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Special Report

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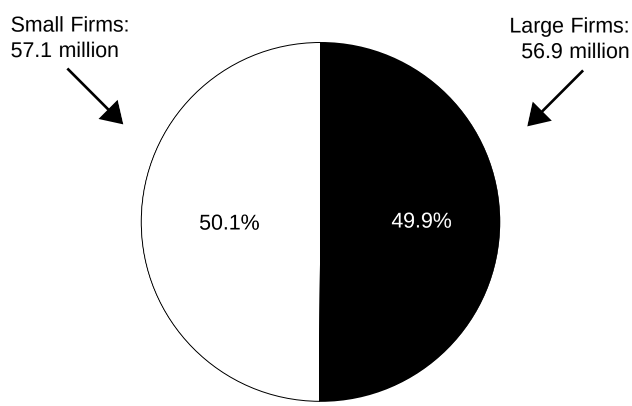
Superfund: Impact on Small Firms

As the debate in 2003 over the reauthorization of the Superfund program continues, the ACCF Center for Policy Research presents research by William E. Wetzel, Jr. and Jeffrey E. Sohl of the Center for Venture Research at the University of New Hampshire on the impact of Superfund on small business' investment decisions. Dr. Margo Thorning, executive vice president and director of research for the Center prepared this summary of a research project commissioned by the Center in the mid-1990s. Visit www.accf.org for a copy of the full report.

INTRODUCTION

Small firms have been a very important source of jobs and entrepreneurial activity for the U.S. economy since the late 1970s. U.S. Census Bureau data show that small firms (defined as those with fewer than 500 employees) employed 57 million people in 2000, the same number as provided by large firms (see chart). Small firm payroll was $1.7 trillion in 2000, compared to $2.1 trillion for large firms. In addition, there were 16.5 million businesses with no paid employees in 2000; these are typically self-employed individuals or partnerships. Small business produced almost half of GDP in 1997 according to a report by Joel Popkin and Company. In summary, small business plays a critical role in U.S. economic growth and job creation. To assess the potential impact of Superfund liability on small business activity, the ACCF Center for Policy Research co-sponsored a research project with the National Federation of Independent Business. While the survey of small firms and the report were completed in the mid-1990's, the findings are likely to be a good indication how Superfund liability affects their cost of capital and investment today.

Figure 1: Small and Large Firm Employment in the U.S. in 2000



A small firm is defined to be a firm with fewer than 500 paid employees.
Source: U.S. Census Bureau, "Statistics of U.S. Business, 2000."

This study breaks new ground by surveying a group of small potentially responsible parties (PRPs) to assess the impact of Superfund liability on small firms' ability to raise capital, invest in plant and equipment, and create jobs. Superfund's site-by-site financing mechanism relies on strict, retroactive, joint and several liability. This liability standard means that PRP's are liable for waste disposal that took place before the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), or "Superfund," was passed and therefore may have been lawful at the time. Liability is not limited to a PRP's "fair share" of costs based on its wastes. Each PRP may be held liable for the entire cost of cleanup. Thus, Superfund liability can have a major impact on a firm's cash flow and financial health because remedial costs average $25 to $30 million dollars per site.

INVESTMENT AND CAPITAL COST IMPACT

Given the country's reliance on smaller firms for new products and new jobs, Superfund's potential impact on smaller firms' ability to raise capital, invest in plant and equipment, and generate revenues and jobs takes on particular significance. Investing in long-term assets reflects management's expectations for future cash flow and the availability and cost of long-term debt and equity capital.

Respondents were asked whether any planned investments in plant and/or equipment were postponed or canceled as a result of being named a PRP. Based on responses to questions dealing with plant and equipment decisions, it appears highly likely that the long-term impact of PRP status on the ability of smaller firms to raise capital and create jobs will be substantially greater than the short-term impact.

Overall, 39.1 percent of respondents reduced or delayed their investment in plant and equipment as a result of being named a PRP. The investment planned by small firms (those with 0-19 employees) was even more significantly affected;

This special report is based on an earlier study sponsored by the ACCF Center for Policy Research in cooperation with the National Federation of Independent Business. The ACCF Center for Policy Research is the education and research affiliate of the American Council for Capital Formation. Its mandate is to enhance the public's understanding of the need to promote economic growth through sound tax and environmental policy. Copies of the complete study by Professors Wetzel and Sohl may be obtained from the ACCF Center for Policy Research, 1750 K Street, N.W., Suite 400, Washington, D.C. 20006; 202/293-5811.

almost half of these respondents canceled or postponed investment. This provides evidence that the size and uncertainty surrounding PRP liability concentrates management's attention on short-term survival rather than long-term growth. Creditors and equity investors will likewise be more concerned about survival than growth. Until final PRP liability is established, smaller firms will be obliged to conserve scarce resources to ensure survival, thereby foregoing the investment that leads to long-term growth.

