FEDERAL RESERVE BANK
OF BOSTON

RALPH E. FLANDERS
PRESIDENT

December 3,1945.

Honorable M. S. Eccles,
Board of Governors of the Federal Reserve System,
Washington 25, D. C.

Dear Sir:

At Mr. Flanders' request I am forwarding you copy of his talk before the National Association of Securities Commissioners in Chicago on November 17th.

Very truly yours,

M.E. Anderson

Secretary to Mr.Flanders.

Enclosure

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THE PROBLEM OF DEVELOPMENT CAPITAL
NATIONAL ASSOCIATION OF SECURITIES COMMISSIONERS
EDGEWATER BEACH HOTEL, CHICAGO, ILLINOIS
Ralph E. Flanders

11/17/45

The problem which I wish to discuss with you this morning is one of very great importance. I am familiar with much of the past history and the present situation relating to the financing of new undertakings. I am not familiar in detail with the responsibilities laid upon the State supervisory authorities by the laws under which you operate, and which your bodies were organized to enforce. This will be, therefore, in the main a brief presentation of the problems from the standpoint of public interest, leaving to those who are more experienced and expert than myself any offering of suggestions as to how the difficulties can be met by ways in which the public interest is protected and served.

My connection with American industry goes back to January 1897 when I entered on an old-fashioned apprenticeship in a New England machine tool plant, from which I graduated three years later as a journeyman machinist. In one way or another I have been connected with the machine tool industry for the intervening forty-nine years. During the early part of that period many new companies were established within that industry and many more within related industries. Of these a fair proportion have gone through the difficulties of childhood, have lived through a vigorous youth, and have arrived at mature strength and usefulness as sources of profit to the investors, as producers of needed goods for the nation's economy, and as providers of profitable employment for many thousands of employees.

These new undertakings were started in many different ways, but typically by young men with energy and ideas who obtained the backing of local capital in amounts ranging from a few tens to a few hundreds of thousands of dollars. With this start these undertakings grew by reinvesting their earnings and eventually become solidly and profitably established.

It was seldom that the initial capitalization was supplied by men of great wealth or by large financial institutions. Under the conditions existing up to the first world war, before the income tax had become the colossus which it is today as a result of two world wars and one great depression, a man's income was his own, except for paltry local and State taxes. Investment in new enterprise was attractive because the earnings of the enterprise itself were earnings free of heavy taxation. They could be directed toward building up the company or directed into the pockets of the stockholders, depending on the business judgment of the owners and the management. Under these conditions, investable funds were abundant and new investment was attractive.

The conditions were very different a generation later. Two world wars and the deficit spending of the great depression raised the Federal indebtedness to undreamed of heights and carried an increasingly heavy burden of income taxes as the inevitable concomitant of the indebtedness. Particularly during this period of the second war, even with the rebates allowed on the excess profits taxes, the Federal government is in a position to take 80% of the earnings of successful corporations in addition to the sums it realized by renegotiation. This means that investment in new undertakings has very greatly decreased in attractiveness.

At the same time the personal realization by the investor on these diminished returns was reduced to the vanishing point. Take, for instance, the case of a man who would be considered very well fixed indeed in popular estimation. If that man had income from wages and dividends of $100,000 a year and sought additional income by putting money into a new undertaking, he got no return from it to justify his venture. Even though that new undertaking should return clear to him as a stockholder, after it had paid its own Federal tax, an amount as large as 10% on the investment (and this is practically impossible) the man with the $100,000 would find this new income coming out of brackets so high that he could realize no more than 0.6% on the money he had put into the undertaking. If he were a man with a $200,000income the return on the successful investment would be still more meager. He could hope for no more than 4/10s of one percent.

From this drying up of the possibilities of adequate returns in a new undertaking and the still greater barrier put to the realization of the investor for his own personal use of any considerable part of these returns, there has resulted a condition in which new undertakings for the first time in the history of this country ceased to be attractive to the diminishing number of men who might be convinced of their intrinsic worth.

Parallel with this has gone an increasing incentive to old-established and well-financed firms to absorb the new ideas and new undertakings as an integral part of their large operations. When a new idea comes along whose development looks worthwhile the great corporation can put money into its development and charge its cost into expense, thereby and to that extent relieving itself of tax burden by corresponding reduction in its profits. If the undertaking does not prove satisfactory the advantage of the tax reduction remains and the loss is minimized to a small percentage of the funds actually invested On the other hand should the development turn out well, the big corporation has that added volume of profitable operations. The whole result has been to put heavy brakes on the development of new industry and to give greater advantage to the growth and strengthening of large corporations. This is not what the country set out to do, but this is what it did. The result, I am sure you will agree, is not in the public interest.

