UNREVISED

A STUDY AND INVESTIGATION OF THE NATIONAL DEFENSE PROGRAM IN ITS RELATION TO SMALL BUSINESS

HEARINGS

BEFORE THE

SELECT COMMITTEE TO CONDUCT A STUDY AND INVESTIGATION OF THE NATIONAL DEFENSE PROGRAM IN ITS RELATION TO SMALL BUSINESS IN THE UNITED STATES

HOUSE OF REPRESENTATIVES

SEVENTY-NINTH CONGRESS

FIRST SESSION

ON

H. Res. 64

A RESOLUTION AUTHORIZING AN INVESTIGATION OF THE NATIONAL DEFENSE PROGRAM IN ITS RELATION TO SMALL BUSINESS

PART 1

FINANCIAL PROBLEMS OF SMALL BUSINESS: I

WASHINGTON, D. C., MARCH 20 AND 21, 1945

Printed for the use of the Select Committee to Conduct a Study and Investigation of the National Defense Program in Its Relation to Small Business in the United States

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SPECIAL COMMITTEE TO CONDUCT A STUDY AND INVESTIGATION OF THE NATIONAL DEFENSE PROGRAM IN ITS RELATION TO SMALL BUSINESS IN THE UNITED STATES

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FINANCIAL PROBLEMS OF SMALL BUSINESS

TUESDAY, MARCH 20, 1945

House of Representatives,
Select Committee on Small Business,
Washington, D. C.

The select committee met, pursuant to notice, at 10:30 a. m., in room 1011, New House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman (chairman), Jackson, Kefauver, Hall, Ploeser, Howell, and Stevenson.

Also present: Representative Adolph J. Sabath and Dan W. Eastwood, chief investigator for the select committee.

The Chairman. The committee will come to order.

While the other committee members are coming in, I would like to read a statement that I prepared for this hearing.

We open today a series of committee hearings on the subject of financial problems of small business.

Naturally, we do not expect to cover this vast subject in the 3 days of hearing time we propose to use for this purpose during the present week.

We do hope, however, during the hearings this week, to receive testimony which will lay before us a rather broad picture of the manifold financial problems now confronting small business and likely to confront it in the immediate post-war period.

We have received numerous protests from small businessmen as to the adverse effect which the interpretation of our renegotiation laws have had upon their own establishments.

Contract termination problems have been called to our attention also, but possibly due to the fact that our war production economy is still running at full blast we have not received as many of these contract termination complaints as we have of another sort.

During the past 90 days, the Small Business Committee has received upward of 400 communications from individual small manufacturers and distributors protesting against certain provisions in our present tax laws or the manner in which these laws are construed by the Federal agencies. Such a volume of protest mail cannot go ignored by this committee which is specifically charged by the Congress with an investigation into the problems of small business. For that reason, we are prepared to hear testimony on that score if offered to us.

In June 1942 the Congress adopted the Smaller War Plants Corportion Act (Public Law 603) of which Senator Murray and I were the joint authors. This act was unanimously endorsed by both the House Small Business Committee and the Senate Small Business

Committee and was passed without opposition by both Houses of the Congress as a war emergency measure to aid small manufacturers.

Another bill of which Senator Murray and I were also the joint authors was adopted about that same time at the suggestion of the two small business committees. That bill provided that the R. F. C. could loan money on merchandise which had been frozen, the sale of which was forbidden except by special permission or a Government priority. The automobile dealers of this Nation have told us many times that this particular bill saved their industry from extinction and saved many of them personally from bankruptcy.

It is not too early for us now to once again look ahead to what will confront small business in the closing years of this terrible war and to try to visualize what financial problems these people will have to meet in the immediate difficult reconversion years which will follow the end of the war.

The Smaller War Plants Corporation has received much justifiable praise for its splendid contribution to the financial stability of our small manufacturers during wartime and for its other equally important services rendered in securing contracts for these small firms which could not afford salesmen and lobbyists here in Washington on their behalf during wartime.

We note, however, an increasing number of letters from those, especially those in the banking fraternity, who fear that the Congress may decide to continue the Smaller War Plants Corporation after the war as a permanent financing agency to aid small business. These objectors take the position that private financial institutions stand ready and willing to handle the job of financing all competent and qualified small business after the war; that continuance of a separate governmental agency for that purpose is not necessary; and that such an agency's operations after the war would have a detrimental effect upon their own institutional operations.

We hope and propose to hear testimony from these people during these or subsequent hearings on this subject.

First, however, we wish to hear from those who are close to the problems of the small manufacturer and the distributor and have had an opportunity to observe them first hand or through personal experience.

Later, when we have taken this testimony from individual businessmen and students of the small-business financial problem, we shall ask the banking profession and the officials of the various Government lending agencies to supply us with their views also.

I cannot refrain from calling attention at this time to a news article which I recently noticed which, to my mind, gives evidence of the contrasting financial subsidy bestowed upon large business in comparison with that granted to small business.

Every small businessman knows how difficult it is for him to prevail upon his banker to lend him working-capital funds for a period longer than the customary 90-day period. Every small businessman knows that his banker likes to be paid from 4 percent interest on upward for this accommodation.

For a small businessman to be granted a working-capital credit for as long as a year's duration or to be offered a bank loan to retire outstanding long-term indebtedness would be nothing short of a miracle.

Yet I noticed the other day that two large New York City banks had combined to make a loan of $4,000,000 to a large chain store at an interest rate of three-fourths of 1 percent. Now, this was not a short-term loan. It was made repayable over a period of 6 years with only token payments on account being asked for during the first five and a half years. Also, this was not, in the strictest sense of the word, a "working capital" loan. Its announced purpose was to enable the borrower to retire outstanding debentures which carried a much higher rate of interest.

I commend those New York City banks for making available this kind of long-term credit to business. I wonder, however, why it is that competent and qualified small firms cannot ever get this same kind of accommodation.

Several months ago, I was delighted to receive a prospectus from the American Bankers Association announcing the creation of the Post-War Small Business Credit Commission, an organization of member bankers to aid small business firms with their financial requirements. I have followed the progress of this enlightened movement with keen interest. I am hopeful that Mr. John M. Hanes, well-known banker and chairman of this commission, will give us the benefit of his thinking on this subject before these hearings are concluded entirely.

I have been distressed, however, to learn only recently that apparently small business is not taking advantage of this fine plan. At last reports coming to me only a week ago, I was amazed to learn that not a single loan application under this program was under consideration by the New York regional pool organized for this purpose which has an announced capital for small-business-loan purposes of $100,000,000.

I do not wish to presume further upon the time of the committee and our witnesses with my own personal views on this grave question, but I should like to point out in conclusion that we cannot ignore situations wherein our smaller firms are required to pay higher taxes proportionate to their net incomes than are their larger competitors; nor can we condone a situation where small business which is competent and qualified has to pay excessive interest rates for capital, working or otherwise, and cannot secure this working capital for long enough term periods to enable it to compete on an equal financial footing with larger firms.

If the Smaller War Plants Corporation has accomplished no other good end than to highlight the benefits which low interest rates and long-term working capital loans can bring to small business, it has, in my opinion, served an eminently useful purpose.

Whether we continue the existence of such an agency after the war depends, to my mind, largely upon the degree of sincere evidence that private financial institutions can present to the Congress as to their intent and willingness to really buckle down and take care of this vital job of small business financing.

The Congress will readjust the tax structure to aid small business as far as is humanly possible. Of that, I have no great doubt. The thing of which I personally want concrete assurance is that small business is to be given something more than mere lip service by private institutions in the matter of adequate financial assistance on fair rates and terms. In the absence of such assurance, I personally would favor the continuation of the Federal Government in the field of small business finance.

Mr. Hall, would you like to make a statement for the record on this hearing?

Mr. HALL. Mr. Chairman, I am happy that you have decided to hold these hearings at this time. It seems to me they are none too soon because I believe in June of this year the present law with respect to the Smaller War Plants Corporation expires and the Congress must take some action to extend the life of that Corporation before that time.

Personally, I have been a little bit alarmed by some of the legislation which was introduced last year pertaining to the Smaller War Plants Corporation. It seems to me that perhaps some of the members of the other House wanted to make the Smaller War Plants Corporation another sprawling bureaucracy. They did not want to keep it within the limits for which it was created by your first bill and if that bill, which was introduced last year, had passed we would simply have had another bureaucracy attempting to wet nurse small business in the United States.

I am certainly opposed to that and while I think we should continue the Corporation's existence, I do hope that some way can be worked out whereby private institutions will see the light and render financial assistance to small business.

I might say too, Mr. Chairman, that I compliment you on the work that has been done because there is no doubt in my mind that this committee and the committee in the Senate did bring about a situation in this country where the small plants did get a real share in the war manufacturing activities in the United States and by getting their chance to do that work they proved they were able and had the capacity to serve a real purpose and do real work in the war effort of the United States.

The CHAIRMAN. Before we hear our first witness, would you like to make a statement for the record, Mr. Kefauver?

First, however, may I say that what I have done I have done in the name of the committee. The bills introduced in my name were introduced at the request of the committee and I have enjoyed the fine cooperation of the members on both sides, Republicans and Democrats.

Mr. KEFAUVER. I wish to join with Mr. Hall in congratulating the chairman in beginning hearings on the active consideration of problems of financial assistance to small business. I think the situation is becoming acute and as time goes on, the problem will be even more acute.

But I have made the observation, Mr. Chairman, in connection with the contract-termination law, that I have had several small businesses that have had contracts to terminate and those contracts are not being paid as quickly as it was contemplated by Congress when the contract-termination law was passed.

There is also a place where either private or public institutions have got to step in and help the small businesses to bridge the gap.

I think it is quite well that this committee focus attention on the various and sundry problems that small businesses are going to have in further carrying out their part in the war effort and also in helping them to bridge the gap when they come to the point where their contracts are terminated and in getting reconverted back into private production.

I hope that the committee will give people in various parts of the country an opportunity to be heard on this most important problem.

I think that is all I have to say.

The CHAIRMAN. Mr. Ploeser, would you like to make a statement for the record before we call our first witness?

Mr. PLOESER. If I may, I will insert it in the record.

The CHAIRMAN. All right, sir, you may do that.

Mr. Jackson, do you have a statement?

