Testimony
Before the U.S. House of Representatives Committee on Financial Services
Subcommittee on National Security, International Development, and Monetary Policy
Virtual Hearing on "Paycheck Security: Economic Perspectives on Alternative Approaches to Protecting Workers' Pay During COVID-19"

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Chairman Cleaver, Ranking Member Hill, Members of the Subcommittee, thank you for the opportunity to testify before you today.

My name is Diego Zuluaga and I am the Associate Director of Financial Regulation Studies at the Cato Institute.

America's 30.7 million small businesses have taken a very severe hit from the COVID-19 pandemic. The share of small businesses reporting that the health emergency has had a large negative effect on them was 37.7% in late June, down just 14 percentage points from eight weeks earlier.[1] Another survey found in April that 1.8% of small businesses had permanently closed because of the pandemic, which if true would mean 553,000 firms are gone forever.[2]

Yet economic activity and employment are so far recovering faster than many expected. Early action to support small businesses through the Paycheck Protection Program has helped: According to my estimates, around 77% of small businesses with employees had gotten a PPP loan by June 30.[3] And while the proportion of employing small businesses with a PPP loan varies considerably across states, nowhere is it below 60%. By allowing millions of small businesses to keep paying their workers, as well as utility and rent bills, the Paycheck Protection Program has prevented a greater destruction of livelihoods and valuable business relationships than has actually happened.

It doesn't follow, however, that a program of grants based on lost revenue will assist the recovery. I believe, on the contrary, that it will hinder the recovery by delaying businesses' necessary adaptation to changing consumer demand. The pandemic has not just caused all sorts of businesses to suffer losses. It has also led to permanent changes in economic activity, mainly because production processes and consumer preferences have shifted in response to new health risks. Restaurants are

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[1] U.S. Census Bureau, Small Business Pulse Survey, Week of June 21-27. Accessed July 2, 2020.
[2] Alexander W. Bartik, Marianne Bertrand, Zoë B. Cullen, Edward L. Glaeser, Michael Luca, Christopher T. Stanton, "How Are Small Businesses Adjusting to COVID-19? Early Evidence from a Survey," NBER Working Paper No. 26989 (April 2020), p. 8.
[3] Diego Zuluaga, "Paycheck Protection Program: Who Lent to Whom, and Where?," *Alt-M.org*, June 18, 2020. I have updated my numbers to reflect the most recent PPP loan data from the Small Business Administration.

cooking more meals for takeaway and outdoor consumption. More retail activity is moving online, as are larger transactions, such as home purchases. These changes are unavoidable.

Any recession involves the reallocation of workers across firms and industries. But because of the pandemic's wide-ranging consequences, recovery from the present recession will likely involve a larger redeployment of workers and capital than previous downturns. Attempting to freeze America's productive structure in its pre-COVID-19 state will therefore only delay the return to full employment and steady growth. The bounce-back will be swifter, on the other hand, the more quickly businesses adapt to the new conditions.

I don't at all mean to suggest that government policy can't play any additional, valuable role. But it can best do so by removing barriers to geographic mobility and business investment. Instead of rigid support programs that impede mobility and risk prolonging financial insecurity, workers need flexible support in the face of uncertain economic conditions. A program of direct grants to cash-strapped households, whether or not their members are employed, would address paycheck insecurity while preserving the incentive to adapt to the post-pandemic economy. A conditional grant program, on the other hand, would tie up capital and labor in firms whose long-term viability is far from assured.

Besides delaying adaptation, conditional grant programs are costly to administer, as officials must verify applicants' declarations and monitor the use of funds. These programs also raise fairness concerns: Why should laid-off employees who find new work not be entitled to a reward, whereas those lucky enough to keep their job get a bonus? Why should taxpayers support businesses while the national unemployment rate remains above a threshold, but not thereafter? Macroeconomic arguments about supporting demand are unpersuasive, since direct, unconditional cash grants would have at least the same effect on demand, for two reasons: First, a larger share of available funds would go to recipients instead of program administrators. Second, because grant funds would go to the least well-off regardless of employment status, and the least well-off consume more of their disposable income, the immediate impact on aggregate demand might be greater.

Congressional action to support the solvency of small businesses in the direst weeks of the pandemic has enabled a speedier recovery than many expected. Now the goal should be to encourage adaptation so American workers and businesses can resume productive activity. Achieving this goal will require their ingenuity, on which we can count, but also flexible, change-friendly support from policymakers.

Thank you. I will be happy to answer your questions.