BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date May 29, 1945

To Mr. Thurston

From Mr. Cherry

Subject: Hearings before the House Small Business Committee

Secretary Wallace testified this morning. In general, he endorsed the recommendations of the Small Business Advisory Committee of the Department of Commerce which recommended the development of a system by which the Government would guarantee long-term loans made by private financing institutions and also a modification of the tax provisions.

He commended for worthy consideration Senator Mead's proposed Industrial Loan Corporation; the Investment Bankers Association plan for establishment of local investment companies; and the plan of Mr. Rudolph L. Weissman, who proposes a Federal Reserve Investment Corporation integrated into the Federal Reserve System.

During brief questioning he advocated Government insurance of credits to small business up to 90 per cent, modeled along the lines of F.H.A. He said there was no difference in principle in insuring a loan to a small business and insuring a loan on a house.

Mr. Wallace will return to the Committee tomorrow morning at 10 o'clock for further questioning.

MCC

Statement by Hon. Henry A. Wallace
before the House Select Committee on Small
Business, May 29, 1945.

When we consider the problems of small business, we are dealing with a very large segment of the business community from the points of view of numbers of establishments and of total numbers of workers employed. About ninety-six percent of business establishments in this country employ fewer than twenty workers. Together these firms account for over one-third of all workers in manufacturing and commerce. My interest in small business is not based on any antipathy toward large business as such; for I fully realize that, in some fields, production can be carried on economically only by operating on a large scale. Rather, a sound basis for our conviction is that America needs small business. When it is no longer possible for small business to be launched, to grow, and to maintain its independence, it will be no longer possible for our economy of free enterprise to survive.

Small business injects into the blood stream of industry and commerce the health-giving properties of free competition. Free competition is the great regulatory agency which ideally causes industry and trade to adapt themselves to social purposes. As free competition disappears from our economy, its place is inevitably taken by government regulation. Complete disappearance of free competition, then, means eventually complete regulatory control by the state with all the dangers that implies to the continuance of the ideals of American democracy.

In order to encourage small business, it is not necessary to give it special subsidies or privileges. In the past, small business has shown great persistence even under somewhat unfavorable circumstances. I am convinced that in many fields small business, if given the chance, can compete on a sound basis with larger firms; while in other fields - notably certain retail and service trades - affairs can be carried on more economically by small firms than by large enterprises. There are many fields in which the lowest average operating costs are reached fairly low down in the scale of production. This is the grear fertile field of small business and one in which it can operate under favorable circumstances, if no artificial burdens are imposed.

But unfortunately, small business, even in the fields to which it is best adapted, is meeting difficult problems. The recently formed Small Business Advisory Committee to the Department of Commerce in its first session stressed the financial and tax problems of small business as foremost among their current difficulties. The problems of finance and taxation are closely related. For example, some of the problems arise because the present tax structure tends to prevent business from ploughing back earnings. Since small business firms cannot appeal successfully to the money market for funds, opportunities for such companies to grow at the present time are greatly restricted. Keeping the interrelationship of finance and tax problems in mind and remembering that the solution of either problem helps to ease the other, I shall for purposes of presentation deal first with the finance problem and then with the difficulties arising out of the tax structure.

It is generally recognized that small business is handicapped by lack of adequate sources of credit and of equity capital. Traditionally small business depended largely upon informal methods of obtaining long-term funds - the savings of those intimately connected with the business, the earnings ploughed back into the firm, and the investments of local persons.

In addition, banks supplied small business not only with short-term credit but also, to an important degree, with intermediate and even long-term credit.

Changes which have taken place over a period of years, however, have tended to dry up some of these sources of funds, while the need for credit and capital by small business has increased. The development of organized money markets and the extension of interest in, and knowledge of them, have made it possible for local investors to obtain marketability and diversification of investments by purchasing securities in the big money markets. Small companies normally cannot use the organized exchanges as sources for funds because of the high cost of floating small issues and the high return which must be offered in order to sell their securities, if, indeed, they could be sold at all. For a number of reasons the banks are no longer willing to grant loans for capital purposes in volume comparable to that outstanding before 1929.

While these changes have been operating to dry up outside sources of funds for small business, recent tax provisions have made it more difficult for such firms to grow through ploughing back profits. In the meantime, modern methods of conducting business and increased mechanisation have raised the amount of capital needed to launch many businesses, particularly the small incorporated ones. Unless we can, therefore, provide some sound means by which small companies can obtain outside funds on a long-term basis, our competitive system will be weakened.

