

Mr Eccles

May 10, 1950

To: Board of Governors

Subject: Memorandum on Small Business
Problems

From: Woodlief Thomas

At a meeting of the Board on March 7, 1950 it was unanimously agreed that the staff should prepare a memorandum on the basic economic problems involved in small business financing, including the tax problem and other matters having a bearing on small business credit and capital requirements.

The attached memorandum has been prepared in response to the above and is herewith submitted for the Board's consideration.

W. T.

May 10, 1950

PROBLEMS OF SMALL BUSINESS

While small business is possessed of powerful resources in the form of initiative, independence and vitality, it is also handicapped by the complexities of present-day economic life. Broadly speaking, there are three areas of weakness in the small business picture. The first is management, including technical aids and services; the second is competitive inadequacy, particularly in dealing or competing with large concerns; the third is taxation and finance. Some small concerns encounter no particular difficulties in any of these areas, while some face difficulties of varied intensity in all three respects.

I. Special Problems of Small Business

A. Management and technical services

Because anyone who wishes may enter into business for himself, providing he is willing to stake his time and his resources on the venture, the population of small business men includes all varieties of talents, not only the fit and aggressive, but also the unfit. Among those who have survived for any period, however, the predominant type possesses at least average ability and initiative. He struggles earnestly with the many complex legal, accounting, labor, administrative, production, and marketing problems that confront him, and manages to solve enough of them satisfactorily to enable him to stay in business.

The range of technical skills with which the manager must be familiar is very broad, and includes, among other things, the following: taxation; labor and marketing law; quality and performance characteristics of materials and machines; design, installation and operation of accounting systems that will provide accurate information for cost-setting and control-purposes; and, preparation and submission of information required by government agencies, credit institutions, and other organizations. The small owner-manager, wrestling with these problems unaided, is definitely handicapped as compared with the large, established concern with its staff of hired specialists.

Rare indeed is the small business that can afford a full-time accountant, consulting engineer, industrial designer, market analyst, management counsel or other specialist. Yet the same problems with respect to coordination of buying, selling, and financing operations probably arise in the case of the small and large concern alike, although in different degrees.

In an effort to obtain more factual data on the reasons underlying small business financial difficulties, an analysis was made of the records of those small businesses which applied for emergency aid under the industrial loan program of the Federal Reserve Bank of New York during the 1930's^{1/}. This study revealed that small businesses born during the prosperous years of the 1920's earned good profits by providing a limited type of service or a specialized technical skill, or by serving a limited neighborhood market, which could not be handled as well by a larger concern. The owner typically was a highly skilled mechanic, engineer, or salesman, who had little use for accounting or financial administration--the "uninteresting" aspects of his business.

These concerns got into trouble during the depression years of the thirties, partly because of inattention to systematic details, such as analysis of receivables and checking of inventory turnover, and partly because of heavy dependence upon one specialized product or upon one large customer. To a large extent, it was the fault of management, rather than of inadequate financial resources or facilities, that placed these small concerns in the position of having to seek emergency financial assistance.

B. Competitive inequality

An additional competitive disadvantage of the small firm is that it cannot buy its raw materials and sell its finished product in large quantities, as the big firm can, nor realize the same economies of large-scale production. Its bargaining power in dealing with competitors and suppliers is not as strong as that of the larger company. Its fixed overhead costs, such as rent and interest payments, may be heavy in relation to the volume of sales and the level of probable future profits.

While it is true that small concerns often have an advantage in that they are somewhat more adaptable to changing economic conditions, they lack the stability which wider markets and greater diversification of products and services afford the larger companies. The small business concern is frequently able to curtail overhead expenses drastically in periods of declining sales and profits by the simple expedient of reducing the proprietor's salary or negotiating more favorable terms on a single bank loan or mortgage, but if the local market for its particular product or service declines, the small concern may find itself with no alternative source of income.

The growing complexities of modern business techniques, governmental as well as technical and financial, all increase the competitive hurdles which the small business must surmount. For

1/ Robert V. Rosa, "Small Business and Depression," Harvard Business Review, Vol. XXVI, January 1948, pp. 58-63.

instance, interstate and international trade barriers, labor union practices, collusive arrangements to limit competition, and other monopolistic practices and price concessions all tend to favor the large business concern at the expense of the small.

The effect of smallness itself places these concerns in an extremely vulnerable position. It is much more difficult for the small than for the large concern to forecast future trends, and to foresee probable developments in the markets for its raw materials as well as for its product. Most small applicants for loans are full of optimism concerning their own prospects, whether or not such optimism is justifiable.

