article, reread it and then it dawned on me that here is somebody who has taken a look at human beings and employees as human capital and not as statistics.

Included in that article was a chart of ethical responsibility as a diagram. Do you first determine if a decision is legal? If it's legal, then what is the impact that it has upon the employees?

At that point, I saw somebody who was in an area where we find people, such as Andy Grove of Intel struggling. It is an astounding statement that he's torn with the choice of enhancing shareholder value on one hand and then laying off the people who made the company on the other hand just in order to outsource in order to increase shareholder value.

I gave her a call on the phone. She is a former corporate securities partner in the 900 lawyer firm of Bingham McCutchen, the San Francisco office. Her practice currently centers on legal aspects of entrepreneurship and cyberlaw as well as corporate governance.

As I said before, she is also an associate professor business administration at Harvard Business School. Professor Bagley, we look forward to your testimony.

STATEMENT OF CONSTANCE E. BAGLEY, ASSOCIATE PROFESSOR OF BUSINESS ADMINISTRATION AT HARVARD BUSINESS SCHOOL

Ms. BAGLEY. Thank you very much, Mr. Chairman and Ranking Member and Committee members. It is a pleasure to be with you this morning.

I teach in the entrepreneurship unit at the Harvard Business School and would echo the comments with respect to the importance of the issues we are discussing today for small business.

Part of my work deals with venture capital, the private sources of funding. There is no question but that to the extent that the capital markets are shaken the way they have been in the wake of instances such as Enron and Worldcom, that the ability of young companies to get equity funding is substantially impaired by many of the misdeeds that we have seen in the larger companies.

Again, I think that the Chairman's looking at this issue, although it may seem a little tangential, in fact is directly related to whether people that want to go from creating something into a garage to creating perhaps the next Hewlett Packard can get the capital they need in order to do that.

What I want to focus my remarks on today is this whole notion of shareholder primacy. I want to basically just set the record straight on what the law requires, because frankly I think that there is a good amount of misinformation there.

I have been astounded the number of times I have spoken with public company directors who have made decisions, such as closing facilities and the like, that they have anguished over but have basically come down on the side of saying, I did not want to do it. I felt terrible doing it, but I had no choice. I had to maximize value for my shareholders.

That is not what the law says. In the state of Delaware, where more than half of the Fortune 500 companies are incorporated, the Delaware Supreme Court has taken pains to make it clear to directors that the responsibility of the directors of a corporation domiciled in Delaware is to act in the best interest of the corporation. That is broadly defined to include not only the shareholders, but also other constituencies including employees, suppliers, the community, factors such as that.

The obligation of the directors to maximize shareholder value arises in the very narrow instance in which a change of control of the company has become inevitable.

Even in that instance, the Delaware Court has defined it so narrowly that frankly it arises only when you are either literally dismembering a company, so that there is no future for anyone, or you are essentially transferring control of a publicly traded company to either a single shareholder or to another company with one or several dominant shareholders.

To show you just how much power directors have as a matter of law, the Delaware Supreme Court held that it was fully appropriate for the Time directors to go ahead with a merger with Warner Communications, in the face of a hostile bid by Paramount Communications that was at a price that clearly the Time shareholders thought was superior to what they felt would be realized at least in the short-term, from the merger of Time and Warner.

In fact, the deal initially was structured as a stock-for-stock merger, requiring the approval of the Time shareholders. After Paramount made its all-cash offer, it became clear that that approval would not be forthcoming.

In order to obviate the need for that approval, Time restructured the deal as a leveraged acquisition of Warner and proceeded on that basis. Paramount challenged it, saying wait a minute. You are not giving your shareholders an opportunity to get the highest value for their stock.

The Delaware Supreme Court said that, the shareholders are not entitled to run the corporation. It is not as if we have a town hall meeting. They have elected representatives, the directors, and the directors have the fiduciary obligation to look out for all of the interests. Therefore it was held appropriate for the directors to continue with their strategic plan of going ahead with the deal with Warner. This is a stark example of the authority that in fact directors have.

I believe that one of the failures that we have seen in corporate America has been the failure of our directors to assume the mantle of stewardship that comes with being the managers of these major engines of commerce in today's world.

If you look at the percentage of people employed by corporations, the percentage of products manufactured by corporations, the services provided by corporations, there is no question but that these are the dominant economic forces in today's global marketplace. Yet there has been a tendency for directors and for frankly some of my fellow economists at Harvard and elsewhere to, at least in the past, they have back pedaled a bit now I think, but there has been a tendency to say that because of the potential conflict of interest a manager may have in terms of how they are running the company, the only way to make sure that the managers are not feathering their own nest is to require them to maximize shareholder value.

The problem with this is several fold. First of all, you are saying to managers that even if a particular decision strikes you as being unfair, for example to a long-time employee that has been working with the company, to a community that may have built specialized infrastructure in order to accommodate a particular plant, to the people living down river in an overseas country that does not yet have environmental laws as strict as the United States, even in situations where morally you would say I am not comfortable if I were doing this individually, imposing this cost on others, managers must do it here.

I had a rather stark example of that when I was teaching in the fiduciary college at Stanford Law School. We had I think roughly two trillion dollars of institutional money in a room that held fewer than 100 people.

I raised the question with them of and gave them a quote from a CEO who said, 'My responsibility as CEO is to maximize value for my shareholders. I cannot let my own sense of right and wrong get in the way.'

I asked them: How many of you would invest in a company with a CEO stating that position? Few, if any, hands went up.

A little bit later I said, let me give you a hypothetical. Do not fight my hypothetical. Let us pretend that you had the opportunity to invest in a company that has just been given exclusive drilling rights in a country with human slavery. You know that part of the proceeds of the drilling will keep the government in place that has this policy of human slavery.

Would you invest in that company? Assume unrealistically there would be no adverse reputational effect to you or the company. That somehow you could keep this secret. Would you do it? A person raised their hand and said,'Do you mean me personally or do you mean me as a money manager?'

We cannot afford to put on ethical blinders when we go into the board room. It becomes critical, in my judgment, for directors who are given the ultimate legal responsibility to run the corporation in the best interest of all the concerned parties, to look not only at whether something will maximize shareholder value, but also what will be the effect on other constituencies.

A proposal that I made with my co-author Karen Page back in 1999 tried to get at this issue by proposing that the Securities and Exchange Commission amend the requirements for annual reporting on Form 10-K to require companies to disclose the impact of their major decisions on not just the shareholders, what we see in the financial reports, but also on, for example, employees and the like.

We have a situation now where a company that tries to do the right thing can be penalized, because the markets have no way of knowing they are doing the right thing. The information is not out there. It is not being measured. It is not being made public.

I would argue that to the extent that we could require that information to be made public, most of the companies that are really working hard to both get good value for shareholders and to play fair by all the participants would get the credit they deserve and frankly to deter the would-be cheaters who would prefer to force their externalities on others and reap a marginal benefit in price that this disclosure would be a way to encourage the good behavior and deter the more damaging behavior.

Clearly, we need to bring ethics back into the board room. There is no question but that there needs to be concern for shareholder value. I am not in any way suggesting that the capitalist system in our country will survive if we suddenly decide we do not need to worry about that. But in my judgment what great companies do is they figure out how to get a robust return for our shareholders, but not do it on the backs of treating unfairly the other participants?

I would encourage this Committee to consider ways in which, whether it be through disclosure or an amendment to the Warn Act that would provide not only do you have to give warning, but you have to publicly disclose the rationale for closing this facility? What training options were given, what other things did you consider?

That we really require the people in the board room to deal with these issues. Also make clear to them that they have the legal power to do what is right and really need to step up to the plate and have the moral courage to do it. Thank you very much. Be happy to answer questions later.

[Ms. Bagley's statement may be found in the appendix]

Chairman MANZULLO. Thank you very much for that testimony. Our third witness, Dr. Laurie is it Bassi or Bassi?

Ms. BASSI. Bassi.

Chairman MANZULLO. Bassi, CEO and managing partner for McBassi and Company. She is also chair of the board at Knowledge Asset Management, Inc.. She was a co-developer of the human capital capabilities scorecard.

Prior to launching her company, she owned and managed a research based consulting firm and served as a research fellow at Accentures Institute for Strategic Change. Previously as the director of research for SABA, she focused on the economics and measurement of learning.

Before joining SABA, she was VP and general manager at the American Society for Training and Development, where she was responsible for research and enterprise solutions.

Her achievements there include creating internationally recognized standards for measuring and valuing firm's investments in education and training and a core set of benchmarkable indicators for measuring the effectiveness of knowledge management initiatives.

Dr. Bassi spent the early years of her career as a tenured professor of economics at Georgetown University, where she has also served as co-founder of the graduate public policy program.

In addition, she has served as staff director for several U.S. Government commissions, including the Commission Under Work Force Quality, which laid the early groundwork for the emergence of portable skills credentials.

We look forward to your testimony, Doctor.

Ms. BASSI. Thank you, Chairman Manzullo and——

Chairman MANZULLO. If you could pull that a little bit closer to you.

Ms. BASSI [CONTINUING] Thank you. Can you hear now?

Chairman MANZULLO. That is better. Thank you.

STATEMENT OF LAURIE BASSI, CEO OF McBASSI & COMPANY AND CHAIR OF KNOWLEDGE ASSET MANAGEMENT

Ms. BASSI. Good morning and thank you for your invitation for me to speak today. I am Laurie Bassi and a small entrepreneur and run several small businesses.

My testimony today the focus will be that of a PhD economotrician. I am a very hard nosed person on evidence and I have spent many, many years asking the question: Are firms indeed making the right decisions so as to maximize shareholder value and the conclusion that I come up with is, they are not even doing a very good job of that.

I have some public policy suggestions for improving both the attention to true shareholder value interest that would also promote the well-being of——

Chairman MANZULLO. Dr. Bassi, could you pull the mike a little bit closer there?

Ms. BASSI [CONTINUING] Yes. Thank you.

Chairman MANZULLO. Thank you.

Ms. BASSI. Before I go to the substance of my remarks, let me please note—does that help? How is this?

Chairman MANZULLO. That is better.

Ms. BASSI. Okay. I should note that in addition to being an economist, I am also a registered investment advisor personally and nothing that I am about to say should be construed as investment advice. I say this under counsel advice.

What I am going to be talking about may sound like some very specific and narrow evidence, but I encourage you to think of it more broadly. What my colleagues and I have been working on for years and years and years is to look at firms' investments in their people and we can do that by looking at investments in employee education and training, employee development.

Think of that as the tip of the iceberg. They are investments in developing people is really a proxy for investments in people more broadly and what we have is some very compelling economic evidence that firms and I am talking about publicly traded firms here, because those are the ones that we can most readily look at, firms consistently under invest in the development of people. Very bad thing from a societal perspective.

What do I as an economist mean when I say they under invest? What that means is that they are passing up excellent investment opportunities that have a high rate of return. They are just not doing it to the extent that would be optimal from the perspective of shareholder value.

How does she know this you might be asking? This is a research finding that has taken us many, many years. What we have done is we have systematically created databases on how much publicly traded firms are investing in employees. This is an important piece of information, as the Professor was saying, that should be publicly available and is not currently publicly available.

So we have been gathering data on this and what we have found is those firms that make the largest investments in developing their people subsequently out perform comparable firms that make much smaller investments or no investments in their people.

What that means is that firms that are making investments in people are being, as the Professor noted, dinged in the stock market in the short run, but they are being rewarded in the long run.

Why is that so? Think of two comparable firms, Firm A and Firm B. Firm A is investing intensely in its people. Firm B is not.

All the Wall Street analyst sees is that Firm A has inexplicably higher costs than Firm B and therefore, its earnings this quarter are lower. Firm A's earnings this quarter are lower than Firm B. Hence, it takes a ding on its stock market price.

When the benefits of those investments ultimately show up in terms of higher productivity and higher profitability, that firm is ultimately rewarded by the same Wall Street analyst that penalized it in the short run.

Now, if stock compensation, stocks, options are an important part of compensation, then the incentives of the CEO and the C level suite are exactly that of the analyst. They are focusing on this quarter's earnings to the detriment of shareholders' long-run value proposition.

We have studied this, as I have said, over a period of about eight years now. We first did this hypothetically as a research initiative and we discovered that those firms that made the largest investments in their people subsequently out performed their competitors. Over that six-year period, their performance was 16.3 percent annualized rate of return in the stock market, versus 9.2 percent of comparable firms who were not investing in their people.

For the last two years, we have been investing live funds under management, based on this simple finding and I do not want to run afoul of SEC regulations, which might interpret my testimony as advertising. Let it just suffice to say that we are doing very well.

Essentially, we make money by taking advantage of Wall Street's shortsightedness. A shortsightedness that has very real negative implications for workers, employers, shareholders and society at large.

Mr. Kennedy has spoken about the compensation issues that are apart of this. As he said, very complex set of issues. Not a set of issues on which I am an expert, but certainly there is much that can be done there.

There is also a public policy fix and one of them is actually quite simple, I believe. The first thing that needs to be done I think it would be a huge step, not a final step, but a huge step in the right direction is to require that firms report how much they are investing in the development of their people, the education and training of their people, is currently the only form of major investment that firms make that is not publicly reported.

Hence, think back to my example of Firm A and Firm B. Firm A, if a firm is investing in R&D, Wall Street's analysts know that. So while their costs are higher, they are not as severely penalized for having high costs as when they are investing in people.

So there is a fix here that could take us some step in the right direction very consistent with that of the previous speaker and that is to require some disclosure here of very simple accounting disclosure is to report expenses on people, especially the investments made in them, as just publicly report them so analysts can know that those are in fact not costs, but investments.