Mr. JACKSON. At this time I would merely like to state that I want to concur in what has been said by my colleagues regarding the work of our chairman. I think he is to be complimented in taking up this subject matter at this time.

We are getting to the point very rapidly where small business will be facing a serious problem in connection with reconversion. As a matter of fact, in some particular fields of small business at this time they are right in the throes of reconversion. I think we have a wonderful opportunity and I want to congratulate the chairman in taking the initiative at this time.

The CHAIRMAN. I appreciate your kindly thoughts but the chairman is working with the committee and I am just carrying out your will and wishes.

Mr. JACKSON. I appreciate that.

The CHAIRMAN. Mr. Howell.

Mr. HOWELL. I will insert a statement in the record later.

The CHAIRMAN. Very well.

We are honored this morning by having in this hearing the dean of the House who has served longer than any other Member of the Congress and he is a real true and sincere friend of small business and always has been. He is the chairman of the Rules Committee of the House and is our good friend and I think if he wants to say anything we would like to hear from him first.

Mr. Sabath.

STATEMENT OF HON. ADOLPH J. SABATH, MEMBER OF CONGRESS FROM ILLINOIS

Mr. SABATH. Unfortunately I am not prepared for I have been attending another meeting.

The CHAIRMAN. That is all right. You may prepare and file anything you want to later.

Mr. SABATH. My attention was called to this meeting and I want to say that the House has real confidence in this committee and hopes and expects that you gentlemen will do everything in your power to aid small business. The big fellows do not need our assistance. They take care of themselves.

I would like to leave this thought with you, as to whether it would not be proper for the small businessmen to have an organization here or somewhere to look after their interests. I notice every day in the papers that the National Manufacturers Association and the Chamber of Commerce and others, through their organizations, are working. But the little fellow has very few friends, it seems to me, and he should organize and be able to bring forward his trials and tribulations. He needs assistance.

As to the reconversion, I will say this: that the big fellows are doing it now at the expense of the Government. They know how to go about it but the little fellow does not, so I am mighty glad that you have started and I know you will continue. You have a real task before you.

I want to congratulate you and I hope that you will go as far as you can in protecting the rights and interests of the helpless small business.

That is all I want to say.

The CHAIRMAN. Thank you. We appreciate your coming to the hearing.

Mr. Eastwood, will you introduce the first witness?

Mr. EASTWOOD. Mr. Chairman, the witness today is C. C. Fichtner, vice president and treasurer of the Wales-Strippit Corporation, Buffalo, N. Y. This is a successful small manufacturing concern that has made a fine record in war work.

Mr. Fichtner also at one time was with the Department of Commerce as head of the Division of Regional Economy and he is an economist and businessman, which is something of a rare combination.

Mr. Fichtner.

The CHAIRMAN. Mr. Fichtner, would you give your name and residence and official position to the reporter, please, for identification purposes?

STATEMENT OF CHARLES C. FICHTNER, VICE PRESIDENT AND TREASURER OF THE WALES-STRIPPIT CORPORATION, BUFFALO, N. Y.

Mr. FICHTNER. Mr. Chairman and members of the committee, my name is Charles C. Fichtner. I am vice president and treasurer of the Wales-Strippit Corporation of North Tonawanda with offices in Buffalo, N. Y. We manufacture sheet-metal fabricating equipment which, during the war, has found an important place in the aircraft industry.

The CHAIRMAN. Would you like to proceed first without interruption, or would you like for the committee members to interrogate you as you go along?

Mr. FICHTNER. As the committee desires.

The CHAIRMAN. Do you have a prepared statement?

Mr. FICHTNER. I have a statement, yes.

The CHAIRMAN. Suppose you proceed and if the committee members want to interrupt you and ask questions that will be all right.

Mr. FICHTNER. That will be all right.

The CHAIRMAN. Very well, please proceed.

Mr. FICHTNER. The views expressed at this hearing are the result of discussions with a number of manufacturers, bankers, and lawyers in the Buffalo area. To acknowledge their contributions I wish to insert a list of their names in the record, if I may.

The CHAIRMAN. Certainly you may have that privilege. That is the group you have been conferring with?

Mr. FICHTNER. Yes. We have had about three informal meetings to discuss these problems. I, however, assume full responsibility for my statements.

(The names referred to are as follows:)

Ralph M. Andrews, executive vice president, Buffalo Chamber of Commerce, Buffalo, N. Y.

Joseph A. Archbald, president, Jewett Refrigerator Co., 2 Letchworth Street, Buffalo, N. Y.

Chauncey Bacon, president, A. B. C. Welding Corporation, Niagara Falls, N. Y.

Ernest Becker, president, Sponge Aire Seat Co., Inc., 166 Chandler Street, Buffalo, N. Y.

James L. Burke, secretary-treasurer, Swift Lubricator Co., Elmira, N. Y.

Edward H. Butler, publisher, Buffalo Evening News, 218 Main Street, Buffalo, N. Y.

H. P. Faust, president, R. G. Wright Co., Inc., 2933 Main Street, Buffalo, N.Y.

Whitworth Ferguson, president, Ferguson Electric Construction Co., 204 Oak Street, Buffalo, N. Y.

Burton L. Gale, Jr., vice president, Manufacturers & Traders Trust Co., 284 Main Street, Buffalo, N. Y.

Thomas S. Hemenway, president, Metal Alloy & Specialties Co., Inc., 1875 Elmwood Avenue, Bufflao, N. Y.

Maynard G. Hess, manager, Friend Manufacturing Co., Gasport, N. Y.

Geoffrey J. Letchworth, Jr., assistant treasurer, Barcalo Manufacturing Co., 225 Louisiana Street, Buffalo, N. Y.

Robert Millonzi, attorney, Diebold & Diebold, 438 Main Street, Buffalo, N. Y. (director, Hub Industries; Smith Metal Co.; Ford Bros. Co.; Merritt Machinery Co.).

J. Eugene McMahon, attorney, 1028 Liberty Bank Building, Buffalo, N. Y. (Silver Creek Precision Corporation).

George A. Newbury, attorney, Babcock, Hollister, Newbury & Russ, M & T Trust Building, Buffalo, N. Y. (president, Buffalo Chamber of Commerce).

John R. Oishei, president, Trico Products Corporation, 817 Washington Street, Buffalo, N. Y.

Joseph B. Rittling, Rittling, Inc., 133 Elk Street, Buffalo, N. Y.

Thomas Spellers, president, General Engineering Co., 785 Hertel Avenue, Buffalo, N. Y.

Charles Turner, vice president, Buffalo Bolt Co., East Avenue, North Tonawanda, N. Y.

Herman J. Walz, vice president and treasurer, Walz & Krenzer, Rochester, N. Y.

Oliver A. Weppner, vice president, Marine Trust Co., Main and Seneca Streets, Buffalo, N. Y.

Neil Willard, president, Willard Machine Co., 73 Forest Avenue, Buffalo, N. Y.

Lyndon Wilson, vice president and treasurer, General Engineering Co., 785 Hertel Avenue, Buffalo, N. Y.

Mr. FICHTNER. Consideration of the problem of financing manufacturing enterprise of small and intermediate size is particularly important at this time because, after the war, the attainment of full employment must rely to a very considerable extent on these businesses. Small business has, as has been pointed out, seldom been able to satisfy its capital and credit needs adequately. Under wartime conditions, difficulties have been increased by high taxes, renegotiation "take away" and rising demands on fixed and working working capital.

The principal financial handicap of small business, it seems to me, is a shortage of investment or longer term capital. Indeed, one definition of a small manufacturing business is one that does not have ready access to the organized investment markets. This handicap has been growing because of the shrinkage in the disposition or supply of local private venture capital going into small business and the reduced margin of retainable profits available for reinvestment in the enterprise.

Historically, new small manufacturing enterprises in this country have been started by men with an idea, courage, and a small amount of personal savings. If the business succeeded, it grew by reinvestment of its profits. In the automobile industry, for example, it is said that 80 percent of the tangible capital originated in the earnings of the companies themselves.

Reinvestment of profits to supply investment capital is sound practice in a free competitive economy; the existence of a profit indicates a public demand for the goods and services produced. Business profit also proves an ability of management to produce those goods at a social cost in manpower, material, and equipment lower than the value placed upon those products by consumers. Socially, therefore, it is desirable to expand profitable businesses and to discourage or liquidate unprofitable businesses.

In the nineteenth century, business profits were high and industrial expansion was rapid. In recent decades, business profits have tended to decline with a consequent reduction in the ability of small business to finance itself. Smaller businesses, moreover, appear in fields where entry requires little capital and hence where severe competition results in more pressure on profit margins. At the same time, the problem of narrowing profit margins, or operating losses, can frequently be solved by reducing costs through increased mechanization. Thus, there has been witnessed a rising amount of investment per factory worker and per unit output. To achieve that economy, however, funds must first be obtained. Access to cost-reducing investment is more readily available to large concerns than to lesser known smaller plants. Consequently, there has developed a vicious cycle bearing heavily against the smaller manufacturer through no fault of his own.

Local sources of outside capital have also tended to dry up. The consequences of the 1929 crash in security values, and of tax laws, have made local capitalists reluctant to commit funds to new manufacturing enterprises. The investments in small plants are not marketable; the prospect of even large profits becomes a minor inducement to a rich man in an era of high personal tax rates. Local securities dealers since 1929 have disappeared in major proportions. The national investment banking machinery of Wall Street, as is well known, cannot afford to underwrite and sell small issues.

Commercial bank credit, on the other hand, has been more readily available to small firms. Nonetheless, even in this field, small firms have paid a higher rate of interest and have been denied credit with a higher degree of frequency than larger firms. There are adequate reasons for that denial of credit at low rates in many cases. Many small firms have tended to misuse commercial bank credits for fixed asset purposes. Again, the higher costs of servicing smaller loans, the higher risks that are inherent in smaller enterprises and the understandable desire of bankers for a high degree of liquidity have all been deterrents. On the other hand, the denial of commercial loans to small business in certain instances has not been related to their credit rating. The denial has probably been due to the inability of the small business to present its case in an accurate light, to the conservatism of the bank or its lack of vision as to the future potentialities of a particular new business and probably also to undue fear of bank-examiner criticism.