They may regard additional financial aid as the solution to all their problems. They seldom take the trouble, or have the time, to match their costs or the performance of their materials, manpower, and equipment against standards of efficiency for the type and size of business concerned. The large concern, because it is big and because jobs are more specialized, pays more serious attention to all these details which will enhance its competitive position with large firms and, of course, with small firms.

C. Financing

Small business is generally at a disadvantage from the standpoint of financing, too, as compared with large, nationally known corporations. Costs of registering and marketing a small bond or stock issue are relatively much higher than those of marketing large security issues; there are less units over which to spread "lump-sum" costs.

The Securities and Exchange Commission has studied the cost of flotation by American listed corporations during the three-year period 1945-47. It found that costs were 21.91 per cent of proceeds for flotations smaller than 0.5 million dollars, but only 1.15 per cent for flotations greater than 50 million dollars. Considerably more selling effort is necessary in order to market the security of an unknown concern than that of a "big-name" business enterprise, whose credit standing is familiar to prospective investors. For these reasons, the investment banking houses usually regard a flotation smaller than one million dollars as an unprofitable one.

The cost of investigating credit applications and servicing small loans is also high in relation to the income received. The difficulties involved discourage large institutional investors from making loans to small credit-seekers; usually only the smaller local banks, with more limited financial resources, are interested in making small loans of this type.

The stage of a corporation's development, rather than its size, of course, may in part determine the amount and type of financial aid required. A new, growing firm may need more equity capital or financial backing to help set it on its feet than an older, somewhat larger firm. To illustrate, for a new firm, an equity investment of \$200,000 or more may be a small amount, relative to its rather large initial capital requirements. A loan of \$100,000, on the other hand, may be quite adequate to tide a somewhat larger, more mature concern over temporary difficulties.

II. Role of the Tax Structure

The tax structure is an additional source of discrimination against the small business enterprise. First, the present level and structure of corporate income tax rates reduces the amount of retained earnings available for reinvestment in the small business. Second, personal income tax levels may tend to discourage wealthy persons from purchasing common stocks of newly established concerns, because the net return after taxes may not be sufficiently great to compensate them for the additional risks involved. Third, inheritance and estate taxes have the disadvantage that they require substantial lump-sum tax payments upon the death of a small business owner or principal partner.

To illustrate the latter point, Federal estate taxes on a business with a net worth of one million dollars may amount to over \$300,000. The owner would have to save from \$10,000 to \$20,000 a year for from 15 to 30 years during his lifetime in order to build up liquid reserves sufficiently great to pay this amount after his death. As an alternative, the business can be sold for cash to another company, a procedure which is often followed. The result is consolidation of smaller firms into larger ones.

According to the Federal Trade Commission, more than 2,450 formerly independent manufacturing and mining companies disappeared during the period 1940-47 as a result of mergers and acquisitions. The average asset value of each company was a little over two million dollars. The combined pressure of income and estate taxes was undoubtedly instrumental in forcing independent owners of businesses of this size to sell out to the larger companies.

The O'Mahoney-Kefauver Bill, introduced into Congress on January 5, 1949, provides that no corporation engaged in inter-state commerce may acquire the assets of another corporation if the result will tend to create a monopoly or substantially to lessen competition. Indirectly, passage of the bill would strengthen our anti-trust laws and probably restrict the sale of small to larger business concerns. Discouraging consolidation is undoubtedly an important advantage of the measure; however, it might discourage the original formation of other concerns, to the extent that entrepreneurs are interested primarily in building up a business and in selling it later in order to realize capital gains on the venture.

A. Internal financing

The tax structure tends to retard expansion as well as to encourage combination of small firms. First, federal taxation tends to discourage the growth of small, independent firms from business retained earnings. Corporate earnings between \$25,000 and \$50,000 are taxed at a 53 per cent rate, while corporate income in excess of \$50,000 is taxed at a flat 38 per cent rate. It is true that the effective average rate of tax paid by smaller corporations whose incomes are below \$50,000 is always less than the 38 per cent flat rate paid by the larger corporations who earn more than that amount.

Nevertheless, the tax advantage of the small firm may be very slight compared to its initial financial handicap. Discrimination certainly exists against smaller companies who cannot attract funds for long-term capital requirements from outside the corporation, and who therefore must rely upon retained earnings for financing most of their growth. Merely to maintain its competitive position with other, larger firms, in fact, may require additional investment which retained earnings of the small firm are inadequate to cover.