Recognizing these problems, the Small Business Advisory Committee of the Department of Commerce recommended the development of a system by which the government would guarantee long-term loans made by private financing institutions.

The Committee's report reads in part as follows:

"The Committee recommends Government guarantee of long-term loans made by private financing institutions, as a means of providing capital financing to new and established small business enterprises. The guaranteeing agency should stand ready to take over a major portion of such loans whenever necessary ot desirable. Commercial banks and other local financing agencies that originate the long-term loans should be required to participate at least to the extent of 10 percent. This basic method of financing has already been proven effective by the Federal Reserve Banks, the Reconstruction Finance Corporation, and the Smaller War Plants Corporation. The procedure permits the local financing institution to make long-term loans without assuming undue risks or sacrificing necessary liquidity, and it permits the Government to assure the requisite financial assistance without going into intimate detail on the prospects of individual companies.

"A special type of term loan should be developed for the long-term financing of small business. Adequate provisions should be established for amortization of the loan, but the Committee emphasizes the necessity for flexibility in these and other provisions. The interest rate charged should be as low as is consistent with economic conditions. Loans for at least 10 or 15 years should be contemplated.

"Collateral for the proposed term loans should be such as to leave receivables, inventories, and other current assets unencumbered so that a basis is left for obtaining seasonal short-term credit. The guaranteeing agency should provide standard loan contracts, with minimum specifications."

The proposed plan must be considered as a temporary expedient only, to provide a ready means of financing in the period of conversion to peace-time production. It is a plan which could be put into operation almost over night, once suitable legislation is enacted. It does not attempt to supplant, and only if necessary will it supplement, existing sources of credit with government funds; it provides primarily insurance which should permit the personnel of existing banking institutions, already familiar with local needs, to act with greater confidence.

For the long run, institutions which can provide not only loan capital but also equity capital must be established.

In general, small business has low fixed assets in comparison to its volume of sales and long-time loan capital extended on any reasonable basis must, therefore, always be limited. Furthermore, from the point of view of the typical small firm, a large fixed debt is undesirable. Since the earnings of such a firm fluctuate within wide limits, the presence of a large debt, however flexible its governing provisions, may create problems which the management can never solve. The need for outside sources of equity capital is clearly indicated.

Much constructive thought has been given to this problem and recent proposals are definitely steps in the right direction. Senator Mead's proposed Industrial Loan Corporation would not only be empowered to make loans but would also be permitted to acquire preferred and common stock of businesses desiring to obtain equity capital. Related in some respects to Senator Mead's proposal is the plan of the Investment Bankers Association for establishment of Local Investment Companies, which in addition to a lending function would also permit the purchase of preferred and common stocks. Another plan worthy of consideration is that of Mr. Rudolph L. Weissman, who proposes a Federal Reserve Investment Corporation. This quasi-public corporation, integrated into the Federal Reserve System, would become a permanent part of our banking system and would have the power to make loans as well as to purchase preferred stock.

The whole problem of providing equity capital for small business is, of course, much more complex than that of providing loans. There is no shortage of savings. The job is only that of finding some suitable way of directing savings into the proper channels. We must now crystalize our thinking into legislation.

Outstanding among the problems facing small business today is the question of taxation. We all subscribe to the general proposition that taxes must be high during the war period. But the present tax burden appears to rest with disproportionate weight on those small firms which are engaging in war production and which will have to face the problem of converting to peace-time production. For such a firm, one war contract may represent a very large proportion of its total production and one cancellation would involve extensive readjustments in operation.

Hence, the impact of cutbacks and cancellations is likely to be much sharper for the small firm. A small company may be faced almost without warning with the necessity of converting its plants and productive processes, of developing new products, of regaining its old markets and of creating new ones. In general, small firms have not been able to prepare in advance for these changes. Many have not been abåe to maintain their sales organization or to keep open their regular distribution channels through goodwill advertising. Nor have they been able to engage in extensive research on new products. The risks which the small business runs in this conversion period will be relatively large, for their efforts must be concentrated on a few products and markets. Since they lack, then, the benefits of diversification which larger businesses in general enjoy, one mistake could have very serious consequences.