Any solution to the financial problems of small manufacturing enterprise must make substantial amounts of investment capital available to small firms after the war without, at the same time, encouraging inefficient enterprises. The solution should not involve the Government unnecessarily in direct financing or in the administration of industrial properties. The solution, whatever it may be, must avoid duplication of services now available in existing financial institutions.

It is needless to point out to the members of this committee the various financial needs of the typical small business. Working capital, intermediate capital, and long-term capital are well understood types of funds and the broad classes of their sources, equity or ownership money, as contrasted with borrowed money, are familiar concepts. As to sources, I think it is highly desirable that the management of a business have a real choice between equity financing on the one hand and borrowing money on the other. If it is a business which is vulnerable to the ups and downs of the business cycle, as are so many small manufacturing concerns, particularly in the metal-working field such as my company where we are either prince or pauper, the company might wish and probably should obtain funds for expansion solely through the issue of stocks, common or preferred.

On the other hand, there is a situation in which a controlling ownership of a company does not wish to lose control by selling voting stock. In order to retain control, an undue amount of borrowing may unbalance the capital structure. There is an excellent study on that subject published by the Harvard Business School on the Polaroid Corporation. The financial policy of that company has been based on a desire to retain freedom of action by the management of the company. The men who projected the company, seeing in it tremendous possibilities of future growth, naturally wish to capitalize on their early labors.

If private enterprise is to be encouraged, financial and tax controls should not force such concerns to remain small merely to retain control and thus to deny to the consuming public an abundance of new products at low cost.

To repeat, the financial problem of smaller and intermediate size manufacturers seems to be one of acquiring and maintaining adequate investment capital in the business. The problem is not of public interest merely because of concern for manufacturers as individuals. It is of public interest, however, in terms of full employment, in terms of an expanding economy which can come only from a high rate of new investment in sound ventures, and in terms of maximum production of consumers' and producers' goods at steadily lower prices.

The four major sources historically of investment capital are (1) local banks; (2) sale of securities; (3) local private capital, and (4) reinvestment of earnings. These sources are now either restricted or closed to small business. It does not seem practical under present conditions to seek to reopen all these sources.

Our banking system in the past has done much to build our industrial system by making capital loans but at a terrific cost to the public in the form of bank panics and periodic financial collapse resulting from frozen assets. The furnishing of investment capital by commercial banks directly, or indirectly by loans on securities, is held by many to be outside their proper functions. So far as working capital loans to finance pay rolls, inventories, and receivables are concerned, it is reasonable to expect that commercial banks can and will fully service all worthy enterprises, large and small. It should be emphasized, however, that short term bank credit is not the major financial need of smaller manufacturers, except possibly in isolated cases.

Public sale of securities through the Wall Street investment banking machinery can supply investment funds only when the business has grown to a size beyond that of the class of business with which we are here concerned.

As to the second source, there has been too much romanticism about starting a small business and rapidly expanding it to the point that it earns a Wall Street connection. That has been the Horatio Alger story of small business in this country, not substantiated by too many actual cases. Many otherwise promising enterprises are wrecked upon the rocks of inadequate financial reserves in storms of depression before they reach the size necessary to command investment banker connections.

Mechanics, engineers, entrepreneurs will continue to launch businesses on their savings. Revival of outside local investment in new small business to supplement these personal savings can probably be greatly stimulated only by tax revision. The wealthy individual today can probably make more net with much greater safety by a highly conservative investment that he can by investing in a small business that may possibly pay 20 percent dividends. The lack of marketability of investment in small concerns also lessens the present attractions of capital gains taxed at only 25 percent.

Finally, the major source of equity capital throughout American industrial history—reinvestment of earnings—also can be broadened only by tax revision. Therefore, the financial problem of smaller manufacturing would seem to reduce itself under existing conditions to the tax question and for the remainder of my time I should like to address myself to that subject.

The CHAIRMAN. Go right ahead, sir. We will be glad to have your views.

Mr. FICHTNER. The wartime tax structure, by severely taxing any increase in earnings above the pre-war average, has not permitted smaller industrial plants to strengthen their finances in a degree that would seem necessary to meet their post-war obligations. The present tax laws tend to prevent the birth and growth of small businesses. Thus, they tend to maintain pre-war competitive relationships and to remove the traditional challenge of new, growing enterprises to established business monopoly.

The Congress in the Revenue Act of 1942 recognized the need of special adjustments to offset the serious discriminatory effects on growing enterprises. Among the devices designed to alleviate discrimination were the 80 percent ceiling on total taxable income and the relief provisions of section 722. Even with these adjustments, however, the excess-profits tax treats smaller, growing enterprises more severely than large, established corporations.

It is important that small business be relieved of discriminatory burdens as soon as the war is over. The excess-profits tax should be repealed either immediately on the cessation of hostilities or a short time thereafter. After the defeat of Germany, for example, the date of repeal could be specified in advance as becoming effective, say, with the cessation of hostilities with Japan.

During this interim post-war period, the excess-profits tax should be revised in order to lighten the burden on small, growing enterprises. These revisions should probably include (1) a decrease in the excess-profits tax rate, and (2) an increase in the specific credit from the present level of $10,000 to $25,000.

In addition to these revisions, other modifications in the tax structure are needed to encourage the formation and growth of small businesses. For purposes of discussion these proposed modifications may be summarized under two headings: (1) Revisions applying particularly to the period of transition from war production to peacetime production; and (2) revisions designed to aid small business after the transition to peacetime production has been completed.

TAX REVISIONS TO FACILITATE THE TRANSITION FROM WAR TO PEACETIME PRODUCTION

Large numbers of small businesses will be confronted with acute cash and working capital shortages immediately on the cessation of their war production. A study of the National Industrial Conference Board of the metal trades companies shows a very serious situation in their working-capital position.

Unless steps are taken to provide liquid funds to these enterprises at this time, the transition period will be needlessly painful and protracted. At best, the resumption of peacetime production by many business enterprises, especially small enterprises, will be delayed. In some acute instances, shortages of funds may actually result in insolvency. These financial problems on the part of small businesses will, of course, have serious repercussions on the level of employment and national income during the transition period. In the interest of maintaining independent enterprise, it would seem preferable that corporations be allowed to establish post-war reserves through wise tax revision rather than throw too heavy a burden of financing small business on the Government.

The post-war financial problems of business have not been ignored by the Congress. The present tax law contains several provisions which can be utilized after the war to provide cash and working capital. Most important among these provisions are (1) the carry-backs of net operating losses and unused excess-profits credits, and (2) the post-war refund of 10 percent of excess-profits taxes.

CARRY-BACK PROVISIONS

The carry-back provisions are designed both to alleviate the inequities of the annual accounting period on the basis of which income and excess-profits taxes are levied and to provide business with the reserves needed for the transition to peacetime production. They allow losses and deficiencies in income below a corporation's normal profits allowance under the excess-profits tax to be carried back and offset against income and excess profits earned in the two preceding years. Any taxes paid on income and excess profits, so offset in the preceding 2 years are refunded to the taxpayer. Thus, in effect, the wartime tax burden is levied on the income of a period of years rather than on the income of a single year.

The carry-backs are of great potential value to all businesses with fluctuating incomes or with serious reconversion problems. Since the incomes of small business tend to fluctuate more over a much wider range than those of large corporations—they do not have the stability resulting from diversification of sources of income—the carry-backs will be of particular value to small enterprises. In their present form, however, they contain one, and possibly a second, crippling defect.

Under the existing law the carry-back refunds will not be made with sufficient promptness to relieve the working capital stringencies that will confront thousands of small firms in the acute transition years. The present law provides that the taxpayer may file a claim for a carry-back refund at the time he files his tax return showing a loss or an unused profits credit.

Thus, the claim for a refund on a loss or unused credit incurred in, say, 1945, ordinarily would not be submitted until March 1946. The refund ordinarily would not be received by the taxpayer until some indefinite period after March 1946, even though the taxpayer would need the refund to offset his losses and abnormal reconversion expenditures during 1945. The receipt of funds might be 12 or 18 months after the need for them.

The delay in making these refunds, which is inevitable under the present law, may be a matter of life and death to many small businesses.

The seriousness of this situation is currently recognized. Recent reports indicate that the problem is being seriously considered both by the Joint Committee on Internal Revenue Taxation and by the technical staff of the Treasury Department. Indeed, the Treasury has already made informal recommendations for legislation to alleviate working capital shortages resulting from delayed refunds under the carry-back provisions. The Treasury has proposed that taxpayers accumulating deficits or subnormal earnings be allowed to postpone current tax payments in the amount of their estimated refunds accruing under the carry-back provisions as a result of current deficits or subnormal earnings.

That is, if a taxpayer suffers a deficit in 1945, he would be allowed, under this proposal, to postpone payments on his 1944 tax liabilities, which payments would ordinarily be made in 1945, up to the estimated amount of his currently accruing carry-back refund.

The effect, of course, would be to permit him to retain cash in the business.

The enactment of this recommendation in the immediate future is urgently recommended. Most industry groups which have studied the problem have recommended this revision; it also has, I believe, the support of organized labor and agriculture. It is also urged that if the revision is to be of maximum benefit to small businesses, such businesses must be given adequate assurance that all reasonable requests for postponement of tax payments under the proposed revision will be granted in the field. As in most areas of Federal taxation, the administration and regulation of the tax law in the field must be based on an understanding of special financial needs of small business if such provision is to be helpful.

A corollary of this recommendation would be to incorporate the loss carry-back principle into the Renegotiation Act for a period extending back to April 28, 1942, and to continue until the transition period is completed. Although renegotiation is not a part of the tax law, smaller manufacturers on war production have probably suffered more in a marginal sense through renegotiation procedures, deemed by many to be arbitrary, than from the excess-profits tax.

This is particularly true in industries subject to wide fluctuations of earnings over a period of years, a phenomenon which is characteristic of smaller industrial units. The failure to give adequate consideration to this factor in renegotiation determinations has made many small enterprises vulnerable to the recessions which will come in the transition period.

Figures on renegotiation are not published but from available information it would seem that profits after renegotiation but before taxes are slightly lower on the smaller firms than on the larger firms. This fact would indicate that, in general, in adequate consideration has been given to the more widely fluctuating income of the small manufacturers in renegotiation.