There are things that are being done in other countries that I think also should be replicated here in the United States. The European Commission and also countries in Asia now are beginning to put public monies into systematic study of what will it take to transform our industrial era accounting and reporting system into a knowledge era accounting and reporting system, one in which people are recognized as investments and assets, rather than simply costs? Thank you very much.

[Dr. Bassi's statement may be found in the appendix]

Chairman MANZULLO. Very compelling testimony. I am going to start off the questions here and look forward to Mr. Kennedy. As I cut you off, you were just about ready to talk about what specifically could be done to decrease the pressure on small businesses. Is that where we left off?

Mr. KENNEDY. That is where I left off.

Chairman MANZULLO. Okay. I have five minutes on my clock. Hopefully we will have an opportunity to ask other questions. If you want to summarize that and what else, because all of your testimony is very good. Do you want to summarize that?

Mr. KENNEDY. Yes. Because it is small business, let me summarize that briefly and then comment on the bigger issue I had hoped you would address earlier.

Chairman MANZULLO. Okay.

Mr. KENNEDY. The pressure on small business is primarily to cut costs or to meet really tough requirements from big business that they are supplying. That is a direct manifestation of short-term cost pressure from big business on small business.

What can you do to help out? Well I think there are two categories of things you can do in small business. One is to help level the playing field, particularly against offshore competition and the other is to try to build on strengths that small business has to make them more competitive in this marketplace.

The options for leveling the playing field are to do something to eliminate dis-incentives for companies to shift jobs overseas. The way it works right now, if you are a large company and you decide to close a factory in, for the sake of argument Illinois, God forbid and shift those jobs over to the Far East, you will take a tax write-off against your profits for the costs of severance, the costs of closing that factory, all of the costs incurred and then you will open up with a lower cost of operation, sometimes subsidized by the government of the overseas country.

That is the tax system encouraging you to close that factory in Illinois. In effect, large companies are not paying the social costs associated with them closing factories over here and that is almost a plumbing issue for the tax code to say what is an allowable deduction and what is not.

I mean sure factories need to close, but when they are closing to transfer jobs someplace else, it seems to me we are subsidizing something that is not a public good.

The other side of the leveling of the playing field is to try to force working conditions and job conditions to a higher level overseas. I am not quite sure how much you can do on that ground, but certainly in negotiating trade agreements, requiring minimum wage agreements, requiring working conditions, OSHA-like working conditions to be met in overseas factories is a step in the right direction, but unenforceable, it seems to me, from this side.

Finally, a small thing that can be done to help level the playing field for small business is one-time grants to help small business cope with sourcing jobs overseas. I mean if you are a small business trying to figure out how to move to a low cost manufacturing location, it is really monumentally difficult and expensive, but a group of small businesses if they could apply for funds to help them try to figure out the optimum balance of where jobs should be that I think would help small business quite a bit.

In terms of helping to building their strengths, grants to help them train their work force, even more generous than there are right now. The unique skills that are being lost are in fact the skills of the talented American workers and the more we can invest in those and the more grants there are for small business to train their workers, the better off we are going to be.

Tax allowances or even accelerated depreciation to allow them to invest in systems that allow them to meet new requirements from big business, like just-in-time inventory requirements which require systems upgrades, which very often small business cannot afford. Simply too expensive for them.

And/or special market development funds to try to create markets for the products that can be manufactured here, but that are being shifted overseas. Do not know what can be done, but short-term things to allow people to find new markets for their products, when they have lost their supply to large business would help. So those are some of the things for small business.

A brief comment on the heart of the problem, which is very difficult to address, but I do not think we will really solve the problem until we address it. The real problem here is that the value system changed.

All of a sudden greed became acceptable. Uncontrolled, unabashed greed became acceptable as a mode of behavior. Now, why did that happen? Well, a lot of things. You know the family broke down. We went to two earner households and so kids without parents at home when they came home from school were well aware that their parent was working because they wanted more money. That communicated a sense of getting more money is more important than probably a bunch of other things that a resident parent might have communicated.

That is a fact. I am not making a value judgment about that, but the family system breaking down contributed to this change in ethic.

The change in formal religion. Certainly the fact that people are not going to church as much, that ministers and priests do not have as much sway I think over the value systems of families probably contributes a great deal too.

But there is no question that the value system changed and that none of the existing institutions in society, church or education or family are really countering this shift in the value system.

I would like to argue that our political mechanism really should take on this task. That if nothing else, the bully pulpit that is afforded to elected members of Congress and other elected officials is a useful device for trying to offset the pressure that is growing in society to allow greed to be the dominant factor.

What is an example? Well Dick Grasso is not a bad guy, the Chairman of the New York Stock Exchange, but his taking home the kind of pay he took home was a violation of public trust.

It seems to me an awful lot of the things that are going on, I am not a lawyer so I am not qualified really, but a lot of things that are going on represent individuals violating public trust and we could develop a body of law that says if you, in fact, violate public trust you will be subject to penalties.

It is not a hanging offense or something like that, but you certainly could pay large fines. You certainly could be banned from continuing in the business you were in.

So for example, if CEO's of large public companies, not private companies, public companies take home really excessive amounts of compensation, that is a clear violation of public trust. It is something we all have an interest in and they could be subject to penalties under that, but I think that Congress should be addressing the issue of the value system. That is my fundamental point.

Chairman MANZULLO. All types of issues out there.

Mrs. Velazquez, I was at seven and a half minutes so I will set the same for you.

Ms. VELAZQUEZ. Mr. Chairman, I just want to thank the excellent presentation made by the witnesses and challenging presentation and I have no questions at this point.

Chairman MANZULLO. Okay. Dr. Bartlett?

Mr. BARTLETT. Thank you very much. Our manufacturing jobs of course have been fleeing this country for a long time now and now following the manufacturing jobs are jobs like software.

Three things I think are driving this. You indicated a fourth here and that is greed, but I think that the limit to which greed can drive this is limited, because ultimately even without greed and even without being respectful to public trust, the three things that I think are driving jobs overseas will continue to drive jobs overseas.

One is our tax climate in this country. Second is our regulatory climate in this country and the third, in the little Wall Street article here about IBM says it very clearly, you can divide these numbers by three or four, if you are talking about manufacturing, but you know the cost in China and it would be roughly the same in India, maybe a hair higher, $12.50 an hour, $56 an hour here.

I do not see these three things changing and unless we can change those three things, what is going to stop our jobs from going overseas and what we ultimately end up with are businesses here that just fill a niche market or manufacturing, where there is something really innovative and creative, but you cannot protect that forever in a world as transparent as our world is?

So if you have something really creative and innovative that gives you a leg up in manufacturing for countries that do not respect intellectual property rights, won't they soon steal that, copy that, whatever?

What is going to stop more jobs from leaving, if these three things are driving them overseas? I do not see any of those changing. Do you see the tax climate changing? Do you see our regulatory climate changing? Do you see this big, big disparity between wage costs changing? If they do not change, what is going to keep even more jobs from going overseas?

Yes, ma'am?

Ms. BAGLEY. I think that one of the factors we need to look at is what is the output from that worker in China earning that amount per hour, that worker in India versus the worker in the United States.

Companies, such as Dell Computer and Delphi in the automotive parts area, have embraced information technology and used information technology, which certainly is expensive, to become very competitive and remain competitive.

I think that the reality is that we do need to continue to innovate. It has been a tremendous source of growth in this country. It is why small business is so critical. Why entrepreneurship is so critical.

We cannot rest on our laurels. I agree with you that technologies will change, various different supply chain mechanisms that are innovative today may not be ten years from now. But I think we need to do everything we can to keep things going in the pipeline of innovation and really try to figure out how can we look not just at the cost of the worker, but say okay for given an amount of cost, for the $50 an hour we are paying in the U.S., how can we restructure their job?

How can we better train them? How can we form more of a team atmosphere? Maybe compress the structure in the company so that we get rid of the executive dining room and the reserve parking spaces and value people in a more effective way so that we are getting frankly more bang for the buck? We can afford to pay 50 bucks an hour, depending on what that worker produces.

A number of companies have found in terms of outsourcing some of their customer support that it has not worked as well as they thought it would. That it turns out that in some areas customers are really not getting as knowledgeable an answer from their 24/7 call center based in Bangalore.

In other situations, you have code being written overseas and it is turning out when you look at it, it is not the quality that we needed. So I think we need to look not only at the cost side, but what the output is from the workers and really be creative about ways we can increase that.

I would commend to the Committee a book written by a former colleague of mine, when I taught at the Stanford Business School, Jeffrey Pfeffer. He is a professor of organizational behavior.

He published a book in the mid 1990's called Competitive Advantage Through People, Unleashing the Power of the Work Force. He provides a number of excellent examples of companies, ranging from Lincoln Electric, the largest arc welding firm in the world that has beaten the GE's of the world, to smaller concerns like Southwest Airlines, that have accomplished this and really used the strength of our people as a competitive advantage instead of seeing the cost of our people as a competitive disadvantage.

Mr. BARTLETT. For the short-term of course that cannot keep us on the playing field. But ultimately, cannot other countries do those same things? As long as we are going to have these enormous disparities between the wage rates, what ultimately will keep the jobs from going?

For the moment we can be more clever. We can be more innovative. We can be more creative. But you know we have not cornered the market on that in this country and ultimately they are going to learn how to do it just as well as we do it.

I just do not see in the long-run, unless we change all three of those things, that we are going to stem the flow of jobs overseas. We are one person in 22 in the world. We have 25 percent of all the good things in the world. You need to ask yourself: How did we get here and what do we have to do to stay here? Thank you, Mr. Chairman.

Chairman MANZULLO. Did you have a comment to that?

Ms. BASSI. As an economist, I would say that nations advantages are driven by their comparative advantage and the only way you can have a comparative advantage in resources or in land or in people. We have had all of those things. That is why we have become so wealthy.

But the path forward, I think, you can sort of think of as a high road and a low road to profitability. The low road is competing on costs and we are going to lose that. The high road to profitability is to compete on value and the only way to have that is to have it embedded in our people.

That is why human capital is so important and why I look at the accounting and reporting that either encourages or discourages firms to invest in human capital, because we cannot maintain our lifestyle any other way.

Now ultimately, in 100 years, the rest of the world could start to catch up with that, but then the world will be a richer place and we may not be so concerned about wage disparities as we currently are.

I think the only sustainable path forward for us is the high road, where we compete through value added through people as opposed to the low road, where we treat people as costs. We will lose that.

Chairman MANZULLO. Thank you.

Congressman Ballance, did you have any questions?

Mr. BALLANCE. Mr. Chairman, I have no questions.

Chairman MANZULLO. Mr. Bradley?

Mr. BRADLEY. Yes, thank you. It is interesting after hearing Dr. Bartlett's question that I had written down the same three issues: The differential of wage and benefits, tax policy and regulatory policy as really what I had thought the driving points were going to be in this morning's testimony.

It is interesting there was an article in the Wall Street Journal maybe a month or six weeks ago about a study that had been done not just on the United States and manufacturing jobs, but on the productivity increase worldwide and I was taken by the fact that even China has lost manufacturing jobs to productivity increases.

With the exception of Ms. Bassi's comment about disclosure, for the most part what it seems that we have heard today is that we need to limit executive compensation and the government should do that, not shareholders and that we need a new round of Sarbanes Oxley, which business leaders in my state are telling me has led to a restriction in the ability to take risks and move forward and try to grow the economy.

I would like to return to what we can in fact set, which is tax policy and regulatory policy, because I think that if we are going to try to save manufacturing jobs or outsourcing of high knowledge jobs, that is where this Congress has to focus and I would hope that we can focus our efforts there.

I would put that open to any of you.

Mr. KENNEDY. Just if I may comment on that and again, I am not a lawyer so I am not into the details of how you write these codes, but it seems to me that currently the tax codes subsidize companies that want to move jobs.

They are not paying their share of the social costs associated with closing a factory and shifting jobs overseas and that a lot can be done.

I worked for ten years in Europe and in Europe, you know the argument is the labor market is much more rigid. Well, it is much harder to lay someone off. You incur much higher contributions to the equivalent of the unemployment insurance fund or something like that if you lay off a worker.

There is no reason why we cannot do things like that to slow down the progress until people think more carefully about where they are shifting those jobs and whether or not there are gains to be had.

Mr. BRADLEY. But would you trade, if I can follow-up on that question, Mr. Chairman, would you trade Europe's lower growth, higher unemployment, higher social costs for numbers that I think are far better in this country, despite the fact that we have lost some ground over the last couple of years, given the rigidity in their labor markets and their higher labor costs?

Mr. KENNEDY. The answer is no, but I think at the margin there is a lot of room for maneuver that minor corrections on our side might help with the problem and that would involve moving slightly in the European direction, but you know for the lower growth in Europe things are not so dire in Europe.

It does become a question of social, you know the lifestyle of the American people and that is in balance.

Ms. BAGLEY. May I comment as well? I tend to disagree with the proposals by my panelist, because I think we forget the fact that one reason why inflation has not been an issue for this country is frankly we all are enjoying the value of low cost imports from China and other countries.

So it is a system. To the extent that we fail to look at the whole system, we can end up with either protectionist policies or others that frankly in the long run are really not going to be to anyone's benefit.

We saw this after the stock market crash when suddenly individual countries said, well we are going to up our excise tax and import taxes and the like. You know we do not want your goods coming in. It basically became a race to the bottom.

I tend to agree with my fellow panelists here that we are not going to win this doing it based on our dollar per hour in terms of our workers. I do think the government can help. I think that if the government were to provide a tax credit, for example, in connection with employee education training that that could be very significant.