While the income tax situation has been the major deterrent to new undertakings, I am assuming that there have been others which lie within your field of responsibilities. The general public was very severely burned in the speculative spree of the late 20's and in the ensuing liquidation and depression of the 30's. It was necessary that the lessons learned during that period should be taken to heart and that proper safeguards should be set up around the offering of securities to the public, so as to prevent the serious abuses which had been current. Has not the time now come, however, when the situation should be reviewed to see whether means cannot be found for reviving the financial support of new developments, while still affording all proper protection to the investing public?

In raising this question we do have to recognize that new undertakings involve risk. The problem is to recognize the risk as a necessary element in a progressive, industrial economy, while protecting the general public not merely from fraudulent solicitation, but from too serious subjection to the necessary risks involved. I believe that means can be found and must be found to do this within the limit set by the responsibilities which have been laid on you gentlemen by your State governments.

As a clue to the solution of this problem, your attention might be called to a law passed by the Legislature of Connecticut early this year. This law provides that 5% of the admitted assets of a life insurance company shall be freed from all legal limitations as to the character of investment allowed.

Now there are two or three interesting things about this new idea. The first thing is that it removes the limitations on a small percentage only of the total admitted assets. Even though there should be a considerable amount of loss in this unrestricted investment it would not be enough to affect the financial stability of these insurance companies, which are subject both to such skillful internal management and such minute public scrutiny that their investment policies as a whole can be depended upon to be safe and conservative.

Another interesting thing is that the great body of fiduciary funds has taken the place of the vanishing aggregate of smaller personal funds as the primary source of new investment. The proposal to free 5% of such funds allows room, if the directors of these insurance companies so desire, to make full scale experiments in raising the birthrate of new enterprises. The opportunity at least is there for rendering a great public service. As to the extent to which that opportunity is being grasped I am at present uninformed.

With this to point the way other possibilities suggest themselves. Why should not a comparatively small percentage of other types of fiduciary funds be similarly freed? What about the funds in the hands of investment trusts? Much could be done with 5% of the capital of the most responsible and successful of this group. There would be required in any case a spread of investment over a sufficient number and variety of new undertakings to wipe out losses in some against larger gains in others. Under wise management the net result ought to be a larger return to the investor than is possible from the diminishing returns of debt evidences and seasoned equities.

Still another interesting possibility is involved. Such an investment fund would naturally turn into a revolving fund by the process of public sale of the securities in the new undertakings as soon as they had come to the point where they stood on their own feet as securities of proven intrinsic value. The money realized from the sales becomes available for initiating still more new enterprises; and thus the total volume involved might serve as a catalyst in a continuous revivifying of American business by new growth from the bottom.

As stated at the beginning I am not fully informed as to what regulations and administrative practices would interfere with an undertaking of this sort. If this, or projects of a similar nature and for similar purposes are devloped, I do urge that you gentlemen give them sympathetic treatment and make such recommendations as may be necessary in your State laws to permit the operation of all well conceived projects of this sort.

Much has been said of late years to the effect that this nation has reached industrial maturity and can no longer expect the vital growth of new enterprise that has been the energizing source of our progress in generations past. Some have even pressed this point so strongly as to lead to the suspicion that they are really fearful that we are approaching senility rather than maturity. I cannot hold with this belief. As I endeavored to show earlier, I feel sure that the brakes on new enterprise do not arise from any internal decay. They have been brought upon us by the deadening pressure of high taxation. In the new tax law for 1946 this pressure has been lifted sufficiently to give some small measure of the freedom for investment and the hope for profit that existed two generations ago.

Meanwhile there is no lack of new and hopeful ideas for new enterprises. As President of the Federal Reserve Bank of Boston, I find myself sitting in a spot where large numbers of new opportunities come to my attention. Our country is boiling with new ideas and I am the recipient of but a minute fraction of them.

Of these many ideas at least a half can be discarded without a second glance. Of those remaining a little thought would indicate that not more than a half are worthy of investigation. Of that remaining number, possibly a half on thorough investigation would seem to warrant investment. Of those invested in perhaps no more than one-half would turn out successfully, but the success of that remaining small percentage of the original total should be and would be sufficiently great to far more than pay up the cost of screening and the losses on the failures.

Private individual funds have become scarce, but we have this great accumulation of fiduciary funds. We have the great number of possibilities for new investment. We have various means for selecting the most attractive possibilities and for spreading the risk on those selected. Does not this furnish a sound business basis for trying new methods of applying development capital?

American business, American employment, and the prosperity of the citizens of the country as a whole cannot be indefinitely assured under free enterprise unless there is a continuous birth of healthy infants in our business structure. We cannot depend safely for an indefinite time on the expansion of our old big industries alone. We need new strength, energy and ability from below. We need to marry some small part of our enormous fiduciary resources to the new ideas which are seeking support.

The purpose of this paper is to urge that you gentlemen within your own important sphere of responsibilities consider the over-all importance of this birth of new undertakings; and that you endeavor to allow enough freedom so that wise and farsighted endeavors in this field will not run into unwise legal restraints.

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