"Excessive profits" taken away by renegotiation will in many cases prove not to have been profits at all after the costs, properly chargeable to wartime income, have been realized.

Mr. KEFAUVER. Excuse me, sir. You mean the percentage of profits? That is what you referred to?

Mr. FICHTNER. The profits on sales after renegotiation take-away but before taxes is the percent I had in mind. There is not a great difference in net remaining but the percent left to the smaller group is slightly less than that left to the larger. The reasons may be that the principles used in applying renegotiation assessments are somewhat similar to those used in determining the excess-profits tax, namely, the amount of capital invested or pre-war average earnings. Both of those criteria for the judging of excessive profits seem to me inherently to discriminate against the smaller concern.

The smaller manufacturers produce by use of labor and management ingenuity rather than by a large amount of capital assets. He does not have, therefore, as large an invested capital base relative to sales as the large concern. Similarly, before the war, the record shows that the small manufacturer had a much lower level of earnings, both absolutely and relatively, than the large manufacturer. By using pre-war standards the method of defining excess profits and excessive profits in renegotiation both naturally discriminate against the smaller enterprise.

Mr. HALL. Realizing Congress has placed a limit of $500,000, I believe it is, on renegotiation which is the ceiling below which they will not go, what percentage of small business in your mind is affected by renegotiation?

Mr. FICHTNER. There are quite a number of plants with less than 250 employees, which is one definition of small manufacturing, that produce more than $500,000 in sales and a large number of them with 500 employees or less which produce more than $500,000.

Mr. HALL. But certainly that limitation placed by Congress does eliminate a number of small businesses.

Mr. FICHTNER. That is correct.

Mr. HALL. I was wondering if you had any idea how many are eliminated?

Mr. FICHTNER. The higher exemption has been very helpful in 1943 and 1944 as contrasted with 1942 to the smallest manufacturers.

Mr. HALL. I asked that because you are stressing the renegotiation problem and I agree with you, but it seems to me that a tremendous amount of small business is not affected by that at all.

Mr. FICHTNER. Not since the exemption of $500,000. There remain thousands of small manufacturers still subject to renegotiation who will be faced with inadequate reserves to prepare for post-war reconversion.

The impairment of reserves by renegotiation is particularly a problem in the machine-tool industry which is an industry of relatively small units. It is a problem because such companies tend to fall in the prince or pauper category. We have, during the war years, produced in this country about 850,000 machine-tool units, or more than we would normally produce in 15 or 20 years of normal production. It is not known what the market for machine tools is going to be after the war but there is considerable fear expressed that the machine-tool industry may have sold itself out of a market for the next decade.

If machinery companies are negotiated down to an 8- or 9-percent base, which is a typical figure before taxes, many are not going to have the reserves to carry them through. It is short-sighted statesmanship to crucify the machine-tool industry in that manner because, as we have seen in this war, it is our first line of defense in modern warfare, no less important than our Navy. Without machine tools, a nation cannot be strong in a military sense. As a matter of national defense, we should adopt policies to preserve and foster our machine-tool industry and they have been conspicuous sufferers under renegotiation.

Mr. HALL. I am wondering, Mr. Chairman, if there is not some way we could find out how many war plants come within the limitation of $500,000.

The CHAIRMAN. We will make an effort to determine that.

Mr. EASTWOOD. Can you find out for us, Mr. Fichtner—or we can undertake to find it out ourselves.

Mr. FICHTNER. The Price Adjustment Board, in charge of renegotiation, is reluctant to supply figures to contractors but it would be helpful to know what the experience has been by various industries and by size groups within each industry.

Mr. PLOESER. Mr. Fichtner, if it is any addition to your statement which I think is very interesting and informative, I can remember back in 1938 and 1939, just prior to war, when friends of mine who were trying to finance in the machine-tool industry simply could not get any help at all; and yet that became the core on which we built our entire defense and, as we all know, the machine-tool industry had to be virtually financed by the Government through contract support.

It seems to me there is a great danger of returning quickly to that same status.

Mr. FICHTNER. The same observation might apply to the tool and die industry. During the 1930's, the number of skilled workers in that industry tended to diminish. New apprentices did not tend to come in and we are still suffering from that shortage. It is to be hoped that our vocational education programs will never permit that class of skilled worker again to decline to a dangerously low level in terms of national defense.

The second potential defect in the carry-back provisions is the danger that they may be repealed before the transition period has ended. A repeal of these provisions prior to this time would have disastrous effects on many small enterprises.

THE POST-WAR REFUND OF 10 PERCENT OF EXCESS-PROFITS TAXES

The post-war refund of 10 percent of excess-profits taxes suffers from a defect similar in nature to that of the carry-back provisions. The taxpayer is now authorized to receive a certificate or bond representing his right to this refund. But these bonds are nonnegotiable until the cessation of hostilities, and mature in a staggered number of years thereafter. Consequently, they will be of no help in meeting working-capital problems until the official declaration of the cessation of hostilities. For many firms, however, reconversion problems will arise before the war is over. Indeed such problems have already arisen for many small firms. I know of at least two firms in Buffalo that are in very serious financial shape as the result of cut-backs in January.

The working-capital problems of such enterprises could be solved in part if means were devised to provide ready cash in place of nonnegotiable post-war bonds to those firms which could demonstrate that their reconversion period had already begun. A revision of the tax law to make this possible has recently been reported to be under consideration by the Treasury and the Joint Committee on Internal Revenue Taxation. Such a revision is strongly recommended.

It should be noted that both of these recommended modifications in the tax law follow a single basic principle. They would make available to the taxpayer funds to which he has a clear right under the present law at a time these funds are needed. They would thus greatly facilitate a rapid transition to peacetime production. Moreover, their beneficial effects would be attained without leaving business vulnerable to the charge that it has benefited from hidden Government subsidies.

TAX REVISIONS DESIGNED TO AID SMALL BUSINESS AFTER THE TRANSITION PERIOD IS COMPLETED

Revisions under this heading can be divided into two categories: (1) General revisions in the tax structure needed to provide fair tax treatment to business income in general and to venture capital; and (2) special provisions designed to aid new enterprises and small businesses.

General revisions in the tax structure and in tax administration needed to provide fair tax treatment to business income in general and to venture capital can be presented in 11 points.

(1) The excess-profits tax should not be retained as part of the permanent peacetime tax structure. It should be repealed either on the cessation of hostilities or shortly thereafter. If it is retained after the cessation of hostilities, adjustments should be made to lighten the burden of the tax on small, growing enterprises.

(2) The 2-year carry-back of unused excess-profits credits should be retained during the 2 taxable years following the war.

For many small corporations the period of transition following the war will be particularly hazardous and their survival may depend upon the immediate availability of funds and the adjustment of their tax burdens to allow for abnormal incomes.

Unless the Congress otherwise provides, the 2-year credit carry-back will expire with the repeal of the excess-profits tax. I was asked yesterday by a Government economist working on post-war plans which the metal trades would prefer, the repeal of the excess-profits tax together with the repeal of the 2-year carry-back or the retention of the excess-profits tax with the retention of the 2-year carry-back. That is, of course, an unwelcome choice.

What the metal industries would like to have is the repeal of the excess-profits tax with the retention of the carry-back. Forced to make the choice as presented, I think we should prefer to keep the excess-profits tax in order to have the 2-year carry-back, so important would that feature be to our post-war planning and to the fluctuating fortunes of the industry.

Mr. PLOESER. That is the last choice with you.

Mr. FICHTNER. That is the choice that would follow after the one that I am recommending.

Mr. PLOESER. That is the last resort.

Mr. FICHTNER. The last resort would be to repeal the carry-back.

Mr. PLOESER. I did not want your statement to be interpreted to mean that that would be acceptable.

Mr. FICHTNER. Thank, you, sir.

If this tax should be repealed before the post-war transition to peacetime production and marketing is completed, tragic consequences would ensue for numerous small enterprises if they could not take advantage of the unused credit carry-backs to which they are fairly entitled.

Moreover, many enterprises which would not exercise the privilege of the carry-back of unused credits, because their fears of subnormal incomes were not realized, would be encouraged boldly to plan for increased production, sales and employment. We hope not to have losses to carry back. With a contingent asset in the carry-back privilege, however, we would be encouraged to spend the necessary sums to rebuild our marketing organization to peacetime business. It is very comforting to know if you do go in the red that you have something against which to offset that loss although at the same time, you hope you do not realize the loss. It is a psychological buttress to confidence in forward business planning. It would be effective in assuring business expansion and full employment after the war.

(3) The capital-stock tax and declared value excess-profits tax should be repealed as soon as possible. There is no reason at all to wait. Loss of revenue to the Treasury is not significant and would automatically be offset by other tax revenue. These taxes place a discriminatory burden on the small business and are almost universally recognized as being inequitable and discriminatory.

(4) The corporate income tax—and here I depart from most publicized income-tax plans—should be retained with rates adjusted to post-war budgetary needs.

At moderate rates the tax will not retard the rise of small enterprises and would leave a reasonable income for reinvestment in the business. The present tax rates progress from 25 to 40 percent, reaching the maximum for corporations with incomes in excess of $50,000. These rates are onerous for smaller corporations struggling to accumulate reserves for future needs.

Moreover, with no access to capital markets, smaller concerns must depend on reinvestment of net earnings for growth. While no special exemptions for small business are recommended, the following illustrative graduated scale of rates applicable to all corporations can be recommended on the lower brackets of income.

Taxable corporate income:	Corporate tax rate (percent)
Up to $20,000	15
$20,000 to $39,999	20
$40,000 to $49,999	25
$60,000 to $79,999	30
$80,000 to $99,999	35
More than $100,000	40

I use the 40-percent rate because that is the rate now in effect and if it is fiscally possible, of course, the rate should be lowered. There is talk, I understand, of a 35 percent normal and surtax combination rate; 25 or 20 percent would be less restrictive to business expansion. Everything depends on Treasury estimates of yields. Small manufacturers, however, have more interest in a Government budget under control than in low rates, as such, attended by inflationary dangers.

Mr. PLOESER. I Do understand you to say you do not advocate exempting the low bracket, for instance possibly the first $20,000 of profit from any income tax at all?