I would caution, however, the Congress to be careful that that money is not spent primarily on higher level managerial professional staff. Historically it has often been the case that to the extent anyone gets training, it is not the low level person that is now losing the job, because a factory has closed.

I think it is important to rifle shoot what we are doing here in terms of what we are going to be rewarding. It is not that we are going to reward people for going to executive programs.

There are some specific things like that, but I think that if we are trying to artificially and unduly penalize what may be a rational decision, I do not know that that makes sense.

I certainly do believe, however, that tinkering with the capital gains holding period is always helpful. Even Michael Jensen, who was one of the most vehement scholars at Harvard pushing for we have to maximize shareholder value, has now, in the wake of

Enron and like, backed off and said, all right, we have to maximize long-term shareholder value.

So to the extent that we are finding that pension managers and the like are being chosen based on their quarterly numbers, we can say to institutional investors the reality is that the tax is going to be such that you are going to be penalized if you are trading on a short-term basis. Maybe that means imposing tax if you trade too early, even on entities such as pension funds that otherwise would not be paying tax.

The reality is we have 50 percent or more of the publicly traded stock in the hands of institutional investors and we need to ask: What considerations are they making when they decide to get rid of this fund manager and substitute another, and how can we give them an economic incentive to be the patient capital that we really need them to be? Thank you.

Chairman MANZULLO. Congresswoman Majette?

Ms. MAJETTE. Thank you, Mr. Chairman, but I do not have any questions.

Chairman MANZULLO. Congressman Akin?

Mr. AKIN. Thank you, Mr. Chairman. Just I guess one comment and then one over-arching question kind of along the lines of what a couple of other members have said.

The first thing is, I am not as upset about a disparity in wage rates, per se and that is for a couple reasons. First of all, in manufacturing, the cost of labor relative to the overall cost of product is a part of it, but it is not everything.

The second thing is to give you an example that I think you were referring to, but I do not know if you thought of it quite in this context and that is: I serve in the Armed Services Committee. There is a big difference between the American military and how they function and different foreign militaries.

Many of the foreign militaries are so hierarchical that if anything is disruptive to that chain of command, they just literally stop running, whereas the American military for years and through many years have had the reputation that you knock off an officer and the Sergeant kicks in and it keeps going. You knock off the Sergeant and the Private raises himself to take command and to take over.

I think that is something that is somewhat built into the psyche of our American way of doing things and our sense of freedom and our sense of leadership. I think that is something that is not easy to replicate and it is a big asset that we have.

So that does not concern me as much, but on the other hand my sense is this: You have got to get to the real simple basics of things. The reason people move jobs is because it is a better deal to move them somewhere else, because there is an incentive to do it.

If you do not want our jobs to be moved out of our country, it says we have to be more competitive and the things that we in government control and affect are a lot of the regulatory burdens, both in terms of reporting and in terms of OSHA and in terms of EPA, in terms of taxes.

All of these different things are essentially hurdles that make it more expensive for our business people to function in America. If we in government could drop that overhead, it makes us more competitive and it seems to me that is the main place where we should be functioning as a Committee and as Congressman. Respond, please.

Ms. BASSI. I certainly agree that people are not acting irrationally. Decision makers are not acting irrationally when they choose to move jobs overseas or lay off folks.

But, it is also the case that the pressures from Wall Street are focusing these decisions disproportionately on the short run so that it is not clear at all, to me as an economist, that these short-run decisions are consistent with long-run value creation.

So I think a part of the inquiry needs to be precisely the questions that we were asked in the beginning is: What is behind the short-run focus, which is myopic and destructive to shareholder wealth creation in the long run and destructive to small businesses and employees and what might be done to unplug that?

Some of it is the value process, which is very difficult to change, but there are tax implications and actions that Congress could take to help relieve this pressure that Wall Street is creating to focus myopically on the short run at the expense of the long run.

Mr. AKIN. It makes me nervous when you say that Washington is going to take action. I mean there are some companies in my district, some big employers in my district and I have talked to some of their top managers and I know how they are motivated and it is usually by the quarter or at the most by the year.

It seems to me they should be looking five and ten years out and that short-term focus results in poor quality management, but my belief is that the system finds people like that out eventually and I am not sure the government, it is like trying to do eye surgery with something as blunt as a Crayon, the government is a pretty blunt instrument to try to get people to think in a longer term sense, it seems to me.

Mr. KENNEDY. If I may add to that, except in the context of short-term pressures from investors, in which case the government in fact does dictate the rules for capital gains to reinforce what one of my co-testifiers said.

If, in fact, you were penalized for cashing in short-term gains and really forced to think hard about holding for a longer period of time and I don't know what the right period of time is, it might well change some of that short-term orientation on the part of management.

Mr. AKIN. Okay. I understand. Good point well taken.

Ms. BASSI. And the point that I made earlier, that if investments in people were treated or at least reported as investments in people, rather than buried hidden costs that analysts then ding firms for, for having these hidden costs, that ultimately show up as benefits, that is a reporting issue that needs to be fixed. It would help change the focus of Wall Street.

Mr. AKIN. Thank you very much. Thank you, Mr. Chairman.

Chairman MANZULLO. I think Professor Bagley, did you have a response too?

Ms. BAGLEY. I just wanted to mention two things. In addition to the capital gains holding period requirement, I think that to the extent that we are going to continue to have executives given equity as an incentive, looking at that holding period requirement for stock acquired pursuant to stock options in terms of when that can be taken as a capital gain versus ordinary income will become another one.

I think, frankly, as a former securities lawyer, that is something we ought to think long and hard about modifying anyway so we cannot have the Ken Lay's of the world selling stock today and then having the house crashing down in three or four months. I think that is one specific one.

In addition——

Mr. AKIN. Can I make sure I——

Ms. BAGLEY [CONTINUING] Yes, sir.

Mr. AKIN.—understand what you are saying?

If you are going to give an executive, pay him partly in terms of stock of the company, which theoretically is designed to give him an interest in the company to do well, you are saying make sure that he has to hold that for some significant period of time so as a longer term perspective?

Ms. BAGLEY. That is correct.

Mr. AKIN. Sounds like a good recommendation. Proceed.

Ms. BAGLEY. The second point I would make, following up on what my co-panelist has said, is that we have precedent for the impact of disclosure on how companies are evaluated in the banking area.

The controller of the currency for awhile now has required banks to disclose something called reputation risk. That follows from the fact that it has become clear that how a bank is perceived in the community, you know are they in fact red lining, are they being fair and that sort of thing, ultimately the chickens come home to roost, and that does have an effect.

When you are able to give that information to the public, to the analysts, it becomes something that they can crank into recommendations, which will of course therefore impact the projections and the evaluation of the numbers. I think more information is helpful in that regard.

Ms. BASSI. And may I add to that, if you go to the analyst community and ask if they want that, they will say absolutely not. It is actually not in their short-run interest to have more useful information disclosed, because they make their living by knowing things that nobody else does.

So the analyst community will never tell you that they want this. In fact, they will tell you they do not want it, but more disclosure that allows people to make informed, rational, long-run choices is clearly a part of the solution, but you will not hear that from Wall Street.

Mr. AKIN. Thank you. Thank you very much. Thank you, Mr. Chairman.

Chairman MANZULLO. Congressman Napolitano?

Ms. NAPOLITANO. Thank you, Mr. Chairman. I apologize for being late. I have had some questions that have been answered with some of the gentlemen, my colleagues, that have asked it.

The comment I would make is that we seem to forget that we continually lose jobs to foreign competition and while we feel that they can do a better job, I do not believe. They are learning how, but it is such a big world, especially in China that they are going to learn like we did, that the minute you start training good employees, somebody else is going to take them away from you and it is such a big country that they are going to have a long time before they begin to understand how it feels, like we have in this country.

As far as my colleagues' comment in regard to cutting some of the expenses, the overhead if you will, well and good, except in this country that is what has made the United States the world's largest economy and California specifically is because we do have the train laborer that is paid well and spends the money. It is all relevant.

You build up economy, you spend it locally and it builds it up. Thank you.

Chairman MANZULLO. Good. Question: First of all, this testimony is refreshing to see people speaking about the way things should be, sometimes given some very innovative, if not radical, answers as to what should be done, but what I appreciate about what you are doing is you are raising the issues, such as what Andy Grove did.

You are asking the questions and making the comments about what is wrong and Dr. Bassi, you said ultimately you have to change the corporate culture. You have to change the way people think about the definition of profit, the value of stock.

Ultimately, perhaps there may be some legal issues in there. For example, I never looked upon the holding period in long-term capital gains as being part of long-term planning, as opposed to three-month of planning now that we have on the next quarter.

Ultimately, there has to be a change in the way business does business. I mean none of us wants to get involved and Mr. Akin expressed that quite well, with passing more laws and more regulations that could end up doing the adverse effect.

But where do you start in changing the corporate culture? In the district I represent, the biggest city is at about 11 percent unemployment. 11 percent. That does not count the four factories that have announced they are going to close, because those lay offs have yet to begin.

In December, we lost 28,000 manufacturing jobs and the guys back home have a name for where the machinery is going. It is called black holing and they look on it and they figured out what the codes are. This machine is going to Mexico. That one is going to China. This one perhaps is going to Eastern Europe.

The march continues and the shoe has yet to fall on the devastation and ultimate destruction of manufacturing in this country. This is the 54th hearing that we have held involving manufacturing and the way companies do business.

No other Committee has got involved in manufacturing the way this Committee has and manufacturing jobs are gone. They are not coming back. What do you do? How do you start?

Go ahead, Dr. Bagley.

Ms. BAGLEY. One precedent that comes to mind is a government-private enterprise organization that was set up in Silicon Valley when the Valley was going through a slump in the 1990's, there was something set up called Joint Venture Silicon Valley.

I am not sure whether any of you are familiar with it, but it was a voluntary association of representatives from primarily the state government, from the cities, together with heads of a number of the major companies.

One of the things they looked at was the question of regulatory burden on small business, on high tech companies. They were able, for example, to do something as straightforward as adopting more of a uniform building code and substantially reduced the expense of expanding some of the factory spaces and the like.

So things that might not be first on your agenda, in fact can make a very real difference when you are able to look at it from that point of view.

But really what they did is they also looked at things like infrastructure. You know what sort of transportation system makes sense, in terms of getting workers to San Jose, to Silicon Valley. There is always a common goods problem whenever companies are considering whether or not to spend money on education, roads and the like, because it is like I pay for the road, but then my competitor's workers drive on it.

When we are able to get some of these cooperative organizations, I think it can help with some of those issues. I would suggest perhaps looking at that organization and some of the work that they did. I know from having done some research on it three or four years ago, I am not sure where they are now, maybe with tech back up they have put themselves out of business, but it was a collaborative effort where you had the best of the business and the best of the government saying, how can we do this hand-in-hand?

Because I do not think it is going to be fixed by the government mandating all sorts of things and I do not think it is something that any one company is going to fix either, because you really do have this common goods problem and there are going to be free riders out there.

So disclosure helps in terms of kind of outing the free riders, the cheaters, but I think that trying to get some of the best minds around to ask what is it that keeps us from creating the amount of value per worker that we would like to be creating?

If it is changing a building code, let us change the building code. It does not mean we give up structural safety or anything else, but sometimes there are bureaucratic bumps like that in the road that no one has really focused on that once focused on can make a difference.

Ms. BASSI. I think that is a brilliant framework to think about the question that you asked. Where are the common goods? Where are there issues that can and this is particularly acute for small business, where are there issues that they are struggling with that they cannot solve individually, but could solve collectively? And how can collective help be made to exist?

I mean just calling these folks together is a struggle. An appropriate role for government is to facilitate that convening. I look at this from the perspective of investing in people.

Many small businesses have a tremendously difficult time investing in their people, because their people are constrained by time and space. You know they have to be at a certain spot. They cannot go off to class.

Electronic learning could help tremendously, because then you can access learning any time, any place. It is much more flexible, but small business cannot invest in electronic learning, because it is high fixed cost, low marginal cost, but high fixed cost. Collectively though, they can solve those problems.

I think looking for where collective action would really make a big difference in helping organizations get over these high fixed costs in exchange for low marginal costs, that is a conceptual structure from which to view the problem that I think you will find some creative answers.

Chairman MANZULLO. Okay. I want to thank our first panel. You have obviously raised more questions than we have answers for, but that is good.

This has been one of the finest hearings that we have had. You have really done a service to this Congress, especially to the members of the panel.

I am also a member of the Financial Services Committee and so is Mrs. Velazquez and Nydia, are you in the Capital Market Subcommittee also?

Ms. VELAZQUEZ. Yes.

Chairman MANZULLO. So we are both on the Capital Market Subcommittee, very much interested in working with you on these additional disclosures and we will be contacting you in the very near future, with regard to the specifics on those.

It is good. Again, we thank you for coming. We are going to take a five-minute recess while we excuse the first panel and set up for the second panel.

[Whereupon, a short recess was taken.]

Chairman MANZULLO. The first witness or the witness on our second panel is Anthony Wilkinson, President and CEO of National Association of Government Guaranteed Lenders and we will set the clock at eight minutes. We look forward to your testimony.

Mr. WILKINSON. Thank you.

Chairman MANZULLO. I would advise there may be some votes coming. The four votes, that will probably wipe out about 40 minutes and you could probably grab lunch during the interim if that happens.

We look forward to your testimony.

STATEMENT OF ANTHONY R. WILKINSON, PRESIDENT AND CEO, NATIONAL ASSOCIATION OF GOVERNMENT GUARANTEED LENDERS

Mr. WILKINSON. Thank you, Mr. Chairman. I appreciate the opportunity to testify today. I know that my topic is not totally germane to today's hearing, but for many small businesses across the country, my topic is a critical issue.