Current tax provisions for carry-back and carry-forward of losses do not adequately consider the needs of small business, either. Businessmen may carry their losses forward and back for two years for purposes of computing their corporate tax liability, under present terms of the law. The difficulty is that the small firm usually requires more than two years before it can get on its feet and show profits.

The large company with a long record of satisfactory business earnings is far less likely to experience a long series of loss years. Even if it does lose money for any length of time, the large firm often has available financial reserves upon which it can draw in order to sustain any temporary losses. Its credit rating in the market and its ability to borrow needed funds in an emergency, if necessary, may be greater than that of the newly established enterprise.

B. External financing

Second, the tax structure probably restricts the supply of risk capital available to business from external sources. In the past, the bulk of the venture capital usually has been supplied by the well-to-do and higher-income groups. A wealthy person could well afford to take a chance on losing a part of his savings when he faced the desirable alternative of substantial appreciation in the value of the investment.

Today, a man with a net income of \$10,000 (after tax deductions and exemptions) must turn over to the Government at least 33 per cent of his gains in taxes. Loss offset provisions are not fully compensating in the opposite direction. In general, he can offset capital losses against capital gains or against other income up to \$1,000 for five years. Thus, a loss of \$25,000 might be fully offset if capital gains of \$25,000 were realized at the same time; otherwise, \$1,000 a year could be applied against future income for five years, a total loss offset of only \$5,000.

In addition, the stockholder's dividend income is taxed twice by the Federal Government, once at the source and once when it is distributed. In many states it is taxed by the State government as well. Multiple taxation of dividend income discriminates against the man who supplies risk capital. It may retard the growth of new firms because it tends to dry up the sources of venture funds.

The net return after taxes depends upon the original income level of the investor, as the table below illustrates. In comparison, it must be remembered that tax-exempt bonds of State and local governments yield two to three per cent and more. They therefore compete with common stocks for the savings of the well-to-do in the highest income brackets.

	\$10,000 income receiver	\$50,000 income receiver	\$200,000 income receiver
	<u>After deductions and exemptions</u>		
Stock investment	\$10,000	\$10,000	\$10,000
Corporation profits 10 per cent	1,000	1,000	1,000
Corporation tax	380	380	380
Profits distributed as dividends	620	620	620
Tax at top income bracket	205	409	508
Per cent	33	66	82
Net after tax	415	211	112
Net on investment (per cent)	4.15	2.11	1.12

Source: Report of the Subcommittee on Investment of the Joint Committee on the Economic Report, Volume and Stability of Private Investment (Washington, D. C., 1950), p. 30.

Another source of equity funds for business enterprise might be the savings of numerous small savers of only moderate means. Combined, these savings are currently very large. A larger part might be channeled into business enterprise if the savings institutions and insurance companies, who hold the bulk of these savings, were both permitted and willing to hold business equities. Unfortunately, this is not the case. Common stock holdings of these institutions are rigidly restricted by most states, and are often prohibited altogether by the combined weight of court decisions, custom, public preferences, and state law.

III. Role of Commercial Banks in Business Financing

Unlike individual investors and some financial institutions, the commercial banks cannot be expected to assume the risks of outright ownership of business enterprise. They may make loans to small business but should not ordinarily make equity investments directly. In general, bank credit needs of small business fall into two general types: (1) short- and intermediate-term loans for very small enterprises, and (2) long-term loans (to supplement outside equity capital) for small and medium-sized business concerns.

The commercial banks can and should supply short-term working capital credit needs of small and large business. Short-term funds for working capital purposes probably do exist in ample supply in the economy today. However, medium- and longer-term bank loans may be inadequate to supply all justifiable credit needs of small business. Until just recently, the local banker has usually failed to supply sufficient help to the new firm at the point where its financial requirements are for permanent or long-term capital funds.

New financing plans of the Chase National Bank and the National City Bank are examples of recent attempts to fill in this gap in the supply of medium- and long-term credit available to small business. The National City Bank announced that it would grant capital or term loans between \$1,000 and \$10,000 in size to "Help Small Business Grow Bigger." The loan may be for a term up to 36 months, or in special instances, up to 60 months, repayable on a monthly basis. Anyone engaged in business in New York City who can "readily demonstrate the capacity to repay" is welcome to apply to the Bank.

Similarly, the Chase National Bank has established a loan fund of 10 million dollars to be used in furnishing intermediate-term credit to small local business firms all over the country, in cooperation with local banks. The scheme differs from that of the National City Bank in the respect, first, that Chase's 3,700 correspondent banks (at least one of which is located in virtually every county in the 48 states) are active participants in the arrangement.