Mr. FICHTNER. On the normal tax; no. I think small businesses want to pay their fair share of taxes. The exemption suggested earlier was on the excess-profits tax.

Mr. PLOESER. You do not advocate any exemption? It applies to the first earnings of any size business and does not apply only to small business?

Mr. FICHTNER. That is right.

Mr. PLOESER. It does become an incentive of small business?

Mr. FICHTNER. Taxes are part of the cost of carrying on a business and should be considered in that light. These suggested rates, of course, would apply to the incomes of all corporations, to General Motors and U. S. Steel as well as to smaller corporations. The graduated rates in the first $100,000 of corporate income would not be as significant to large concerns as to smaller companies.

Mr. PLOESER. That is right.

Mr. FICHTNER. (5) To eliminate so far as feasible, the so-called double taxation of dividends as corporate and as individual income, and to equalize the taxation of corporation and unincorporated enterprises, it is proposed that corporations should be given the privilege, to be exercised voluntarily, to be taxed as partnerships.

We have seen, during wartime taxation, when there was such a wide deviation between taxation on partnerships and on corporations a hasty and ill-considered movement to disincorporate and to assume the partnership form. The form of doing business should not depend so largely on tax avoidance. This suggestion would remove those inequities that recur with such changes in the tax law.

Mr. PLOESER. How would you make it optional?

Mr. FICHTNER. I recognize, of course, that in management-owned companies with only a limited number of stockholders would the exercise of the privilege be feasible. Therefore, it becomes a small and independent business recommendation. If it is tried in a large company with a large number of stockholders, some of whom are in a high personal income-tax bracket and others in a low income-tax bracket, it might precipitate controversy. Practically speaking, it becomes a privilege which would be exercised only by the smaller closely held corporations, and then only under certain conditions.

Mr. PLOESER. Do you want to apply that even where the corporation might have stockholders who were not active participants in the business?

Mr. FICHTNER. Yes; as stated, that would be the case.

Mr. HALL. Some of our biggest corporations are closely held. Would you grant them the same privilege?

Mr. FICHTNER. The rates on their income might be as great or greater taxed as a partnership as under corporate taxation, depending upon the tax structure after the war, the level of personal incomes, and the extent to which earnings were kept in the business. In any case, the law now permits a big business to be carried on as an individual enterprise or as a partnership if the owners choose those forms.

(6) The present carry-over of business losses should be lengthened to a period of at least 6 years. The purpose is to get away from the annual accounting period. Corporations might make big profits in, say, 2 or 3 years out of 10 and suffer losses the remainder of the decade. Unless business losses incurred in a given year can be carried forward and deducted from profits earned in subsequent years before these profits are taxed, effective tax rates over a period of years on enterprises with fluctuating incomes will be greatly in excess of the statutory tax rate.

(7) Greater flexibility should be allowed in charging off depreciation expenses and research and development costs.

Present Treasury regulations require a rigid allocation of depreciation charges and of many research and development expenses to specific accounting periods. Greater flexibility in writing off these items would have important beneficial effects in many business situations and would remove much friction in the administration of the tax law.

In a period of relatively stable tax rates, the interest of the Treasury would not be seriously harmed by greater flexibility in these respects so long as the total deductions are limited to the actual costs incurred by the taxpayer.

(8) The minimum individual income tax rate should be reduced to 15 percent or to about the level as the proposed minimum corporate tax rate. To encourage risk taking by individuals in the middle and upper income brackets, and to stimulate the free play of entrepreneurial ability by hope of adequate reward, rates in those brackets should be lowered as much as possible.

The total taxes collected from persons of high incomes are not a major but only a minor part of our total tax revenue but those are the people who can afford to assume the speculative risks of investment in new small business.

(9) Efforts to simplify the income tax and the withholding of taxes at the source should be continued. Attention should be directed at tax evasion in small businesses and professions characterized by cash transactions and inadequate records for tax audit.

(10) The determination and payment of tax refunds should be completed as quickly as possibly.

(11) Recognition should be given to the necessity of adequate salaries for the administration of smaller enterprises. The assumption of the administration of the law in the field seems to be that the size of salaries is logically to be correlated with the volume of business, which is unsound. In a large business with a high subdivision of executive labor, the administration of a narrow department or function may not require experience or judgment of a high order. In a small business, the executive may need rare judgment and experience in many functional fields.

Indeed, higher salaries might well be allowed for tax purposes for executives with multiple managerial functions in a small business than for executives with narrow functions in a highly organized, large-volume concern. Small concerns should not be placed at a disadvantage in securing managerial ability and other skills to meet their requirements.

The present environment which provides large salaries in large corporations is a seriously limiting factor in the launching of new enterprises by competent individuals. It is of social importance, if we decide that we want an active, small enterprise economy in this country, that the best talent in the Nation should not be unduly encouraged to direct itself to the large corporations because that is where the large salaries or large incomes exist.

I have been interested to learn that the Harvard Business School has taken a position on that. Dean Donham and Dean David both feel, I understand, that the tendency of their better men to seek jobs with the large corporations has not been in accord with the development of a spirit of venture on American business. Both of these gentlemen have now taken a very keen interest in anything that can be done to encourage the graduates of Harvard Business School to start small businesses on their own.

The CHAIRMAN. In connection with that and under the G. I. bill of rights, a number of veterans may pool their Government guaranties and loan privileges for the purpose of going into a small business.

For instance, suppose that they want to get up a concern with a million dollars' capital. Two hundred and fifty veterans could get together and they would have a borrowing capacity of $4,000 each or $1,000,000; and that would be a Government guaranty to the extent of one-half but, of course, they would have to have some kind of a working interest in the concern.

Can you not in that see some possibility of aiding these veterans in engaging in small business when they return?

Mr. FICHTNER. Veterans will no doubt start many new small businesses after the war and association together to raise capital is sound.

The CHAIRMAN. I do not think that has been given very much consideration. I have not seen anything about it in the newspapers or magazines.

Mr. FICHTNER. Very few types of manufacturing concerns could be started on $4,000.

The CHAIRMAN. I am talking about pooling it.

Mr. KEFAUVER. If ten of them get together, they can have $40,000.

Mr. FICHTNER. When you get that amount you can start a small manufacturing plant.

Mr. HALL. When you refer to restrictions, you are referring to the salaries they will allow when they go over your books?

Mr. FICHTNER. That is right.

There is another source of controversy with auditors in the field. So many small plants are controlled by the officers and directors who, therefore, vote salaries to themselves. Wherever that situation exists the auditor is naturally suspicious and begins to disallow salaries.

Mr. HALL. Are you speaking of your own auditor?

Mr. FICHTNER. No, I mean the Internal Revenue auditor. The same situation does not exist in large private concerns; salaries of hundreds of thousands of dollars to officers apparently are seldom questioned.

These revisions may not provide sufficient tax relief to permit the establishment and growth of small business on the scale needed to maintain adequate levels of employment and a healthy competitive structure in industry. If additional relief is needed, they could take several forms such as (1) a specific exemption from corporate taxes for newly formed, independent enterprises; (2) special tax relief limited to newly formed, independent businesses undertaking the development of radically new industrial innovations; and (3) special credits on individual income taxes designed to encourage persons in the upper income-tax brackets to assume the risks of equity investment in new enterprises.

The latter approach can be regarded as an alternative measure under control to the previous suggestion of lowering the high personal rates in the upper brackets.

All of these possibilities offer considerable attractions, but they also present substantial difficulties in administration, and I make no specific recommendations concerning them.

To summarize: Federal taxation has been weighted too heavily against risk-taking and against the birth and growth of smaller enterprises. The tax structure has become highly complex. It imposes burdens which smaller enterprise cannot long endure in time of peace. To provide a Federal tax environment in which smaller enterprise may have the opportunity to become established and grow to provide greater employment, invite investment and produce more goods at lower prices to consumers, fundamental revisions are required in the tax structure and in tax administration. Many small manufacturers complain that tax administration is their major difficulty because it is approached in the manner of a hunter seeking his quarry.

The tax program which I have proposed is, in the main, a post-war program. It is designed to provide meritorious small business with equity capital by reinvestment of earnings. Some of the elements could be introduced after the end of the German war and not wait for the cessation of hostilities with Japan.

Moreover, the taxpayers should be informed in advance of the essential features of taxation which will become effective after the end of the war so that they may plan their production and employment to accomplish the transition to peacetime conditions as smoothly and speedily as possible. Thank you.

The CHAIRMAN. Have you finished your statement, Mr. Fichtner?

Mr. FICHTNER. Yes, Mr. Chairman.

The CHAIRMAN. Thank you very much, Mr. Jackson?

Mr. JACKSON. Have you considered the effect of your tax proposals on the over-all tax picture after the war? It has been estimated, for instance, that our Budget will run between 20 and 25 billion dollars, speaking of the Budget of the Federal Government. Do you think that the reductions and modifications you have suggested will have a substantial effect on the amount of income that we will need for the operation of the Federal Government?

Mr. FICHTNER. Since the tax revenue is a product of rate times the income of business, I would hope that after a brief period the tax revenue product would be larger than if the tax rates were not adjusted.

In other words, with a vigorous, expanding economy, the Treasury revenue will be maximized. If the present high tax rates are retained, the Treasury, will not get the $25,000,000,000 you speak of.

The CHAIRMAN. I wonder if the witness can be back in the morning? Could you return conveniently tomorrow morning?

Mr. FICHTNER. Yes, Mr. Chairman.

The CHAIRMAN. I think a number of the committee members would like to ask questions, and if it would be agreeable to you, would it be agreeable for him to return tomorrow morning, Mr. Jackson?

Mr. JACKSON. Certainly.

The CHAIRMAN. Then we will recess at this time to meet promptly at 10:30 tomorrow morning and to adjourn at 11:45. That will give the members an opportunity to do their correspondence before they come here and time at the conclusion of the hearing to get to the floor of the House.

I have conferred with Mr. Hall, the ranking member on the minority side, and we think it will be all right to continue these hearings from day to day until we recess, beginning at 10:30 each day and adjourning at 11:45.

With that understanding, we will continue the hearings from day to day and if you will be back here tomorrow morning, Mr. Fichtner, we will appreciate it. Thank you for your very fine and comprehensive statement. It has been very instructive.