As you know, the Small Business Act requires the SBA to give 15 days notice to the Small Business Committees when making a significant policy change. On December 23 at about five o'clock in the afternoon when most of Capitol Hill was gone, the SBA delivered to the Small Business Committees their notice to put a loan size cap in place and limiting the program to many small businesses across the country.

Then before the 15 days is even up, on January 6, the SBA announced that it was shutting down the 7(a) program, injuring thousands of small businesses and lenders that had submitted applications for loans.

One week later the Agency announced that it was restarting the program, but with a cap of $750,000 in place and a prohibition against the use of 7(a) loans in larger loan packages frequently called piggybacking or much like the 504 loan structure.

Together, these limitations will prohibit small businesses and lenders from accessing the capital they need to grow and expand their operations and on top of these restrictions, it is likely that this program will shut down again before the end of January.

These actions have harmed thousands of entrepreneurs at a time when the nation's economy is struggling to create new jobs and move forward.

Most disturbing about this occurrence is throughout 2003 the Administration repeatedly ignored signs that loan demand was exceeding SBA available funds and chose not to act. Instead, delaying action until Congress was adjourned for the year.

Rather than foreseeing and acting to prevent this crisis, one of the federal government's most important economic development programs has been destabilized.

The SBA's recent action to reopen the program falls well short of what small businesses need and in fact, this program is closed to about 40 percent of those small businesses who would have used the program prior to SBA's recent actions.

Two quick statistics I would like to offer up and then I would be happy to entertain some questions. First of all, this program is going to be funded this year at about $3 billion below demand. So if the omnibus bill had passed yesterday or if it passes today, there is going to be about $3 billion in demand that will go unmet.

At one job for every $33,000 loan, that means we are going to miss out on the opportunity to create or retain 90,000 jobs simply because this program is under funded.

Second, from bank call reports, we know that there are about $485 billion worth of loans to small businesses in this country. Only 20 percent of those loans have maturities in excess of three years. That puts it somewhere between 95 and $100 billion in lending to small businesses is done on a long-term basis.

The balance of the 7(a) and 504 loan programs is about $76 billion. SBA is where small business gets its long-term capital and we need these programs up and running and fully funded.

So Mr. Chairman and Ms. Velazquez, I hope that we can work together to find a solution. Let us get this program fully funded and operational so we can serve the small business constituents who need access to capital. Thank you.

[Mr. Wilkinson's statement may be found in the appendix]

Chairman MANZULLO. Thank you very much, Mr. Wilkinson. When we had the hearing on the budget last year and our comments on the budget estimates, we expressed concern, both Republicans and Democrats, that the SBA loan programs were being woefully under funded.

We are not prophets, but the chickens have come home to roost on this. If the omnibus passes, what is the scenario there?

Mr. WILKINSON. The conference report in the omnibus bill has a program level of 9.55 billion that is going to be $3 billion short of demand. If it passes, nothing is really going to change. There will still be a cap. There will still be program restrictions and there were still be a lot of businesses who do not get access to capital.

Chairman MANZULLO. I guess the practical question is: At what point do you judge demand, and then how do you factor that into the budget that the White House puts out? I mean are you working a year behind or working a year ahead? Do you understand my question?

Mr. WILKINSON. Sure. It is a little tricky to in a February budget predict what loan demand is going to ultimately be at the end of the next fiscal year, but the Administration had several opportunities to amend their budget request.

You know the omnibus bill to this day is not finished and there have been opportunities all the way until Congress adjourned for the holidays to take some action and they chose not to.

Chairman MANZULLO. Thank you.

Ms. Velazquez?

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. Wilkinson, when the SBA shut down the program in early January, it canceled all pending loan applications. This left many small businesses without any options for financing and unable to meet their immediate commitments.

When the program restarted last week, how did the SBA handle these applications that were canceled or returned during the shutdown?

Mr. WILKINSON. First of all, can you imagine the anxious moments that many of these small businesses went through who thought they had submitted their application in a timely fashion and that they were going to be able to meet the obligations that they had, be it a contractual closing date, to all of a sudden out of the blue have a program close and not know when it was going to reopen? Some very, very anxious moments and I am sure we have seen some of the press stories from around the country how this impacted a lot of small businesses.

Many of the applications that were submitted and then returned were applications in excess of 750,000 that the SBA now claims they cannot process because it is above their loan cap.

Even though applicants had spent time and money to put the applications together, they were in by the deadline and now they were rejected, which in my opinion is just a way to circumvent the Small Business Act's 15-day notice.

Ms. VELAZQUEZ. You know here we are, Mr. Chairman, conducting a hearing about protecting our American jobs, but yet we shut down a program. We are impacting small businesses who make commitments and now they either might have to shut down their businesses and those jobs will be lost or they will not be able to grow their businesses. So at a time when in December we just created 1,000 new jobs, it is really outrageous.

Mr. Wilkinson, in your opinion, how should have the SBA handled this situation so the small businesses would not have suffered so unfairly?

Mr. WILKINSON. First of all, I want to start all the way back to the budget process and up through the time Congress adjourned. The SBA knew what its loan volume was all the way back in May, June, July. We were beginning to run at about a billion dollars a month in 7(a) loan volumes. So we have known quite some time what the 7(a) loan volume was.

Given that, the SBA could have taken action as early as October 1, start of the fiscal year, to put on a loan cap, but that would have been admitting that they had made a mistake on their budget and for whatever reason, they chose not to do that, because the cap could have been much higher than 750 and we could have not impacted the applicants like we did, rejecting applicants' packages that had been submitted in a timely fashion.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. I just want to hold my other question and I would just want to allow my other members to be to ask their questions now.

Chairman MANZULLO. Thank you.

Mr. Bartlett?

Mr. BARTLETT. Thank you very much.

Mr. Wilkinson, as you know, at the end of the day there is no such thing as a federal dollar. Every dollar that the federal government spends, it took from the paycheck of some hardworking American or it took from the profits of some company that is trying to compete in a global marketplace.

Actually, sir, in the final analysis, as you know you cannot tax a business. In a former life, I was a businessman. You could not tax me. That simply became a part of my cost of doing business and I passed it on to the consumer.

So in the real world, sir, every dollar that the federal government has they have taken directly or indirectly from the pocket of some hardworking American.

Now why should the government forcibly take money from Americans to loan back to Americans? The money that has not come into this program, is it not in the private sector, sir and is it not available there to lenders to lend to these small businesses? I do not see how taking money forcibly from our people at the government magnifies the value of that dollar.

Are we lending money to people that private sector lenders would not lend to?

Mr. WILKINSON. That is absolutely correct. These are the kinds of loans that the private sector does not make without the government guarantee.

To steal a phrase that Mr. Kennedy used in the panel before, what this program does is level the playing field for small businesses who do not have reasonable access to long-term capital. They are not a General Motors who can go to the bond market.

Mr. BARTLETT. Sir, there are lots of venture capitalists out there looking desperately for small business. There is a lot of money out there looking for a home. An awful lot of money looking for a home, which is one of the things driving the stock market.

I am just having some problems understanding why the government should assume that we are better able to make judgments as to what an appropriate loan is more than the business world, more than the private sector, since ultimately all of the money comes from the private sector.

No such thing as a federal dollar. Nothing magic happens to it when we take it in. Well something does happen to it. We consume a whole bunch of it with a big bureaucracy, but other than that, nothing magic happens to the dollars.

Chairman MANZULLO. Would the gentleman yield for a question?

Mr. BARTLETT. Yes, sir.

Chairman MANZULLO. Roscoe, you are on the Science Committee?

Mr. BARTLETT. I am on the Science Committee.

Chairman MANZULLO. Do you believe the government should spend money on science or science research?

Mr. BARTLETT. This is different. The government should only do what the private sector cannot do and there is some big science things that——

Ms. MILLENDER-MCDONALD. Will the gentleman yield?

Mr. BARTLETT [CONTINUING]—The private sector will not invest in and then the government then has to invest in that.

Ms. MILLENDER-MCDONALD. Will the gentleman yield?

Mr. BARTLETT. I am not sure that that is true of funding businesses.

Mr. WILKINSON. But what we have seen is that the private sector is not willing to make the long-term kind of loans that the SBA guarantees allow a lender to do.

In addition, applicants pay fees to obtain these loans and over the last decade, applicants have been paying in far more fees than they needed to.

Mr. BARTLETT. I know and we need to reduce those. The failure rate has been much smaller, which should incent the private sector to make these loans. The failure rate has been very much smaller than we anticipated so the fees are greater and a large amount of money has accumulated. These are not bad investments, sir. They have been good investments.

Mr. WILKINSON. They have worked out fine, but these——

Mr. BARTLETT. They have.

Mr. WILKINSON [CONTINUING] Tend to be new business start-ups and younger stage companies who need the credit enhancement until they can get to a point where they can borrow.

Mr. BARTLETT. As the private sector looks at this record, should they not be incented to loan this money? These have been very low risk loans. They have been so low risk loans that the small fee that we charge has now resulted in a big accumulation of money.

We need to reduce the fee, because we should not be taking money from small business unnecessarily, which is what these fees have been doing, right? Wouldn't you recommend reducing the fees, because we now have a surplus?

Mr. WILKINSON. With the help of this Committee, we reduced fees about a year ago I believe it was.

Ms. VELAZQUEZ. That is correct.

Mr. BARTLETT. Yes, sir. Yes. So these are good loans.

Mr. WILKINSON. They have worked out fine so far.

Mr. BARTLETT. They have worked out just fine. Don't you think the private sector can see that?

Mr. WILKINSON. Thus far the answer has been no, they have not found a mechanism to do it.

Mr. BARTLETT. Somehow, Mr. Chairman, we need some kind of an incentive so the private sector can see that, because I do not think that we add any value to it and these have been very good loans. They have performed very well. The failure rate has been very low and so these fees then accumulated to a very large amount.

Ms. VELAZQUEZ. Will the gentleman yield for a second?

Mr. BARTLETT. Yes, ma'am.

Ms. VELAZQUEZ. For your information and this is numbers coming from Price Water data regarding how much money venture capital lent to small businesses, only two percent.

Mr. BARTLETT. Maybe that is because we took the money from them and they did not have it to loan.

Ms. VELAZQUEZ. Well, well.

Mr. BARTLETT. Thank you very much, Mr. Chairman.

Chairman MANZULLO. Congressman Ballance. Yes? We have interesting hearings, don't we?

Mr. BALLANCE. My goodness. Maybe we are finding out why this program was closed down. We are hearing some arguments against the whole program.

Mr. Wilkinson, what are you hearing from the small business people about this whole crisis that we are talking about here today?

Mr. WILKINSON. I will tell you what, we have heard from a lot of businesses across the country who are really upset. They got caught in a crisis when they did not know where they were going to turn to.

Our lenders are calling daily with another story of how an applicant is unable to obtain the financing they need to adequately run their business. It is a tough time for many entrepreneurs.

Mr. BALLANCE. Just as a follow-up to what was said earlier, I take it if small businesses could go to the local bank and get their loan, that is where they would go?

Mr. WILKINSON. Absolutely. There are fees attached to these loans and if they can get a loan without paying the fees, they would absolutely do it.

Mr. BALLANCE. All right. Thank you, Mr. Chairman. I am going to yield at that point.

Chairman MANZULLO. Congresswoman Majette?

Ms. MAJETTE. Thank you, Mr. Chairman and thank you, Mr. Wilkinson for being here this morning.

My question has to do with this cap, the $750,000 cap that has been imposed. It is my understanding that the imposition of that cap will prohibit nearly one-third of small businesses that would have used the 7(a) program from using it and that would prevent small businesses that have greater capital needs from securing the funding that they need.

In particular, can you address the issue of how that cap will affect manufacturers?

Mr. WILKINSON. Well in particular for manufacturers, they have a requirement many times for high tech equipment, plant and facility and they tend to be larger loan requests that would be precluded now under the $750,000 loan cap. So they could be hit very hard.

Ms. MAJETTE. Do you have any idea about how many manufacturers would be affected by this?

Mr. WILKINSON. I am not aware of what percentage manufacturers make up of the large loans that are made in the 7(a) program, but I would guess that it is a significant percentage.

Ms. MAJETTE. What kind of notice was there given with respect to the imposition of the cap? The shutting down of the program and the imposition of the cap?

Mr. WILKINSON. A notice was provided this Committee late on December 23. That notice did not provide an amount and I understand there was a subsequent e-mail that listed the amount.

We were given the 15-day notice so that applicants who had already started the process would be allowed to finish what they had started, because many people put down down payments for contractual reasons, employ their attorneys, their accountants, et cetera to get the loan applications put together.

Many applicants had spent thousands of dollars to get their application ready to submit. Then early in January the program was just closed, with no notice at all. Just closed.

Those applications that were in were told too bad and especially those that were $750,000 or more, their application was returned and they were told they are not eligible, when in fact they had been in, in a timely fashion. Again, which is just a circumvention of the Small Business Act. They should have had their 15 days notice.

The SBA should have processed those loan applications when funds became available. The fact that SBA waited way too long to take action, that cost should not be borne by the small business applicant who just was told too bad.

Ms. MAJETTE. I certainly agree with you and I know I have many constituents in my district who would agree with you as well, in particular one that I have been made aware of who had applied for a $150,000 loan, had signed a franchise agreement, had paid the franchising fee of $30,000, had signed a five-year lease, was relying on a letter of intent that had been given to him by a local bank and that was a business that would hire 12 to 15 people and I suspect that it was not a Merry Christmas for him to find out at that point that the program was being shut down.