To summarize, small firms as compared to large business may be faced with the necessity of sudden conversion and their marketing problems and risks are likely to be very much greater.

All this means that small firms must have a great amount of liquid working capital, if they are to have at least an even chance of working out their conversion problems successfully. Even companies which by customary standards seem to have satisfactory liquid positions may find in reality that their liquid working capital falls far short of their needs. Sihce small firms can obtain outside funds, only with great difficulty and at relatively high rates, if at all, they must arrange largely to provide themselves with the necessary liquid capital out of profits. Unfortunately, current tax provisions tend to prevent these firms from accumulating such liquid funds, and modification seems necessary not only to permit small firms to plough back earnings but also to make available immediately certain funds which under present provisions would eventually be turned over to business concerns.

The Small Business Advisory Committee to the Department of Commerce has made specific recommendations for modifications of tax provisions, particularly those relating to the excess profits tax. In addition to the reasons for modification which I have already given, this tax is particularly burdensome to small companies which cannot establish satisfactory prewar earning averages or which have small capitalization in relation to business volume. The specific proposals made by the Advisory Committee fall in line with those made by many who have already testified before this Committee and require no elaboration. They are as follows:

1. Increase earnings exempt from excess profits tax from $10,000 to $25,000 effective January 1, 1946.

2. Repeal the excess profits tax effective at the beginning of the year following the end of hostilities with Japan.

3. Permit corporations to take their 10 percent excess profits tax credit for 1944 and subsequent years as a deduction against tax payments for those years.

4. Advance maturity of bonds representing 10 percent excess profits tax credit for 1941 through 1943 to January 1, 1946.

5. Modify immediately the carry-back provisions to permit postponement of current tax payments on the previous year's taxes to the amount of estimated refunds accruing under present provisions as the result of subnormal earnings or of current deficits.

6. Speed up refunds resulting from recomputation of the special five-year amortization provision for war facilities by providing that claims be allowed within ninety days from the date of filing. Allowances would be based on taxpayers' claims and returns and would be subject to recovery, if later shown to be erroneous.

These, of course, are proposals only for the immediate or near future. For the post-war period, the whole tax program has to be drastically revised. The tax burdens imposed on business must not be so great that they restrict expansion of production and employment; they must not discourage the opening and development of new and small business and they should have a minimum of influence on business decisions. As a corallory of this, the tax burden must not fall so heavily on any group as to affect substantially incentives to produce or to invest, or as to restrict unduly the demand for consumer goods.

This implies that we need a sweeping modification in business taxes following the war. It means also, however, that the whole question of an integrated system of corporate and personal taxes must be carefully reconsidered. We need to know much more about the impact of various types of taxes on our business economy. Provisions must be made for extending the period of time over which profits and losses may be offset for tax purposes for unincorporated and incorporated businesses.

Full consideration must be given to the need for greater flexibility in the treatment of depreciation and other charges.

Small businesses particularly must be given the right to reinvest earnings so that they may grow and develop.

America has a precious heritage in small business. We are just beginning to realize how precious it is and how deeply it is ingrained in our traditions and way of life. Yet, we may lose that heritage unless we take positive measures to preserve it.

In the postwar world, America's success in attaining full production and employment will be helped by these positive measures.
It is important then that we develop a financial mechanism which will meet the needs of small business for loan and equity capital and that we establish a tax structure which is fully tested with regard to its impact on small business. This Committee is to be congratulated for the clarity

with which it sees the problem and for its great work toward preserving our great economic heritage.

In this broad work of creating an environment favorable to small business the Department of Commerce pledges its full cooperation. The Small Business Advisory Committee to the Department of Commerce in its report has recommended an action program not only with respect to finance and taxation but also with respect to management aids. I ask permission to insert its report into the record. This recommended program will be followed insofar as the resources of the Department permit.

Important as they are, however, the recommended actions will not in themselves assure prosperity to small business. Such actions will help in setting the stage to enable small business to take full advantage of prosperous economic conditions. Prosperity for small business is fundamentally dependent on the continuing expansion of markets, achieved under conditions of full employment. For survival, no amount of specific aid can have the same beneficent effect on small business as that of customers with adequate income derived from regular employment.

If we are to give the maximum aid to small business, we must bring every effort to bear toward achieving the goal of full employment. and production.