Mr. FICHTNER. Here is one item I would like to insert in the record. I have been doing some consulting work for the Smaller War Plants Corporation. Mr. Maverick wishes me to state that my expressions are my own personal views and that my statement is made by me personally and not on behalf of the Corporation.

The CHAIRMAN. All right, sir.

(Statement submitted by Mr. Fichtner is as follows:)

MARCH 19, 1945.

To: Mr. John Blair.
From: Maverick, Chairman and General Manager.
Subject: Mr. Fichtner's Statement on Tax Program.

Please see that Mr. Fichtner makes this simple statement when he testifies:

"I am a consultant of the Smaller War Plants Corporation and have done some research, but this represents my own personal views and this statement is being made personally and not on behalf of the Corporation."

FARRELL.

The CHAIRMAN. Without objection, we will stand in recess until 10:30 tomorrow morning.

(Whereupon, at 11:50 a. m., the committee adjourned until 10:30 a. m., Wednesday, March 21, 1945.)

FINANCIAL PROBLEMS OF SMALL BUSINESS

WEDNESDAY, MARCH 21, 1945

HOUSE OF REPRESENTATIVES,
SELECT COMMITTEE ON SMALL BUSINESS,
Washington, D. C.

The select committee met, pursuant to adjournment, at 10:30 a. m., in room 1011, New House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman (chairman), Kefauver, Keogh, Jackson, Hall, Howell, and Stevenson.

Also present: Dan W. Eastwood, chief investigator for the select committee.

The CHAIRMAN. Mr. Fichtner, did you want to supplement the statement you made yesterday?

Mr. FICHTNER. No, sir; I have no further statement.

The CHAIRMAN. Mr. Hall, would you like to ask some questions?

Mr. HALL. I was wondering, in the event you did not have renegotiation, wouldn't, under our present tax schedule, the Government take practically the same amount in taxes that they now take under renegotiation?

Mr. FICHTNER. That varies, of course, with the business. As I stated yesterday, the data on the whole subject of renegotiation are not available to draw accurate conclusions. There are so many small manufacturers in the metal-working trades that are paying the 95 excess-profits tax rate and reaching the 80-percent over-all limitation that it is true that taxes would take a major part of their excessive profits.

In our case, we made, as I recall, in 1943, 16.6 percent on sales. We, of course, are subject to the 80 percent rate. Then we were renegotiated down so that after taxes and renegotiation we had just about 2 percent on sales. In other words, taxes and renegotiation cut us from 16.6 to 2 cents on the dollar.

Mr. HALL. In your own case, did you figure out what would have happened if you did not have renegotiation and were just subject to the present tax rate?

Mr. FICHTNER. We would have 20 percent of 16.6, or 3.3 percent.

Mr. HALL. It would have allowed you about 1 percent more if you had not had renegotiation but had just taxes?

Mr. FICHTNER. That is right. That is not a serious cash drain. Being a small company, however, it took away about 15 percent of our equity capital and 10 percent of our working capital. After the tax credit the net repayment amounted to 10 percent of working capital and 15 percent of equity capital, which reflects my major thesis yesterday that small firms have difficulty in effecting reinvestment to build up post-war reserves to meet the possibility of a sharp recession in the readjustment period.

Another point, and one that is quite serious, is that in the process of renegotiation, the excess-profits tax base to which the company is entitled to carry back for 2 years is reduced by the amount of the excess profits on gross renegotiation determinations. That contingent asset is thereby greatly diminished and thus lessens the confidence with which management will make its future plans for the transition period. I think that is the most serious consequence to the small company's financial position in the renegotiation procedure.

Mr. HALL. Since yesterday, have you been able to make any determination as to how many of the smaller firms are not affected by renegotiation by reason of the ceiling of $500,000 put on by the Congress?

Mr. FICHTNER. I must have to talk off the record on that because these figures were supplied on that basis. However, I think the committee might well ask the Price Adjustment Board to supply data and if such data were supplied for public information with a break-down by industries and by size of companies within the industry, I am sure that most manufacturers would be very eager to study the information.

I have no reason to believe that renegotiation has not been conducted with the utmost fairness but the typical small manufacturer or at least those with whom I have discussed the subject, feel that in the exercise of this very drastic governmental power, there should be some objective standards to which management could compare its experience. They might be convinced that they were being treated fairly, if these standards were made known.

It may be that the renegotiation process has been eminently fair. I hesitate to say that it has not, generally speaking, but I do believe that the absence of objective standards has been disturbing.

Mr. HALL. The same rule of thumb, however, was used by the renegotiation people in all cases, was it not?

Mr. FICHTNER. There is a feeling among manufacturers in our area that some of the services are quite fair and others are quite tough.

Mr. HALL. In what way?

Mr. FICHTNER. That if one is renegotiated by one branch of the service the result is one set of figures; and if one deals with another branch of the service, the application of the power is much more extreme.

Mr. HALL. If you can, will you tell us just how these two different results are arrived at?

Mr. FICHTNER. As I understand it, the Renegotiation Act sets up a list of rather general criteria; the contribution that the companies have made in the war effort, the efficiency of the manufacturing process, the amount of risk taken, and so forth. Those are general criteria which must be interpreted with a large dose of horse sense, or judgment.

I think what most manufacturers would like to see is some percentage bracket set up, classified by industries within which those criteria would be applied. For example, the machine-tool industries traditionally have a rather wide profit margin, necessarily so because they experience wide fluctuations of business from year to year. Their profits in good years must be set aside as reserves to absorb losses in a long succession of bad years. If the machine-tool companies are regarded as earning an excessive profit in the war years and are renegotiated down to a "norm," they may have their losses to take for 4 or 5 bad years out of capital rather than reserves. The application of renegotiation is probably not so fair to such companies as in the case of a food manufacturer, for example, that has fairly steady earnings year after year over a long period of time.

In other words, it is a difference between a capital goods company and a consumers goods company.

Mr. HALL. And they use the same rule-of-thumb in applying the renegotiation in both cases?

Mr. FICHTNER. I should like to have more information as to just what the standards are. Many machinery manufacturers contend that renegotiation does not leave them with reserves needed by prudent management.

Mr. HALL. You said you had some figures to give off the record. Can you give us any idea of the percentage of small businesses which are not renegotiated by reason of the fact that the Congress put a ceiling of $500,000 below which the Government will not renegotiate?

Mr. KEFAUVER. Is this to be off the record?

Mr. HALL. The witness said he would like to give it off the record. As far as I am concerned, it can be on the record.

Mr. KEFAUVER. Mr. Fichtner, is there any reason why this information cannot be placed in the record?

Mr. FICHTNER. I think the clearance of the Price Adjustment Board should be obtained before any figures are published, because they were supplied as restricted material.

Mr. KEFAUVER. Then this will be off the record until we can get the necessary clearance.

(Discussion here off the record.)

Mr. KEFAUVER. Do you have any other questions, Mr. Hall?

Mr. HALL. No.

Mr. FICHTNER. It is my understanding that the renegotiation process does not attempt to take into consideration the fact that smaller companies might need additional reserves as compared to large companies after the war.

Mr. KEFAUVER. Do you have any question, Mr. Howell?

Mr. HOWELL. I was just wondering about this one point on which I am not exactly certain in my own mind. This $500,000 exemption that is given to small businesses, is that for a year's volume or on one specific contract?

Mr. FICHTNER. We supply equipment which is never ordered in lots of perhaps more than $75,000, so we are renegotiated on an over-all annual basis. Our separate contracts are not broken down. For companies supplying standard items at fixed prices it usually applies to the yearly volume of sales.

Mr. HOWELL. I have in mind a specific business that handles a series of contracts. The gross amount on one contract, we will say, was $125,000 and the next one was about $150,000 and I know that their experience in connection with renegotiation was just exactly as you have described it, a small business with very little working capital and a great need for reserves, and they were not permitted to set up anything in the way of reserves and furthermore, they were given to understand in advance that if the profit showed anything more than around 8 percent that they were certain to be renegotiated and so they used this power of renegotiation, to which you referred, more or less as a threat at the time the contracts were entered into. Therefore, if the small businessmen accept a contract in the performance of its public duty, the duty of the business to contribute all it can to the war effort, they make them accept those contracts almost solely on the basis of just performing it without any consideration as to the effect it is going to have on their business in the years to come.

Mr. FICHTNER. Does it not come down to the theory of what is profit? Profit, it seems to me, can never be judged in a brief space of time like 1 accounting year.

Mr. HOWELL. That is quite true.

Mr. FICHTNER. Therefore, what is being renegotiated away from many companies that are in the fluctuating capital goods field is something that may not be profit at all because when they go to the expense of getting back into peacetime production, the cost of which is properly chargeable to wartime operations, the renegotiation "take-away" will turn into a loss. Considering the whole war and readjustment period, there is not much doubt that "profit has been taken out of war." My fear is that many war producers will not break even and may go broke.

That is the reason that I proposed yesterday that some application of the theory of carry-back be applied to renegotiation so that if a company did lose heavily in getting back into peacetime production, these amounts in the way of excessive profits now seized annually by the renegotiators could be applied to those losses. If war producers do not sustain a loss then, of course, the Government would keep the renegotiation take-away, as it should, because profits have been proved excessive.

Mr. HOWELL. I quite agree with you on that theory because it is inaccurate, really, to limit these little companies to approximately 8 percent and I think generally that is the amount that is determined upon on any one contract or any series of contracts because of the very reason that you point out now and that you mentioned yesterday because you cannot call it a profit when their contracts cease and they begin to reconvert to peacetime production when they will probably disappear entirely and probably some effort should be made by the renegotiation agencies, as well as the Department of Internal Revenue, to provide some sort of cushion for these businesses. Otherwise, many of them might fail when they get into the reconversion period.

Mr. FICHTNER. Of course, 8 percent as a figure seems quite adequate as a profit. Most business would be gratified with 8 percent as a normal profit. The percent is before taxes and manufacturers now pay 80 percent taxes, leaving them with about 2 percent. It is difficult to build reserves on 2 percent to plan to make post-war jobs, even though no dividends are paid.

Mr. KEFAUVER. Gentlemen, we have several Members of Congress here and I want to say for your benefit we will give all of you gentlemen an opportunity to make a statement following this witness.

Mr. Stevenson, do you have any questions?