We are still in the process of seeing how that is going to be resolved with respect to that particular situation, but I am sure that that has been——

Mr. WILKINSON. There are examples just like that——

Ms. MAJETTE [CONTINUING] Happening all over.

Mr. WILKINSON.—all over the country.

Ms. MAJETTE. All over the country and frankly, I think if we are not going to have the program, then we need to say we are not going to have the program and give people sufficient time, due notice to let them know we are not going to have the program.

But if we are going to have the program, then we need to make sure that we are treating people fairly with respect and understanding and appreciating the efforts that they are making to continue to grow their businesses and to make sure that we are strengthening this economy in the way that this administration claims it wants to. I will yield back.

Chairman MANZULLO. Congresswoman Millender-McDonald.

Ms. MILLENDER-MCDONALD. Thank you. Good morning, Mr. Chairman and the Ranking Member. Thank you so much for providing the leadership always on very provocative and interesting and timely hearings to the question of small businesses.

I want the record to show that Congressman Bartlett left before I could rebuttal him, but we use the people's money for everything else on earth here and we are the people. So, we should be using, in order to keep the government running, we should be using the capital that is provided by the people. We are the people.

But I say to you, Mr. Wilkinson, thank you so much for your very timely and very openly discussion on this issue, because I got the letter in December as well. It was not a good Christmas for small businesses.

As I continue to say and as the President said in his State of the Union last night, small businesses that need to drive and will drive this economy and it is inconceivable to me that the Small Business Administration, which tends to like the leadership that these two fine leaders on this Committee tend to do, cannot see that.

Is this a reasonable excuse for the shutdown of the 7(a) program for heaven's sake?

Mr. WILKINSON. I cannot fathom a reasonable excuse for shutting down this program. This is where small business gets its long-term capital and the way this whole process has been mismanaged is just unconscionable, especially considering the damage it did to many, many small businesses who got caught in the mess.

Ms. MILLENDER-MCDONALD. I could not agree with you more. I had a hearing in my district toward the end of the last year and the small businesses were just yearning for more capital to expand their businesses, to go international markets and yet we cannot do that.

Did you say to me, did you say to the Committee rather and to me too, that the 504 program and the 7(a) programs will yield $7 billion if in fact we kept those intact or what was your comments of the combination of the 504 and the 7(a) programs?

Mr. WILKINSON. The correlation I was trying to draw was that from bank call reports we know that there's 485 billion in small business loans. Only about 20 percent of those have maturities in excess of three years. So, longer term loans.

Of that 485, about 95 to $100 billion is long-term. Compare that to the fact that banks making 7(a) loans, first mortgage portion of 504's and the debenture portion of 504's, those three portfolios added together total about 75 billion. So 75 of the 100. It is not a true apples-to-apples, but it is a close correlation.

A big part of the long-term capital provided to small business is coming from the SBA 7(a) and 504 programs.

Ms. MILLENDER-MCDONALD. You know, Mr. Chairman and Ranking Member, there is a bill that is pending where the credit unions will provide loans to small businesses. Perhaps we need to engage in supporting that in light of the fact that these banking institutions and this SBA, which provides no leadership to the small businesses———.

Chairman MANZULLO. If the gentlelady would yield.

Ms. MILLENDER-MCDONALD. Yes.

Chairman MANZULLO. That was already done to allow the credit unions to give 7(a)'s.

Ms. MILLENDER-MCDONALD. I am sorry?

Chairman MANZULLO. The Administration by was it executive order? Just by regulation has allowed the credit unions to give 7(a)'s.

Ms. MILLENDER-MCDONALD. That is great. We need to increase those, because we really need to. Also, Mr. Chairman and Ranking Member, I think we need to—also what? I am sorry?

Chairman MANZULLO. They are also out of money, too. So they are similarly affected.

Ms. MILLENDER-MCDONALD. I see. This is why the tax cut should not be permanent. Anyway, Mr. Chairman and Ranking Member, we should send a letter to the SBA administrator blasting them on this very untimely position that they took and we should send a letter to the President and ask him for a meeting with the Small Business Committee and talk with him about the urgency or hearing to provide the urgency with this whole notion of cutting off our nose to spite our face, for heaven's sake.

I think there is a bill that is pending that has not quite come to the forefront with the credit union. So there is still another bill pending. I would like for us to look at that.

I think it is urgent that we call the President into question and ask for a meeting with the President.

Chairman MANZULLO. Mr. Barreto will be here on February 11.

Ms. MILLENDER-MCDONALD. That is too late.

Chairman MANZULLO. For the budget hearings on it.

Ms. MILLENDER-MCDONALD. That is too late. We need to do that expediently, Mr. Chairman. Thank you.

Chairman MANZULLO. Congresswoman Bordallo.

Ms. BORDALLO. Thank you, Mr. Chairman. First, I would like to thank our witness, Mr. Wilkinson and of course both our Chairman and our Ranking Member for taking such a strong stand and always standing up for small businesses. I am always impressed.

I have a couple of questions, Mr. Wilkinson. The SBA and others are suggesting that small businesses use the 504 program as an alternative to the 7(a) program. Is the 504 program a viable alternative for those that are shut out of the 7(a) program would you say?

Mr. WILKINSON. Some of the 7(a) loans that will be shut out would be candidates for the 504 program, but according to NADCO, the trade association for the 504 program, they believe only about 25 percent and I believe that to be a good guesstimate, only about 25 percent of the loans shut out of this would be eligible for 504 financing.

Ms. BORDALLO. So that leaves——

Mr. WILKINSON. There will be a whole lot of borrowers that still———.

Ms. BORDALLO [CONTINUING]—75 percent. The other one is the export/import banks financing programs have also been suggested as an option to entrepreneurs.

Mr. WILKINSON. Those are typically short-term transactional kinds of financings and they really would not fit what we do in the 7(a) program.

Ms. BORDALLO. So your answer———.

Mr. WILKINSON. That is not———.

Ms. BORDALLO.—to both of these would be———.

Mr. WILKINSON. That is not a viable option.

Ms. BORDALLO. Neither one would be viable, right? All right. Thank you, Mr. Chairman. Those were my two questions.

Ms. MILLENDER-MCDONALD. Mr. Chairman, may I just impose a question here?

Chairman MANZULLO. Sure.

Ms. MILLENDER-MCDONALD. There is a letter dated January 12 of which the minority side of this Committee submitted a letter to the President inquiring about the inability to provide the 7(a) loans. Is there something that we can do as a whole? Should not the complete Committee do this in light of the fact that we know the economy is not going to move until small businesses move?

Chairman MANZULLO. I do not know what more we can do. I agree that the program was woefully under funded in the first place. We worked together to knock down the fees for the program for the 7(a) and corrected the subsidy rate, which has helped bring in more money and Anthony, I do not know of anybody in this country that knows this topic better than you do.

That is why when I found out you were coming, I put you on a separate panel to give you more prominence, more attention.

Mr. WILKINSON. I appreciate that.

Chairman MANZULLO. In order to center in on the 7(a) loans.

Mr. WILKINSON. Mr. Chairman, just a couple things off the top of my head. First of all, the SBA has the ability to do some minor reprogramming on its own. The appropriation bill from last year would allow ten percent of the 7(a) appropriation to be reprogrammed.

So they could put I believe it is——

Chairman MANZULLO. But it still requires approval by the Appropriations Committee, is that not correct?

Mr. WILKINSON [CONTINUING] I was under the impression that they had unilateral authority up to ten percent.

Chairman MANZULLO. Okay.

Mr. WILKINSON. That is just my understanding. I am not an appropriations expert, but I have been told that they could do up to ten percent and to the best of my knowledge, those actions have not yet been taken.

I do not know whether there is going to be a supplemental appropriations bill moving for us to fund an additional two and a half billion dollars or so. The amount of the appropriation is 25 to $30 million, which is not a lot of money.

Ms. VELAZQUEZ. Mr. Chairman, can I just ask a question?

Chairman MANZULLO. Certainly.

Ms. VELAZQUEZ. Mr. Wilkinson, don't you believe that maybe this Committee should push for a supplemental appropriation at this point?

Mr. WILKINSON. I would work on any solution we can so that we can get access to capital to small business, be it a supplemental appropriation, be it reprogramming from other areas inside the SBA where the money is going unused. Something has got to be done so that the flow of capital starts back up.

Chairman MANZULLO. What I would be willing to do is if you want to send me a letter, just set forth the seriatim, you know capsulize the problem. Put forth your suggestions and we will take and send it over to the White House and also to the SBA on it.

Chances are there may be another supplemental. If there is an amount of money that you think would be required, put that also in there, but give us a blueprint and we will send it over.

Mr. WILKINSON. I do not mean to beat a dead horse, but there were applicants who have been treated very unfairly by the SBA. They had their applications in on time and now they have been told, too bad, after they spent time and money putting the application together and I believe———.

Chairman MANZULLO. But that would have been covered by the CR or not the CR, by the supplemental.

Ms. VELAZQUEZ. No.

Chairman MANZULLO. Some of those up to 750.

Mr. WILKINSON. That were submitted within the——

Chairman MANZULLO. Right.

Mr. WILKINSON [CONTINUING] Those applications should have just been held and then funded when additional monies became available. Never before has the Agency returned loan applications and said, start over.

Before this particular instance, they have always continued to process loan applications up to the point where they put an SBA loan number basically fund the loan and this year they decided, we are just going to send them all back. That has never happened before.

Ms. VELAZQUEZ. Mr. Chairman——

Ms. MILLENDER-MCDONALD. Mr. Chairman———.

Ms. VELAZQUEZ [CONTINUING] In listening to Mr. Wilkinson, it just occurred to me, it does not occur to me, we affirm my quest for a hearing where we could in depth analyze how this crisis, how much damage we are inflicting on these small businesses. They spent time. They make plans and now they are being told, look, the money is not there and it is your problem.

But how could we, in this Committee, allow for this to happen and not bring in SBA administrator, OMB, the industry that is going to be impacted? Lenders. This whole crisis is calling into question the integrity and the credibility of this program.

It is going to lead to force lenders to leave the program all together. So how could we be here conducting hearings saying how important small businesses are, they are the job creators and then we do not provide for a thorough investigation? How could SBA make an action, take an action like this without consulting with us, this Committee and then without allowing for the 15 days notice? It is just outrageous and we should be taking our responsibility more seriously.

I will ask again, Mr. Chairman, this Committee has the responsibility to conduct a hearing on this and to bring all the stakeholders.

Chairman MANZULLO. Congresswoman Majette, do you have a comment?

Ms. MAJETTE. Yes, I do, Mr. Chairman and I would associate myself with the remarks of the Ranking Member and I really do think that this reflects terribly on this country. I mean the notion of fundamental fairness and due process and how we are conducting business for the SBA to have taken the action that it has taken and having an untold effect on so many people who are trying to grow this economy and for that to occur at a time when Congress was out of session and then we were coming up on the expiration of the unemployment benefits, which we did not address before we recessed and we have people who are prepared to offer other individuals employment, but the program was shut down.

Mr. Chairman, I hope that we will take every opportunity to stand united on this issue and at least hold a hearing and make sure that we are acting in accordance with the notions of fundamental fairness, due process and common sense, which are the hallmarks of our government. I would yield back. Thank you.

Ms. MILLENDER-MCDONALD. Mr. Chairman?

Chairman MANZULLO. Ms. Millender-McDonald.

Ms. MILLENDER-MCDONALD. Thank you, Mr. Chairman. I am listening to this and more and more I see, in light of the fact that the small businesses have done their due diligence of submission of their application and gone through that necessary pre-loan process, that is the fair thing to do and that should be the impetus by which we go forward with hearings, with the letter that Mr. Wilkinson will submit to us, that we send to the President, but we should ask the President for a meeting so that he can see face-to-face the passion of you, the Ranking Member and all of the members in knowing that to improve upon the economy, the small businesses are the catalyst to do that.

So it would seem to me like this should be our blueprint to go forward.

Chairman MANZULLO. Congressman Ballance and then we will conclude.

Mr. BALLANCE. Well Mr. Chairman, I am sitting here. The SBA is not self-appointed. Have they explained to anybody this action?

Mr. WILKINSON. No, sir, not at all.

Mr. BALLANCE. Did they just run out of money or was it a bad investment? They did not get a notice from their bank?

Mr. WILKINSON. The Agency knew full well the pace of lending that this program has been on all the way back until probably as early as May that our loan volume has been running at about a billion dollars a month. So they have known for quite some time.

When the fiscal year started, I know for a fact that staff at the SBA had discussions with OMB about putting a loan cap in place on October 1 and OMB chose to wait until December 23 at five o'clock, when everybody had left the Hill, to announce a loan cap. Why they waited so long? You know again small business is paying the price for their mismanagement of the situation.

Ms. VELAZQUEZ. Mr. Wilkinson, could you please explain what a piggyback loan is and how will this prohibition on the use of piggybacking affect small businesses?

Mr. WILKINSON. Sure. It is a term where one loan piggybacks on the back of another identical to the 504 loan program, where a lender takes a senior lead position and then we come behind with an SBA loan in second position.

For instance, a borrower may be able to qualify for conventional financing for a piece of the financing package, where they would get a conventional first mortgage and then the SBA would come behind in a second position, the piece that they could not get done conventionally. Again, it is identical to the 504 loan structure.

Ms. VELAZQUEZ. When they imposed the cap the last time, were they able to piggyback?

Mr. WILKINSON. Yes, this is the first time, which to me raises another question. That strikes me as another significant policy change where no notice was provided.

Ms. VELAZQUEZ. I know last week was NADCO's board meeting. Has there been any talk of industry lay off as a result of this crisis?