Required rates of return on capital investments (hurdle rates) reflect management's perceptions of the availability and the explicit cost of long-term debt and equity capital; increased capital costs tend to reduce investment. Respondents were asked about the effect of potential Superfund liability on the expected rates of return required from new investment projects. Approximately 26 percent of the firms reported increased capital costs as a result of becoming a PRP.

It appears that respondents dealt with the impact of PRP status on investment decisions partly through increases in required rates of return and partly through more subjective decision criteria. In any event, the effects of the burden of PRP status will be manifested over an extended period of time as the consequences of delayed capital investment impact the competitive position of smaller-firm PRP's. With 39.1 percent of respondents delaying capital spending, the long-term effects are likely to exceed the short-term effects by a substantial margin.

ABSORPTION OF MANAGEMENT TIME

More than 50 percent of respondents devoted from 1 to 5 percent of senior management time—roughly one business day per month—to Superfund-related issues during the last five years. Another 35 percent reported spending more than 5 percent of senior management time on Superfund issues. Thus, PRP status had a significant impact on senior management time for 87 percent of respondents. This question attracted a 98 percent response rate, the highest response rate of all survey questions. As is true of delayed or canceled capital expenditures, the adverse consequences of management attention diverted to PRP issues will be felt over an extended period of time.

IMPACT ON BANK CREDIT

Nearly 40 percent of the survey respondents reported that the terms under which they received bank credit became harsher after they became PRPs. Their bankers typically did not respond to the increased risk of lending to PRP accounts by raising interest rates (the explicit cost of capital), but instead by imposing terms and conditions designed to reduce credit risk exposure. These terms and conditions are not cost-free to borrowers, the survey authors note. They represent implicit costs that in indirect, nonquantifiable ways impose constraints on management's ability to make otherwise optimal business decisions and/or attract capital from other sources.

SUPERFUND'S STRUCTURE

Almost 70 percent of survey respondents felt the major burden of Superfund was the current liability system for determining a firm's payments. In contrast, only 16.4 percent cited cleanup standards as the major problem and still fewer (14.8 percent) cited the remediation (cleanup) process itself as a problem. Under the current liability system, determining final PRP liability is an extended and expensive process. By some estimates, as much as seventy-five cents of every dollar of Superfund-related expenditures is consumed by legal and consulting fees.

In the space provided for comments on the questionnaire, respondents expressed a sense of outrage at the perceived unfairness of strict, retroactive, joint and several liability, rather than concerns for the impact of PRP status on business projects.

Small-firm PRPs have identified the present liability system as the dominant Superfund problem. From their perspective, equitable and expeditious determination of final Superfund liability should be the primary goal of modifications to the implementation of Superfund.

SURVEY RESPONDENTS

Superfund's impact on small business was estimated by surveying a group of 5,000 small firms that had been designated PRPs. A total of 520 usable surveys were returned, yielding a response rate of 10.4 percent. Firms that did not return the questionnaire were mailed follow-up postcards to see if their major Superfund concerns were similar to those of the survey respondents.

The responding firms comprise a diverse geographical distribution with the principal place of business representing 45 states and 430 zip codes. The overwhelming majority of these small firms are organized as corporations (68 percent) or sub-S corporations (21 percent), with the remaining firms being either sole proprietorships or partnerships. Approximately half of these firms claim manufacturing or mining as their major business activity, followed by wholesale or retail trade and services. Thus, the firms in the sample are a geographically diverse sample of small firms from industries that are typically associated with a reasonable probability of at some point being named a PRP under existing Superfund legislation.

CONCLUSIONS

This study does not suggest that PRP status has an immediate and devastating impact on smaller firms. The findings do support the conclusion that being a PRP tends to reduce investment, raise capital costs, and divert senior management from the goal of long-term growth to short-term survival. However, PRP status may have a significant impact on the long-term ability of small firms to continue their role as an important job-generating engine of the U.S. economy.