Loans must be made through the local banks, not directly through the Chase. The Chase Bank may agree, after a review period, to take up 90 per cent of the dollar amount of each loan. The Chase will allow the local bank one-half of 1 per cent as a service fee for handling the loan and will request for itself a minimum net interest rate of 4 1/2 per cent. Loans may be somewhat larger, too, under the Chase plan than under the National City plan; Chase will "participate" in loans up to a maximum amount of \$25,000.

These arrangements for supplying intermediate-term credit both have the advantage that they utilize the close contact which usually exists between small- and medium-term business concerns and their local commercial banks in the community. Because of this close association, the local banker can use his own knowledge of his customer's character and business abilities in screening loans and in appraising the applicant's credit-worthiness. These personal attributes of the loan candidate may be as important in judging the possible success or failure of the venture as the business' financial statements and its earnings prospects.

The local banker has long been accustomed to appraising the financial prospects of sound business concerns within the local area, including prospects of those firms which require additional long-term credit or equity capital. The local bank can well evaluate investment opportunities of a given firm on a basis of its detailed knowledge of local conditions, the business, and its management, even if the bank itself is not in a position alone to extend direct long-term aid to the business. This low cost credit administration and financial analysis cannot be duplicated elsewhere. Any proposed new institutions created to aid financing of small- and medium-size concerns should provide, therefore, for maximum utilization of the commercial banks' experience and their facilities.

IV. Other Small Business Financing Institutions

The lending experience and judgment of the commercial banking system is one aspect of the small business financing problem which should be considered thoroughly; the experience of the venture capital or investment companies already in existence may also throw light upon the general problems involved. Three such institutions currently in operation have been organized primarily to help the small and medium-sized enterprise: the Industrial Development Bank of Canada, the American Research and Development Corporation, and the Industrial and Commercial Finance Corporation, Ltd., of England. Though they are not precisely comparable, the form of these institutions is fairly similar, in terms of function and organization, to the types of investment companies envisaged in the O'Mahoney and Administration bills.

The Industrial Development Bank of Canada was organized in 1944 with an authorized capital of 25 million dollars subscribed entirely by the Bank of Canada. Its purpose is "to extend financial assistance to sound industrial enterprises which are unable to obtain their requirements from other sources on reasonable terms". The Bank operates chiefly in the medium and long-term credit field, making loans to, or purchasing bonds or equity shares of, Canadian industrial enterprises.

Its experience has been good. Current operating profits have been realized in every year of its operation. Its loans, investments, and guarantees have been primarily to small- and medium-sized industrial concerns, as was originally intended. To illustrate, of the total number of loans outstanding on September 30, 1949, 65 per cent represented loans of less than \$50,000; 84 per cent were for \$100,000 or less while 95 per cent were under \$200,000.

In addition, the financial affairs of several of its larger clients have improved to the point where they have been able to arrange for the public sale of their securities in the investment market. This trend is in line with the original purpose of the organization, which is to provide financial backing only until it can be obtained reasonably from the capital markets, or from outside private sources.

The record of the American Research and Development Corporation has also been good, although its activities have been on a more limited basis. A venture capital company, it was organized in 1946 by New England financial interests for the purpose of locating and developing new and promising enterprises. The corporation has become financially interested in eighteen new companies, in which its total investment is currently over 2 1/2 million dollars. All eighteen of the firms aided have been both relatively new and relatively small in size. Most of these companies are developing new scientific processes, such as rapid leather tanning processes, or manufacturing new types of equipment, such as instruments used in nuclear physics and radioactivity research.

Like the other two institutions, the Industrial and Commercial Finance Corporation of England was originated in 1945 to help small- and medium-sized business. However, in the last four years it has aided no more than 300 companies, and the size of the loans and investments has increased steadily since its inception. In 1949 only sixteen per cent of the loans and investments approved represented amounts of less than £20,000; one-half were in amounts greater than £50,000, most of them made, no doubt, to fairly large-sized firms.

Unquestionably, it is safer to loan money to the larger, well-known firms and especially to firms which have demonstrated through previous borrowing experience their capacity to repay. However, the provision of true venture capital inevitably must involve a certain amount of risk of loss. If private enterprise, the banks, and the financial organizations are not prepared or able to assume these risks, the quasi-governmental establishments formed for that specific purpose at least must not fall into the same trap of extreme caution. As experience demonstrates the pitfall of ultra-conservatism may ultimately destroy the basic purpose of a small-business financing organization.