Mr. WILKINSON. Yes, ma'am. I can tell you that there are folks putting plans in place now. If this is an extended cap with an extended prohibition on piggybacking, that some members in the industry will begin lay offs.

Ms. VELAZQUEZ. So the end result of this will be that an increased unemployment?

Mr. WILKINSON. Absolutely. I have had two of my members tell me that they had stratified their portfolios and if they excluded loans over $500,000 their SBA operations were actually losing money. So without the larger loans in the mix, they would not be players for very long.

Ms. VELAZQUEZ. Mr. Chairman, I just wish that you could answer my question. Can we hold a hearing on this matter?

Chairman MANZULLO. We have got a hearing going on right now. February 11 is two weeks from now.

Ms. VELAZQUEZ. I am sorry that you feel that the small businesses——

Chairman MANZULLO. Mr. Baretta will be here.

Ms. VELAZQUEZ [CONTINUING] Can wait until February 11.

Chairman MANZULLO. I share your passion. I have got the high unemployment and people back there knocking on the doors too wanting to get it done.

Anthony, let me ask you a question.

Mr. WILKINSON. Yes, sir.

Chairman MANZULLO. The problem here is that the 7(a) and 504 depend upon an annual appropriation.

Mr. WILKINSON. 7(a) does.

Chairman MANZULLO. I am sorry. The 7(a) depends upon an annual appropriation.

Mr. WILKINSON. That is correct.

Chairman MANZULLO. That is subject to the whim of Congress and to us getting in line and going up against the space program and I am sorry. Roscoe was sitting there. I was sort of rubbing him.

But in terms of a long-term solution, would it not be better to have a government sponsored enterprise for 7(a)'s with a revolving fund so we do not have to go through this angst each year?

Mr. WILKINSON. Mr. Chairman, you know how frustrating this is to go through this every year. We are open to suggestions.

Chairman MANZULLO. Okay.

Mr. WILKINSON. We would be happy to sit down and visit on how we do not go through this exercise year after year after year. You know part of the problem is not are we at the whims of Congress, we are at the whims of the Office of Management and Budget, because as you know, we collected fees for many, many years we did not need to collect.

Chairman MANZULLO. I would be willing to pursue that, because Congresswoman Velazquez and I both sit on the Capital Markets Insurance and GSC Subcommittee on Banking.

Ms. VELAZQUEZ. Maybe we can get a hearing on that, Mr. Chairman.

Chairman MANZULLO. I want to thank you for coming. I appreciate you coming at late notice.

Mr. WILKINSON. Thank you for allowing me to testify today. Again, I know this is not totally germane.

Chairman MANZULLO. Thank you very much. The hearing is adjourned.

[Whereupon, at 12:19 p.m., the Committee meeting was adjourned.]

Statement of Chairman Donald A. Manzullo

Can U.S. Companies Compete Globally Using American Workers?

While we have good news about an improved economy, we continue to have not so good news about Americans losing jobs to foreign competition. As a capitalist and ardent free trader, I can say with conviction that competition is good. It makes us a better nation, while improving the economies of those nations we are competing against.

There is a false argument, however, that anyone who dares question what is happening with offshoring or the decimation of domestic manufacturing is somehow a protectionist; as if there are no shades of gray between the two extremes of pure protectionism and no-holds-barred free trade.

It is my contention that one of the key issues hidden from this debate is the tremendous pressure Wall Street puts on Corporate

America. I think if we peel back the onion we will find that companies are unduly forced into doing anything, and I mean anything, to drive up stock values in order to make their quarterly estimates. The decision to manage a company by managing stock price has monstrous effects on everyday America. For example, companies are shutting down entire domestic supply chains for the lure of cheaper labor overseas. I'm not against international trade, but neither do I support a wholesale abandonment of small businesses by the big multi-nationals. By looking long-term, I believe companies can put America's jobs first and still win in the global marketplace. Legislation is not the answer; there must be a change in corporate culture.

I realize we're dealing with highly competitive nations like India and China – the problem is we are giving away the store without them giving up much on their end. India has one of the worst trading records with the U.S. And China simply refuses to comply with WTO obligations. Yet we still keep the barn door open. What's interesting is that the semiconductor industry is complaining that China is forcing them to give up technology secrets if they want to do business in China. What they are afraid of - and what they know to be true - is that the Chinese companies will steal their intellectual property and the Chinese government will do nothing about it.

We're not talking about manufacturing employment being in decline because of better machinery, which is the classical definition of productivity. In fact, according to sources in the tooling industry, only about one-quarter of the productivity increases can be attributed to new machinery.

If the argument is that companies can't be profitable using Americans, why are companies like IBM still sending jobs overseas when they have had strong profits? In Monday's issue of The Wall Street Journal, a copy of which is on the table, it's reported that IBM plans to shift thousands of high-paying programming jobs to China, India and Brazil. They even tell their managers not to "be transparent regarding the purpose/intent" of the offshoring decision and cautions that the "terms onshore and offshore should never be used." That's not the worst of it – the poke in the eye is that IBM will have some of the foreign programmers to come to the U.S. for on-the-job training by the very people whose jobs they will take over.

According to a recent news article, IBM's chief financial officer said, "Competitive price pressures in computer services are holding down profitability." But less than a week ago, IBM announced a 41% increase in fourth-quarter earnings per share from the same period in 2002. They had a 42% increase in income compared to the same period a year ago. This same article also noted the CEO's exuberance in stating, "This was a very good quarter for IBM and an encouraging end to a year in which we steadily gained momentum and posted record revenues. Our pretax earnings and earnings per share were up double digits for 2003, and we ended the year with more than $7.6 billion in cash."

This is what IBM's CFO meant when he said price pressures are holding down profitability? I can't say he's blowing smoke, but it's at least disingenuous.

What's remarkable is that the National Science Board and a high-tech CEO policy group recently warned that the economic vitality of America is threatened by a lack of U.S. graduates in science and engineering. My question is how can you get students excited about science and engineering when they see those same jobs being moved overseas for a fraction of the price?

The National Science Board further concluded that U.S. strength in education and innovation is threatened by two major trends. First, global competition for science and engineering talent is intensifying; second, the number of U.S.-born graduates in these fields is likely to drop. I must add a third - the number of foreign-born graduates from US institutions going back home is increasing.

So what does all this have to do with corporate earnings management? I think they are all connected to decisions made in the boardroom to find that extra penny per share at all costs. It is my hope that our distinguished panel of experts can shed some light on how companies can compete in the global marketplace using American workers.

STATEMENT
of the
Honorable Nydia M. Velázquez, Ranking Democratic Member
House Committee on Small Business
Hearing on "Can U.S. Companies Compete Globally Using American Workers"
January 21, 2004

Thank you, Mr. Chairman.

Today, the drive on Wall Street's for short-term profits has damaged our nation's consumers, workers, and local communities.

Unfortunately, such eagerness for rapidly rising profits has made headlines around the world, as company after company has adopted shifty accounting techniques to appear more profitable than they actually are. From Enron to WorldCom, the desire to satisfy shareholders has pushed these companies over the edge.

These types of scandals are not directly related to small businesses since they have occurred in large, publicly-traded companies, calling into question the relevance of this issue for the small business committee. Unfortunately, these types of governance issues are not solely limited to the private sector -- many times decisions that are made at the federal level serve to create the very complications that we try to stop.

An example of this is the continuing crisis in the Small Business Administration's (SBA) 7(a) loan program, which goes without swift and thorough Congressional scrutiny.

This issue surfaced late last month when the SBA announced it would impose another cap on the 7(a) lending program. But this looming crisis was actually foreshadowed much earlier in the year during a Committee hearing when both Democratic members and industry leaders indicated that SBA's budget would clearly fall short in meeting the small business demand for 7(a) loans.

During that testimony and throughout 2003, the Bush administration maintained the program had enough funds. Then, at the end of this year – and to no surprise of some members on the Committee – the Bush administration announced the program ran out of money.

The root of the current crisis is the administration's budget requests. The funding request for this important program has steadily declined from President Clinton's budget request of $11.5 billion in 2001 to the Bush administration's most recent request of $9.3 billion in 2004. This decrease is inconsistent with the demand for 7(a) loans, which has increased to more than $12 billion in 2004.

As a result of these inadequate budget requests, the stage was set for the program's collapse. The first sign of this collapse was the administration's December 23rd announcement of a $750,000 cap on 7(a) loan size. This announcement caused a completely foreseeable "run on the bank" as lenders rushed their applications to the SBA for processing and approval.

As obvious as this was, the administration was caught completely off guard. Instead of managing its operation to account for this heightened demand, the administration made the extreme decision on January 6th to shutdown the 7(a) loan program and return all pending applications to our nation's small businesses.

The administration's current solution is no solution at all. The SBA has continued its $750,000 cap on loans, banned the use of 7(a) loans in larger financing packages, and has not addressed the inequities suffered by those small businesses that had their applications outright cancelled. And, to top it all off, it is likely the program will shutdown again before the end of January. Does this sound like a solution to you? It doesn't to me or my Democratic colleagues on the Committee.

Small businesses in the U.S. drive job creation and contribute to positive economic growth. This is especially important now as recent reports confirm the economy is failing to add the number of jobs necessary to put America back to work. A real commitment from this administration to the small business sector is exactly what our nation needs right now. Without this, the economy will be unable to make a full recovery because small businesses will be left out in the cold.

Putting Values Back Into Shareholder Value

Testimony to the House Committee on Small Business

January 21, 2004

1. Acknowledgements, Bona Fides, and Prejudices

- My thanks to Chairman Manzullo and Ranking Member Velazquez, as well as other members of the Committee, for the opportunity to testify on an issue of great importance
- My name is Allan Kennedy; I am testifying as an individual concerned about these issues - i.e., I have no affiliations and am sponsored by no one. The background I bring to bear in the testimony is
  - 35 years of consulting to mainly large businesses
  - similar amount of time running small (consulting or software) businesses
  - author/co-author 3 books on business as an attempt to give back
- The point of view I bring to the testimony: I care passionately about the long term health of both big business and small business as the primary mechanism in our society that provides its peoples with a real opportunity to build a better life for themselves and generations to come

2. How Big Business has evolved (as described in my last two books - *New Corporate Cultures* and *End of Shareholder Value*)

- Big Business originally started as a series of family enterprises - historically (e.g., P&G, Dupont, Dow Chemical) just as they do today
- With growth of capital markets and the economy, especially after the Second World War, launching a business also came to be seen as a great way to get rich (e.g., Digital Equipment, Intel, Microsoft, Oracle)
- Professional managers employed to run companies after founders had moved along became interested in sharing the wealth created by building a business
- Advent of Buyout specialists and techniques in the early 1980s (e.g., KKR and their ilk) created pressure to make professional managers more accountable for results

- Increase in competition from non-US firms reinforced the need to improve business performance and spurred the development of many techniques to achieve better results - some valuable (e.g., reducing overheads), others of dubious lasting value (e.g., reengineering), most subject to mindless abuse and misuse
- By the 1990s mechanisms had been put in place, primarily stock related compensation schemes, that allowed managers to cash in at unprecedented levels
- By the time the bubble burst in 2000, an ethic of pure, unabashed greed had taken hold as the driving force of big business and many managers cashed in at outrageous, unjustifiable levels, often having caused havoc in the interests of achieving their payout (e.g., Enron)

3. Why running Big Business on the basis of greed is dysfunctional?

- Incentive schemes for managers of big business inherently have two characteristics
    1. They are financially oriented since financial results are the most easily measured "objective" aspects of performance (even if they are subject to manipulation as recent experience has shown)
    2. They are short term in focus, largely because the tenure of professional managers (and their desire to cash in) is quite short term
- As institutional investors have come to dominate the capital markets, money managers have likewise adopted the same kind of short term, financially oriented performance measures - for themselves as well as for the companies they invest in
- The confluence of these tendencies is extreme pressure to manage business for short term, even quarterly in the extreme, financial results, at the expense of any other outcomes, however desirable
- This has resulted in the adoption of a series of tools and techniques which contribute to meeting short term financial objectives almost regardless of their impact on the long term health of the businesses that use them or the welfare, in the broadest sense, of the communities these businesses serve and are dependent on; chief amongst these tools and techniques are downsizing, reengineering, and outsourcing

4. How the pursuit of short term financial objectives hurts Small Business (and the economy)?

- Small business remains the preserve of family oriented firms and is the source of virtually all of the growth in the US economy
- Family oriented firms are run for objectives other than the production of short term financial gains (typically they are focused on preserving employment and building long term wealth)
- Family oriented/small businesses are typically under capitalized
- The demands of Big Business for economies now (the usual and intended outcome of downsizing, reengineering, and/or outsourcing initiatives) place near impossible demands on small business, for example
  - Forced immediate cost reduction (e.g., demands to lower prices) undercuts traditions of preserving employment and building on human capital
  - Insistence on new procedures and systems, often the outcome of reengineering initiatives, impose investment demands which are impossible to meet
  - Demands to move production to lower cost foreign venues create requirements on small businesses beyond their capability to meet
- The end result of these pressures - driven by the demand for short term financial results designed to make a handful of people rich - is lost jobs for American workers and lost capabilities for the US economy going forward

Note: No one would argue, and certainly not me, that pursuit of lower costs in production is not a legitimate goal of a business enterprise and one which contributes greatly to the general well being; however, pursuit of such goals in a destructive manner, simply to achieve personal goals, serves no greater purpose whatsoever

5. What specifically is wrong and needs to be put right?

- Executive and professional compensation has gone crazy and needs to be put right
  - Executive pay levels (and professional pay levels which mirror that of executives) reflect only an artificial marketplace for talent that is

manipulated by insiders, usually abetted by compensation consultants, to enable a small cadre of the rich to get richer - i.e., it bears no relationship to the actual jobs being done to "earn" the pay