Mr. STEVENSON. I do not have any question; no.

Mr. KEFAUVER. Mr. Keogh?

Mr. KEOGH. No.

Mr. KEFAUVER. Mr. Eastwood?

Mr. EASTWOOD. I wonder if you could answer briefly this question. Yesterday you mentioned that Congress recognized the discriminatory effect on going enterprises of the Revenue Act of 1942 and that Congress inserted a relief provision to alleviate this discrimination by the provisions of section 722. What has been your experience with corporations who have applied for relief under section 722 by requesting equalizing adjustments of this base? Do you think that generally the Internal Revenue Bureau has been hesitant to provide this relief that Congress has provided, particularly for small firms? Can you answer that "Yes" or "No"?

Mr. FICHTNER. Quite a number of companies in the Buffalo are filed applications under section 722. We have filed one. Most of them have not had any relief as yet. I learned of one instance where a small refund was given but later it was called back because of some regulation in the administration of section 722.

I feel that the principle is eminently sound but up to the present time I do not think the relief obtained by small manufacturers has been significant. I am hopeful that in the future it might be more significant. After renegotiation, however, it should be pointed out that the area of excess profits to readjust become much smaller.

Mr. EASTWOOD. As you testified yesterday, the small firm does not have very much in the way of reserve and if these relief provisions were followed out it would be possible that it would not have to go into the capital markets to get much, if any, money if this had been expedited by the Treasury Department.

Mr. FICHTNER. It would have been very helpful. Small manufacturers will have to rely for long-term capital expansion pretty largely on tax adjustments. Section 722 is one. The points that I brought out yesterday are in addition because they not only give them a sound source of long-term capital but I think will attract to them a great deal of local capital which is not now forthcoming.

Mr. KEFAUVER. Mr. Fichtner, we have quite a number of questions that we wanted to ask you, and we greatly appreciate the study you have given the matter that this committee has under consideration. I wonder if we could submit these questions to you later and if you would answer any that you see fit or that you can answer.

Mr. FICHTNER. I will be glad to; yes.

Mr. KEFAUVER. I should like to ask you only one question, Mr. Fichtner, and that is this: You have explained the difficulty of small businesses securing long-term capital. Do you think the presently available means of capital for small businesses is going to be sufficient to enable small businesses to reconvert and get started in peacetime production without the necessity, in some cases, of having the assistance of some governmental loaning agency?

Mr. FICHTNER. I think the revision of the tax structure is crucial.

Mr. KEFAUVER. That is, of course, looking toward the future.

Mr. FICHTNER. If the tax structure is revised, I am rather confident that small business will be able to go ahead on its own to a large extent. There will be isolated cases, of course, and particularly in such matters as reconversion loans, where I think the Government will have to step into a very considerable extent. That is really a part of war finance in which the Government always has to take a large hand.

Mr. KEFAUVER. That is not strictly a long-term loan.

Mr. FICHTNER. No; that is simply unfreezing war inventories.

Mr. KEFAUVER. So, in the field of reconversion loans, you feel that the Government will have to supplement the existing facilities?

Mr. FICHTNER. By "reconversion loan," do you mean termination loans?

Mr. KEFAUVER. Termination loans.

Mr. FICHTNER. Yes. The present arrangement, I think, is quite essential to keep working capital from being frozen.

Mr. KEFAUVER. Mr. Fichtner, we are very grateful to you for being here, and the committee appreciates the time and attention you have given to the problem. Your testimony will be very valuable to the committee in its work.

Mr. FICHTNER. Thank you.

Mr. KEFAUVER. Gentlemen, before calling our next witness, we always like to give Members of Congress an opportunity to be heard whenever they can favor us with their attendance at the sessions of this committee. Mr. Bailey, a colleague from West Virginia, is present.

Mr. Bailey, did you have a statement to make?

Mr. BAILEY. Yes, Mr. Chairman. How much time might I have?

Mr. KEFAUVER. We have several witnesses. If you want to make an extended statement, we will see that it is inserted in the record; but how much time will your statement take?

Mr. BAILEY. I think about 15 or 20 minutes. I do not want to impose upon the committee.

Mr. KEFAUVER. Mr. Bailey, suppose you proceed, and then if we see that your statement is going to run too long, we can give you authority to extend your remarks in the record. How would that be?

Mr. BAILEY. It seems to me I have heard that expression before.

Mr. KEFAUVER. We have a number of other witnesses, but give us the high spots of your testimony.

STATEMENT OF HON. CLEVELAND BAILEY, A REPRESENTATIVE IN CONGRESS FROM WEST VIRGINIA

Mr. BAILEY. Mr. Chairman and gentlemen of the committee, I have for presentation to the committee today some three separate matters, one of them of Nation-wide importance and the other two might be considered as somewhat sectional.

The first matter that I wish to discuss is under the caption "The Little Businessman and Insurance Rates."

The gentlemen of the committee will remember that some month or 6 weeks ago Congress approved the insurance moratorium bill.

Mr. KEFAUVER. Mr. Bailey, for the purpose of the record, you are talking about the bill recently passed in the House of Representatives which is to give a 2-year moratorium before the Federal Government begins to take certain supervision and regulation of insurance companies under the recent Supreme Court case holding that the business of insurance is interstate commerce?

Mr. BAILEY. That is true, Mr. Chairman.

Mr. HALL. Isn't it true, too, that before that bill was passed there was an understanding on the part of the legislative leaders and on the part of the President that that bill would be signed granting that moratorium?

Mr. BAILEY. The bill was not passed in the form in which the agreement was reached.

Mr. KEFAUVER. Mr. Bailey, we do not want to rehash this insurance matter, as the bill has already passed the House. We do not want to detail the merits or demerits of that legislation, but we would be glad to have your observations about what this committee can do about any problem you have.

Mr. BAILEY. My observation, Mr. Chairman, would be this—without going into the detail of what I presented in opposition to the bill on the floor of the House—that I want to call the attention of the committee to the discrimination in rates. I presented facts on the floor or endeavored to do so, but, on account of the limited time granted me, I was unable to present all of the facts to show the discrimination between classes of insurance.

For instance, I cited an example in my home capital city of Charleston, W. Va., wherein a company was operating under a blanket policy covering all their property in all 48 of the States, and under that blanket policy, the rate was 10 cents on $100. Under a rate-making bureau set up in the adjoining State of Ohio, rates were made for other businesses not covered by these blanket policies; and in the building adjoining the one owned by this large company operating under a blanket policy, a small businessman occupied this building. His rates are made in this bureau at Columbus, Ohio, and were $1.57 compared to a 10-cent rate under the blanket policy for the Nation-wide concern.

I submit the proposition that whoever was charged with looking after the interest of the little businessman failed him miserably in this instance, because it is a safe assumption that the little businessman must carry insurance for his own protection. He is forced to carry it if he gets any financing outside of his own ability to finance his business. It is not a matter of choice with him.

It is a matter of protection and he should be protected against these discriminatory rates.

Mr. KEOGH. Mr. Bailey is conscious of the fact that this is not a legislative committee; is he not?

Mr. KEFAUVER. Yes; I am sure Mr. Bailey understands that.

Mr. BAILEY. Yes; it is more a committee for compilation of information; is it not?

Mr. KEFAUVER. Mr. Bailey, on the insurance matter—I just received a note that we had Mr. Porter here yesterday and we asked him to come back today and he cannot come back tomorrow—on the insurance matter, could you give us any details that you have and attach any correspondence that you want to which will bring out this point?

Mr. BAILEY. Yes; I could. May I take a couple of minutes to present these other matters?

Mr. KEFAUVER. We will grant you that permission.

Mr. BAILEY. This matter I would like to present under the heading of "Glass industry and reciprocal trade agreements."

I have here, Mr. Chairman, a communication from one of the industries in my district, the West Virginia Glass Specialty Co., Inc., of Weston, W. Va.

Mr. KEOGH. How many employees has it, Mr. Bailey?

Mr. BAILEY. About 240, I believe.

Mr. KEOGH. Do you know what the specialty line of its business is?

Mr. BAILEY. No; I could not tell you that. It is a going concern, however.

I am going to submit the letter to be placed in the record. Their letter is a protest against a rumor or information that has come to them that there will be an attempt made to change the differential granted to the President on tariff rates in the reciprocal trade agreements. If I am correct, I believe at the present time the President has the leeway of, say, 50 percent. That is right, is it not?

Mr. KEFAUVER. Mr. Bailey, we would have to refer to the reciprocal trade agreement. I am not familiar with what it is in that field.

Mr. BAILEY. I think that is right. They have an intimation that Congress is going to be asked to grant the President even greater differentials, and they are protesting that. They said if the reciprocal trade agreements are to be renegotiated they would like to insist on the differential remaining where it is or even lower.

I want to add a little bit about the glass industry. One of the greatest handicaps to little business, as I see it, in this country, is the domestic situation, which is the exorbitant freight rates. Just before the outbreak of the Second World War, this very concern and two or three other glass industries in my district produced evidence to show me that Belgium could produce a window glass and lay it down on the wharf in New York cheaper than the company in Clarksburg, W. Va., could pay the freight rate to New York. That is a question of freight rates.

Mr. KEFAUVER. The question you raise is not a sectional differential but a differential as to this industry?

Mr. BAILEY. That is right. The glass industry, compared with some of the other industries in this Nation, is very small. I would not attempt to even say what percentage of the over-all business of the Nation it is, but they do have an argument; and naturally there are several of the industries located in my district and they are anxious, of course, that I call this to the attention of the Committee on Small Business, because they consider themselves a small business.

Mr. KEOGH. Mr. Bailey, may I ask if you submitted the views with respect to the reciprocal treaty to the Committee on Ways and Means?

Mr. BAILEY. No; I have not. I just got this information a couple of days ago.

The other point I want to mention is an informal communication sent me by the hardware industry, and I have about a dozen communications from hardware dealers in the Third West Virginia District, and I would also like to submit this as a statement.

Mr. KEFAUVER. Without objection, it will be included in the record.

Mr. BAILEY. I might say here that it is stated:

> The present Federal administration has assured small business that its rights and interests will be protected.
>
> The retail hardware trade, which mainly serves the agricultural communities, is a typically small retail business.
>
> The exemption from Federal taxation which is granted consumer cooperatives that are engaged in the sale of supplies and equipment to consumers who are likewise customers or prospective customers of retail hardware stores is a type of discriminative class legislation which unfairly fosters the growth of such cooperatives, thereby threatening the future existence of the smaller retailers with whom they compete.