  - Progressive taxation schemes exist to enable the transfer of wealth from those with too much to those with too little in society to keep society in balance
  - These existing mechanisms should be used to bring executive and professional pay back to reasonable levels
    - High level Commission to define what is reasonable (e.g., $1-2.5 million p.a. for doing a job; no caps on gains from true entrepreneurial activity)
    - Marginal tax rates of 90-99% above this level

- Corporate governance is not up to the task and needs to be strengthened
  - Recent initiatives such as Sarbanes-Oxley are a modest step in the right direction
  - Subsequent debacles such as NYSE pay packages and mutual fund scandals reinforce inadequacies of even these initiatives
  - Continuing timidity of responsible officials/agencies (e.g., SEC) underscores unfinished agenda
  - Key reform that is needed is to break up the small self reinforcing "club" of executives turned board members by broadening pool of candidates to fill board position
  - Minimum reform needed is mandatory staffing of boards with representatives of key interest groups - employees, major communities, suppliers (note: done in Europe with no major downside)
- Rules and incentives on the investment of equity capital need to be changed to increase the focus on the long term
  - Most institutional money is long term in nature, primarily pension moneys
  - But money managers are rewarded for beating comparatives on quarter by quarter, year by year basis

- This results in endless churning which benefits only the brokerage community at the expense of creating dysfunctional pressures on management for positive, short term financial PR - no one should call what management does to respond to The Street "performance"
- While there are risks to investors inherent in stretching performance perspectives, these risks can be managed
- Existing tax structures, particularly capital gains tax rules (which should be relabeled portfolio churning disincentive taxes), provide the means of solving this problem almost immediately

- Existing incentives for destructive corporate behavior focused on meeting inappropriate short term goals need to be rebalanced
    - Globalization and the shift of jobs to low labor cost locales overseas are not wrong per se
    - But dismissing loyal and hard working employees precipitously to gain questionable short term financial advantage is wrong
    - And dumping human capital and know how for short term gain (such as shifting high tech jobs or highly skilled manufacturing jobs overseas for short term wage bill gains) without considering potential long term consequences for companies and the economy is both wrong and stupid
    - Existing tax and fiscal incentives all encourage companies to pursue short term financial results at expense of all else
    - Other parts of the world, particularly Europe and Japan, have put in place mechanisms to make sure such changes are not made cavalierly; rather than being criticized for labor market rigidities, their examples should be studied for the lessons that can be learned
    - At a minimum, tax and incentive schemes ought to be revised to ensure companies pay their share of the social costs attendant on shifting jobs and capabilities from one locale to another

Note: There are likely other areas, as well, that warrant legislative attention to redress distorted incentives in today's economy; there are larger issues that need attention as well from a national perspective

6. What specifically can be done to decrease the pressure on Small Business, especially small manufacturers, from the excesses of the Shareholder Value Era?

- Small business, and especially small manufacturers, have had the rug pulled out from underneath them by big business's pursuit of short term financial gains
  - "trimming fat" through layoffs in large companies often works because there are enough people still around to fill the gaps left behind; small companies rarely have such built in excess capacity so demands for price cuts come right out of (often non-existent) profits
  - moving production overseas - as demanded, for example, by Jack Welch of GE - is beyond the scope of what a small manufacturer can do
  - meeting new systems and supply requirements such as JIT deliveries, often necessitated by reengineering programs, impose investment requirements on small business beyond their ability to fund or take on
- Cutting costs and meeting new supply requirements is required, however, to stay in the game
- Government can help small business respond to some of these pressures in two ways
  1. Leveling the playing field somewhat against offshore competition
  2. Reinforcing the inherent strengths of small suppliers to enable them better to compete against low cost, overseas alternatives

  Congress should exercise caution, however, in trying to help out to avoid either building bureaucracy and dependence on the one hand or ineffective giveaways on the other - i.e., even with the best of intentions, it is not easy to create truly effective support programs that might work
- Options to help level the playing field include
  - Direct disincentives (i.e., taxes, charges) to large companies to discourage shifting jobs overseas
  - Trade provisions requiring overseas suppliers to raise working conditions and wage levels

    - Subsidies/one-time grants to help small enterprises get their toes wet in offshore operations

  There are likely many more, as well, better understood and articulated by those more directly involved in the trenches; in my view, all of these options are tricky, at best

- Options to help small business build on their unique strengths include
    - Grants to enable upgrading of workforce skills
    - Tax allowances, even very generous ones, to enable small firms to build new systems infrastructure and ensure they can compete in a JIT world
    - Accelerated depreciation on investments to enable lasting and substantial cost reductions
    - Special funding to enable small firms to co-venture with other small firms to remain competitive
    - WPA-like programs or special market development funds to assist/enable firms find outlets for their goods when orders are lost to overseas suppliers

  While care must be exercised in program design and implementation, in my view, there is more scope for government interventions with targeted support than there is for leveling the playing field

7. What are the leadership issues that arise from this crisis in business oversight and behavior?

- While not unprecedented in historical terms, the movement in business to an ethic of greed represents a breakdown in the value system of the society
- Arguably, this suggests that the heart of the problem we are all grappling with in relationship to short termism, corporate and individual executive misbehavior, and issues of corporate governance is a breakdown in and failure of the value system of society
- A lot of factors likely contributed to this breakdown, e.g.,
    - The changing role and nature of families in society (if an extra income is so important to a family's economics that child rearing can be neglected,

what lesson are children likely to draw from this about what is important to them going forward)

- The decline of formal religious affiliation and practice has likely left a vacuum in value formation no other mechanism has arisen to fill
- Increasing mobility in society, spurred by advances in communications and transportation technologies, has likely contributed to a shortening of time frames in most people's value systems
- The democratization of higher education, while unarguably a societal advance, has lessened the potential role of educational institutions - now increasingly training factories - in value formation

- In an increasingly secular society, senior political leadership should, in my view, take responsibility for setting the tone and agenda for the society going forward
  - There are really no other leadership vehicles appropriately responsive to society as a whole to fulfill such a leadership role
  - Failure to exercise leadership at this level, the level of setting standards and reinforcing values, will inevitably force a diminution of the role of political institutions in society as politics reacts to micro issues it is confronted with rather than setting the agenda; this will open the door to increasing societal alienation and the inevitable and uncontrollable movements this can lead to (extremism comes from somewhere, after all)

8. What can and should be done to refocus leadership in this country?

- This is a really big subject and one I am willing to opine about but likely not really qualified for
- However, I am struck by the fact that you can't really solve the problems I am qualified to address without (a) recognizing the value system failures that underpin them, and (b) doing something to address the shortcomings in today's societal value system
- As a non lawyer, I am impressed by the degree to which a lot of the recent failures in the business environment are not necessarily strict matters of law, e.g., market timing by insiders of mutual funds is not prohibited by any laws I know of; nor

could laws ever be formulated that would address all of the potential excesses likely to occur in a society motivated by greed

- While not strictly illegal, however, many such actions - e.g., market timing in mutual funds, excessive pay packages for senior executives, arbitrary and unnecessary downsizing to meet artificial short term financial targets - are simply wrong, in a value system sense of the word
- This suggests to me that a strong case can be made for legislation concerning violations of public trust
    - Many positions in society are positions which carry with them unwritten public responsibilities including, senior executive positions in public companies, educators, law enforcement officials, people with senior fiduciary management positions, senior governmental officials
    - When people in such positions act in their own selfish interest without regard for the effect on others, they violate a public trust
    - While seldom "hanging offences" such as one would find in the criminal justice system, such violations of public trust should subject those who violate the trust to severe penalties, certainly including exclusion from a continuation in that walk of life, retribution of all ill gotten gains (and penalties to discourage others from seeking such gains), likely some forced exclusion from society for a period of time (i.e., incarceration)
    - As a final suggestion for today, may I encourage members of the Committee to think about and take some action on beginning to define an agenda for monitoring the public trust by, perhaps, sponsoring a commission to articulate how this area of society might be regulated in an environment in which the society itself fails through its normal mechanisms to set the standards of behavior necessary to ensure the common good.

Thank you for inviting me today and hearing me out. I hope my views are helpful.

Allan A. Kennedy
21 January, 2004

Testimony of

Constance E. Bagley

before the

House Committee on Small Business

January 21, 2004

Mr. Chairman, my name is Constance E. Bagley, and I thank you and the members of the House Committee on Small Business for this opportunity to speak with you today. I am an Associate Professor of Business Administration at Harvard Business School, a member of the state bars of New York and California, and a former partner of the law firm of Bingham McCutchen. I am also the author of *Managers and the Legal Environment: Strategies for the 21st Century* (4th ed. 2002) and the co-author of *The Entrepreneur's Guide to Business Law* (2d ed. 2003).

I would like to address my prepared remarks to the limitations of the shareholder primacy model of corporate governance and its effect on nonshareholder constituencies, such as employees and communities.

In the past several decades, we have been assailed with the mantra that corporate directors must maximize value for the shareholders, even if that means laying off long-time employees and shutting down company towns. The *New Yorker* captured the sentiment quite nicely in a cartoon depicting a group of directors sitting around a table with the caption, "I, too, am tired of being a greedy bastard, but we have a responsibility to our shareholders." Or as one CEO put it, "As CEO I have a duty to do what's best for the shareholders. I can't let my own sense of right and wrong get in the way."

Let me begin by debunking the notion that the corporate law requires directors to put on ethical blinders when they enter the boardroom. The courts have made it very clear that corporate directors have a fiduciary duty to manage the corporation "for the best interest of the corporation." In deciding what is in the best interest of the corporation, the board may legitimately consider not only the effect a decision might have on the shareholders, but also the effect it might have on employees, customers, suppliers, and the community where the company does business.

The legislatures in a majority of the states have enacted so-called constituency statutes, which expressly authorize the boards of corporations incorporated there to take into account all stakeholders and constituencies when deciding how to act even when a change in control or break-up of the corporation has become inevitable. Delaware, where a majority of the *Fortune 500* companies are incorporated, does not have a constituency statute. Even so, the Delaware Supreme Court has made it clear that the role of the director shifts from "being a protector of the corporate bastion" to being an "auctioneer" charged with obtaining the highest realizable short-term value for the shareholders only when the breakup of the corporation has become inevitable or there has been a change of control. For these purposes, the definition of what constitutes a change of control is quite limited. Thus, Time was permitted to rebuff a cash tender offer by Paramount Communications that the Time shareholders wanted to accept to protect Time's culture and journalistic integrity.

In short, directors may *choose* to do anything in the name of the shareholders even if it imposes costs on others without their consent, but they are not legally *required* to do so.

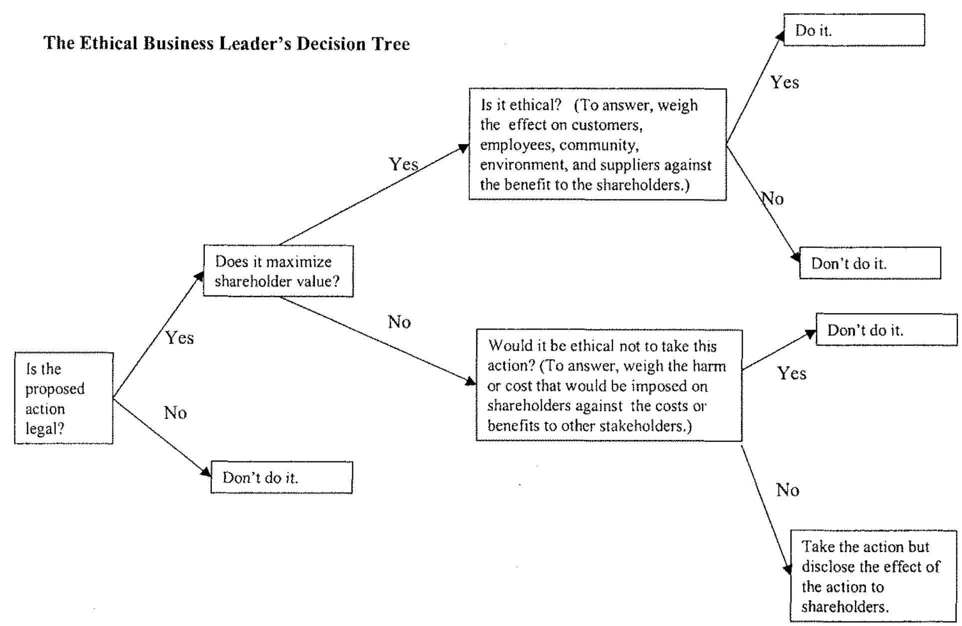
Indeed, it is not economically efficient to permit corporations to exploit externalities, actions that affect the welfare of others, by externalizing the costs while retaining the benefits. As Stanford economists Paul Milgrom and D. John Roberts explain in *Economics, Organizations and Management*, in deciding whether to close a plant, for example, economic efficiency requires that the firm give weight to the interests of (1) workers and others in houses near the factory, which may lose much of their value if the factory were to close; (2) workers who invested in firm-specific human capital that is co-specialized with the plant; and (3) the township as a whole, which may have invested in roads, sewage-treatment facilities, and schools to support the plant.

Although the federal Warn Act, adopted in 1988, requires companies with one hundred or more employees closing factories employing more than fifty employees to give advance notice of the plant closing, it does not require companies to take these other economic interests into account when deciding whether to close a plant or on what terms to do so (e.g., with or without severance pay, continuation of health benefits, or payment of relocation expenses). Perhaps a modest step might be to amend the Warn Act to require companies to publicly disclose whether and how they took those other interests into account when deciding on what terms to close a plant.

When we call on individuals to abandon their own moral strictures to maximize shareholder value, we weaken and desensitize the individual's ethical tripwire, which often is triggered before a person crosses the line and violates the law. To put it differently, if we try to make individuals' ethical systems overly plastic, they will crack or shatter, leaving the person on the slippery slope to illegality.

As a start, I have created what I refer to as *The Ethical Business Leader's Decision Tree.*

The Ethical Business Leader's Decision Tree



The legality of the proposed action is addressed first to reinforce the notion that legal compliance is the baseline standard. If an action is not in accordance with law, then regardless of the likely effect on shareholder value, the action should not be taken. The filter for shareholder value is intended to require consideration early on of whether the interests of the group given the ultimate authority to change management are or are not being served by the proposed action. The inquiry does not stop there, however. Directors and managers must then ask whether the proposed action is ethical and whether it would be unethical not to act. If the board decides to take an action that will have a material adverse effect on shareholders, then that decision and the reasons for it should be disclosed to the shareholders.

As a way to both reward the responsible directors who want to vote their conscience and to act in a socially responsible manner, and to deter would-be "cheaters" from seeking a competitive advantage by secretly imposing their social costs on others, I would reiterate a proposal Professor Karen Page and I first published in the Fall 1999 issue of the *San Diego Law Review.* We propose that Congress or the Securities and Exchange Commission require public companies to publicly disclose in their annual reports on Form 10-K or in some other fashion all board-level corporate decisions made since the last report that had a material impact on any constituencies, including shareholders, employees, suppliers, creditors, the community, government entities, and the environment. This proposal would give all market participants, such as investors, employees, customers, and suppliers, the information they need to decide whether to invest in or do business with a particular company.

Thank you very much. I would be happy to answer any questions.

-TESTIMONY OF LAURIE BASSI

CEO OF McBASSI & COMPANY AND
CHAIR OF KNOWLEDGE ASSET MANAGEMENT

BEFORE THE
HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS

JANUARY 21, 2004

Good morning Chairman Manzullo and members of the Committee. I am Laurie Bassi. Thank you for the opportunity to appear before you today. I will be sharing with you some important evidence that demonstrates that many U.S. based, publicly-traded firms focus myopically on this quarters' earnings, and in so doing, harm their long-run performance. My testimony will focus on one particular aspect of firms' decision-making—their investments in the education and training of their employees.

My remarks are based on what I have learned as a co-founder of Knowledge Asset Management (a registered investment adviser) and as the CEO of McBassi & Company (a research-benchmarking company that specializes in measuring the "human capital" factors that predict business success).

By way of background, I should note that I myself am a registered investment adviser, and caution you that nothing I say here today should be construed as investment advice. I am also a Princeton-trained, Ph.D. economist. The perspectives that I share with you today are based on years of econometric research that I have undertaken with a group of extremely able colleagues.

The bottom line on this research is that we have rigorous and compelling evidence that U.S. based firms consistently under-invest in the education and training of their employees. This is synonymous to saying that there is a consistent tendency to forfeit long-run value creation in exchange for boosts in short-run (quarterly) earnings.

Before diving into the research that backs up this statement, it is first necessary to take a bit of a detour into the arcane field of economic theory in order to be able to put the research results into the proper context.

It is a basic truth that organizations must perpetually make choices among competing options in determining where to invest their resources. Budgets must be divided among all of the "factors of production" that are necessary for an organization to be effective: buildings, equipment, technology infrastructure, R&D, and people (including their salaries, benefits, and development).

According to the logic of economics, a necessary condition for maximizing profitability is that an organization should invest in each of these factors up to the point at which the marginal return on an additional dollar spent is equalized across all factors. Given the "law of diminishing marginal return", an over-investment in any given factor will result in a lower return on that factor. Conversely, an under-investment in a factor will result in a higher return on that factor (and a lost opportunity to have optimized the productivity and profitability of the organization through additional investment in that area). This logic leads inexorably to the conclusion that in an organization that is investing effectively, the "return on people" should be identical to the returns on other factors of production (e.g., equipment, technology).

This insight from economic theory is important in interpreting the findings that emerge from a small but growing body of empirical research on the relationship between organizations' performance and their investments in people. (See "Beyond Quarterly Earnings" for a summary of this evidence. A copy can be obtained at www.mcbassi.com.) This research consistently finds that organizations that make an extraordinary investment in people enjoy extraordinary returns. The inescapable conclusion is that there is a general under-investment in people among most organizations, and as a result, organizations that make unusually large investments will consistently outperform those that don't.

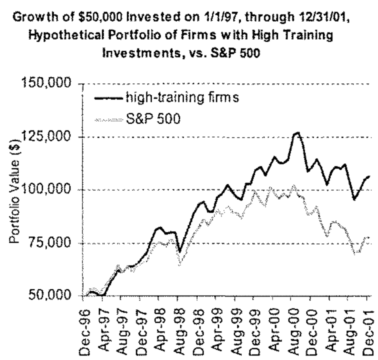
Knowledge Asset Management, the registered investment adviser of which I serve as the Chair, has produced some of the most compelling evidence in this regard. Between 1997 and 2001, we constructed a series of "hypothetical portfolios" that consisted of firms that make unusually large investments in employee development.[1] Here is what we learned:

- Companies that invested more money in training performed better on the stock market than companies that invested less—even after controlling for each company's own past performance and a wide array of other "control" variables.
- The nature of the relationship between training investments and stock market performance was particularly strong for companies that make the very largest investments in training.
- For these companies, training investment served as a powerful predictor of future market performance, with its predictive ability strengthened by including a small number of additional traditional financial measures in the statistical model.

[1] As a registered investment advisor, I must emphasize that, as indicated in the text, much of the performance information summarized in this testimony (including the "Growth of $50,000" graph) is based on the HYPOTHETICAL back-tested performance of a series of annual portfolios selected based on KAM's proprietary model. There are limitations inherent in model results, including the fact that the results do not represent actual trading and may not reflect the impact of material economic and market factors on the advisor's qualitative decisions when managing client assets. Hypothetical performance results include dividend reinvestment and are net of all fees and expenses. This hypothetical performance is not a guarantee of future results, and is not indicative of actual results for any past or present clients.

The KAM research team also carefully examined, and ultimately ruled out, a variety of alternative explanations for the observed relationship. Among these rejected hypotheses were the following: (a) that the relationship was simply the result of more successful companies having additional money available to invest in training and learning, (b) that training investments were serving as a proxy for another publicly-available variable, (c) that the relationship was caused by disproportionate representation in the data sample of particular industries, and (d) that the relationship was in some way merely a product of the bull market of 1997 to 1999.

Further, the finding that training is a significant predictor of future market performance has a strong theoretical basis under the "efficient market hypothesis," which holds that all available relevant information is promptly incorporated into the current price of a given stock. In most cases, however, data on training is *not* available to investors in the market, so the expected future benefits of a company's training investments (unlike the expected benefits of many other financial investments or practices, which *are* publicly-known) are not already systematically incorporated into its current stock market price.



KAM then developed a model and algorithm (now known as the Knowledge Asset Management Index™) to select and weight a portfolio of firms that would be expected to outperform the market, based on the research results. This quantitative model was developed using four years of training data (1996 to 1999) and tested on five years of market performance. The hypothetical back-tested portfolio, selected and weighted annually based on the rigorous application of the model rules, performed well in both the bull market of 1997-1999 and the bear market of 2000-2001. Overall, this hypothetical portfolio had an annualized return of 16.3 percent for the five years, compared with an annualized return of 9.2 percent for the S&P 500 index for the same period.

As a final test before the decision to create an investment firm, the Index was tested "out of sample," applying it to data that had not been included in the development of the model specifications. Based on the positive results of this test, KAM was incorporated, and began actively managing funds in December 2001.

So for the past 2 plus years, we have been investing in live (rather than hypothetical) portfolios of companies that make significant investments in training for their employees. Since I do not want to run afoul of SEC regulations that might interpret my testimony to be advertising, let me simply say that all 5 of our portfolios have substantially outperformed their benchmarks[2] (additional detail can be found at www.knowledgeam.com). That is to say, our performance to date strongly supports our previous findings.

In essence firms must invest in the development of their employees *despite* the pressure Wall Street, rather than *because* of those pressures. To understand why this is so, imagine the following thought experiment. Two publicly traded firms are comparable in all but one respect: "Firm A" makes substantial investments in individual and organizational learning, and "Firm B" does not make such investments. What most analysts will see is that Firm A has higher "overhead" expenses (and therefore, lower current earnings) than Firm B. What will not be evident to analysts is that some what appear to be higher "expenses" for Firm A are actually investments that can be expected to generate future productivity gains and financial benefit. Consequently, A's stock prices will be lower—at least in the short-run—than B's.

In the long-run, however, Firm A's stock price will be higher than B's (this is the principle on which Knowledge Asset Management invests). We seek to make money by taking advantage of Wall Street's short-sightedness. This short-sightedness is reinforced by executive compensation packages that too closely tie senior executives' incentives to that of analysts, and by public policies that reinforce this myopia.

Clearly, there are actions that firms can take to counteract the pressures from Wall Street that destroy long-run value creation in exchange for short-term "profitability." These have to do with the structure of executives' compensation, as well as developing credible systems for signaling to Wall Street about the nature of their long-run investments (this is very much a part of the work that our research company, McBassi & Company, is engaged in).

But there are also steps that Congress can and should take to help remedy this situation. First, investments in "human capital" should be put on an equal footing with all other investments—that is to say they should be publicly reported (even if they continue to be accounted for as "expenses"). Second, Congress should follow the lead of other industrialized nations and require the appropriate federal agencies (e.g., the Department of Labor and/or Commerce) to begin to systematically study what it will take to transform our industrial-era accounting system, which recognizes people only as costs, into a knowledge-era accounting system that recognizes people and investments made in them as the assets that they are.

I thank you for your time and attention, and welcome your questions.

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[2] Of course, it should always be remembered that actual past performance is not a guarantee of future results.

House Committee on Small Business
"Can U.S. Companies Compete Globally Using American Workers?"
January 21, 2004

Prepared Remarks of Mr. Anthony R. Wilkinson
President and CEO, National Association of Government
Guaranteed Lenders
Stillwater, OK

The National Association of Government Guaranteed Lenders, Inc. (NAGGL) a trade association for lenders and other participants who make approximately 80 percent of the Small Business Administration (SBA) section 7(a) guaranteed loans. The SBA's 7(a) guaranteed loan program has proven to be an excellent public/private partnership. Over the last decade, the SBA has approved more than 424,000 loans for over $90 billion. We thank the Committee for the opportunity to testify on issues concerning U.S. companies' ability to compete globally.

NAGGL's members run the gamut of financial institutions, including internationally-active bank holding companies to local community banks. A common thread for many of these institutions, however, is that they are publicly-owned by our nation's investors. Such public ownership has provided our members with ready access to capital markets, affording expansion into other lines of services demanded by their diverse customer base. With public-ownership come many responsibilities, however, including compliance with a multitude of federal regulations aimed at protecting investors.

In complying with disclosure requirements, publicly-traded lenders participating in the Small Business Administration's loan programs must provide investors with an explanation for any material increase or decrease in their financial statements. Such disclosure contributes to investors' ability to evaluate their investment decisions and to decide whether to hold, sell, or purchase more of a certain lender's stock. The recent events concerning the administration's mismanagement of the 7(a) loan program will adversely affect many of NAGGL's members, and as a result, will likely be cited in their financial statements.

Because many NAGGL members rely on the 7(a) loan program as a primary line of business, smaller lenders with fewer product offerings will face greater losses as a percentage of their total revenues. For larger lenders, with a broad product line, the effect may be minimal, swamped by revenues from their other profit centers. Regardless of an institutions' size, the continuing crisis in the 7(a) loan program will substantially affect short-term earnings for all of NAGGL's lenders. Responsive to short-term shareholder pressures, these lenders will likely take the unfortunate step of reducing costs, likely through reductions in their workforce.

Recent Crisis

On January 6, 2004, the SBA announced that it was shutting down the 7(a) program, injuring thousands of small businesses and lenders that had submitted applications for loans. One week later, the agency announced that it was restarting the program, but with a cap of $750,000 and a prohibition against the use of 7(a) loans in larger loan packages, frequently called "piggybacking". Together, these limitations will prohibit small businesses and lenders from accessing the capital they need to grow and expand their operations. On top of these restrictions, it is likely that the program will shutdown again before the end January.

These actions have gravely and irrevocably harmed thousands of entrepreneurs at a time when the nation's economy is struggling to create new jobs and move forward. Most disturbing about this occurrence is throughout 2003 the administration repeatedly ignored signs that loan demand was exceeding SBA's available funds and chose not to act, instead delaying action until Congress was adjourned for the year. Rather than foreseeing and acting to prevent this crisis, one of the federal government's most important economic development programs has been destabilized. SBA's recent action to reopen the program falls well short of what small businesses need – in fact, the program is closed to more than 40 percent of those small businesses that would have used the program prior to SBA's recent actions.

Conclusion

Small business lenders have been irreparably harmed by this recent crisis in SBA's 7(a) program. As public companies, many of these lenders will face reduced revenues from their 7(a) lending operations. In the short-term, these lenders will likely cut costs by laying off employees. In the long-term, however, these lenders will have to decide whether to continue to participate in the 7(a) program. Due to the uncertainty surrounding the 7(a) program's structure and operating status, SBA loan products are increasingly being viewed as unreliable. Shareholder pressure may lead lenders to drop out of the program, and ultimately reduce the financing options for America's entrepreneurs.