I do not intend to go further into the matter. They are protesting the agricultural cooperatives, and they have to live just the same as the others.

Mr. STEVENSON. I think every Member of Congress has received dozens of those complaints.

Mr. BAILEY. Yes. Mr. Chairman, if you would care to put it in the record I would like to present it.

Mr. KEFAUVER. We will be glad to extend your remarks in the record.

(The matter submitted by Mr. Bailey is as follows:)

WESTON, W. VA., *March 17, 1945.*

Hon. CLEVELAND BAILEY,
Third Congressional District, West Virginia,
Washington, D. C.

DEAR SIR: We are writing in regards to the Reciprocal Trade Agreements Act coming up for renewal in June of this year.

The present Trade Agreements Act gives the President the power to reduce or increase tariff 50 percent. Some publications have even stated that the administration is hopeful that the tariff will be taken entirely out of the hands of Congress. This is contrary to our belief. We believe that the tariff control should be vested in Congress. Congress should approve all trade agreements as they are made, since it is held responsible by the people for any serious wrongs that may result from their operation.

The glass industry, which is one of the leading industries in the United States, has suffered deeply in the past through low protective tariff. In order to adequately maintain and safeguard American standards and employment, it is vital that our domestic commodities and the manufacturers be protected by a high tariff from cheaply manufactured imported goods. As important as the tariff is, we earnestly feel the full authority on the matter should be placed in Congress.

If the Trade Agreements Act must be extended we sincerely hope it will be altered or rectified in such a manner that Congress must approve all changes in tariff and all trade agreements.

Your support and aid to this end will be greatly appreciated.

Yours very truly,

WEST VIRGINIA GLASS SPECIALTY CO., INC.,
JOHN PERTZ, *Sales Manager.*

JANUARY 23, 1945.

Hon. CLEVELAND M. BAILEY,
House of Representatives, Washington, D. C.:

STATEMENT BY THE NATIONAL RETAIL HARDWARE ASSOCIATION

1. The present Federal administration has assured small business that its rights and interests will be protected.

2. The retail hardware trade, which mainly serves the agricultural communities, is a typically small retail business.

3. The exemption from Federal taxation which is granted consumer cooperatives that are engaged in the sale of supplies and equipment to consumers who are likewise customers or prospective customers of retail hardware stores is a type of discriminative class legislation which unfairly fosters the growth of such cooperatives, thereby threatening the future existence of the smaller retailers with whom they compete.

4. The officers of the National Retail Hardware Association, on behalf of its more than 16,000 members, take this means of reminding the Congress of the administration's promise to protect small business.

They ask that this promise be speedily reflected in the following actions:

(a) Revision of the Internal Revenue Code to abolish the special tax exemptions now granted to cooperatives which are engaged in the sale of supplies and equipment at retail to consumers.

(b) Pending such revision that the Congress insist that the Bureau of Internal Revenue thoroughly audit the tax returns and operating procedures of retail consumer cooperatives to determine that every such organization claiming exemption is complying with the requirements as at present set forth in section 101 (102) of the Internal Revenue Code.

I approve the above statement.

LATHAM HARDWARE,
Buckhannon, W. Va.

Mr. HALL. I do not think we want to get into the insurance picture. It is settled.

Mr. BAILEY. Suppose I present a new bill?

Mr. HALL. I did not understand that we were going into that question before the recess surely.

Mr. KEFAUVER. Mr. Bailey, if you will submit to us the statement you would like to include, we will consider it in executive session and consider whether that is a subject matter that has pertinency to the hearings we are now conducting.

Mr. BAILEY. All right, Mr. Chairman. Thank you for hearing me. Maybe I did not have any business coming here but I have gotten some things off my chest, anyway.

Mr. KEFAUVER. Mr. Eastwood, will you call the next witness?

Mr. EASTWOOD. Mr. Chairman, our next witness is Mr. G. Harvey Porter, the executive vice president of the Industrial Corporation of Baltimore, and although I have some knowledge of the corporation's activities, I think possibly it would be more helpful if Mr. Porter himself would describe the operation of the corporation.

Mr. KEFAUVER. Yes. Will you state your connection and tell us something about the company you represent and then just make your statement in your own way, Mr. Porter?

STATEMENT OF G. HARVEY PORTER, EXECUTIVE VICE PRESIDENT, INDUSTRIAL CORPORATION, BALTIMORE, MD.

Mr. PORTER. My name is G. Harvey Porter, executive vice president of the Industrial Corporation of Baltimore, Md.

I have divided this briefly into two subheads, one, the experience that we have had briefly, and the second, the lessons that have come out of that in a 30-year period that might be helpful on this subject.

Mr. KEFAUVER. Mr. Porter, before you go into your analysis of problems we are considering, would you tell us something about the Industrial Corporation of which you are executive vice president? What type of business are you in?

Mr. PORTER. I was going to take that in sequence. My statement was going to cover that.

Mr. KEFAUVER. All right; go right ahead.

Mr. PORTER. It constitutes, of course, merely one example of something that has been done. It does not go beyond the experience in Baltimore. It does, however, cover a 30-year period and the origin of the corporation was after an industrial survey of the city of Baltimore as to what the needs of the city were to increase its manufacturing business as that would affect normally small businesses being brought to the area, and so forth.

A recommendation of the survey was that a group be formed to aid in securing or assisting in securing the financial requirements of these businesses. First of all, businesses that were established in

Baltimore and that could expand and could be increased for more employment and secondly, those industries in other cities that could be well and soundly relocated in Baltimore and the third objective was to take new ventures that seemed to have promise and to stimulate the financing and formation of those units in Baltimore.

The sponsors of the industrial survey of Baltimore which was made, however, by an outside independent group, was the power company which was looking into the possibility of increasing Baltimore's potential business. The purpose of the organization I have stated.

The organization was done by securing a representative board of directors out of banking, industry, real estate, insurance, retail businesses, professions, engineering, accounting, legal, and so forth, and a board of 31 directors was secured in that way which operated entirely without any compensation.

It was a semicivic objective. $100,000 in capital was raised through businessmen or through institutions that wanted to subscribe. It was not held out as being an investment in any way, but merely a fund needed to back up and assist this effort in Baltimore, and to give it working capital.

The original idea was to have these funds to put into businesses, to secure their formation or to prime the pump of the thing and get other people interested.

So, for the first 5 years, the corporations and the things that they first of all carefully investigated and then determined to help or assist would take a nominal investment. If $100,000 were required, maybe they would put in $5,000 or if $25,000 were required, maybe they would put in $2,500 but just some nominal amount to back the thing that they said they believed was all right.

Mr. Keogh. When was that corporation formed?

Mr. Porter. In January 1915.

Later, in 1919, after the war, it was determined to get an additional $100,000 because these funds had been used in starting ventures before the war and during the war, and so another $100,000 was obtained. To complete this picture while we are at it and so we won't forget it, about 3 or 4 years ago it was obvious that the money was not any factor in the work that we were doing; that the essential thing we were doing was rendering management and advisory counsel to businesses in their problems and in their best methods of getting capital and that our funds were no factor in the $22,000,000 of money that we had secured through outside sources in the period of the first 25 years for small business and, therefore, our capital was reduced in the period of some 26 or 27 years. Naturally, a lot of the original investors had died and their interests had gone through estates and gotten into other hands so our corporation bought back at cash value all of the outstanding stock except about $40,000 worth that remained in our board of directors' hands and we stopped any supplying of funds directly because we found it unnecessary in our experience.

Mr. Keogh. Will you tell me how the corporation operates now? What is its source of income?

Mr. Porter. I will come to that. Can I just digress for a second and talk about what the base is that we consider small business and, therefore, the field in which we operate? That is all I am trying to describe now.

Mr. Keogh. Yes.

Mr. PORTER. Small business is a relative term. It varies in each industry and, therefore, while some of the cases that we have handed may seem to be rather large units, they have been relatively small in their respective industries, so that you cannot divide it by number of employees or amount of capital in a particular case, but merely those people who do not have access to normal sources of finance because of their nature and size.

As to the method in which the corporation obtains its income, which I think was what you had in mind, I will be specific about that because that has not changed in the 30 years. We have really followed this pattern and I have it exactly.

We secure, first of all, the unbiased and uncolored facts with relation to each business seeking financial assistance through us. When a project comes to the Industrial Corporation, we first of all make a study of it without any cost to that project to determine whether we believe we can assist it or secure its needs.

In other words, we cull out at our own expense the matter of the likelihood of being able to help it. In other words, if it has little foundation, somebody trying to capitalize a job for themselves with little experience or little need for the industry, only setting up other competition that would be harmful to established people, we do not undertake that thing because we do not believe it would add any sound business units to the community.

If we do, however, determine to go into it we then ask them to pay the expense of an investigation of whatever extent it may need, we appraise the cost of that investigation in advance and in addition we will receive a fee of a nominal amount for the funds secured for that company when these funds are received. In addition, we receive revenues for services in following up the management of the projects in certain cases.

As I said, we then make a thorough investigation including the angles mentioned, sales and marketing, and so forth, and diagnose those to determine the logical source from which to secure the moneys required by that corporation.

In other words, we have no fixed sources of financing. We believe that there are ample sources of private financing of small business in the great majority of ventures. We feel that the things made available through the Federal Reserve and the Reconstruction Finance Corporation prior to the war and the Smaller War Plants Corporation during the war were very excellent adjuncts to that.

We have operated in securing funds through all of those sources in addition to private sources but we believe from our experience that the majority of small business needs can be obtained from existing private sources and that, of course, includes the range of banking, investment bankers, private capital, and insurance companies, savings banks, and all the other sources that you know. We think that the important thing is the matter of determining where they should be gotten, presenting the complete and intelligent balanced facts to those sources with some help in the negotiation of those funds because of the lack of experience of the small business people in how to go about it.

We think also that many a case comes to us from a bank because 90 percent of the cases will drift in through the fellow who goes to the bank because he wants money and looks at that as the logical public source, is told they are not in a position to do that particular thing, and then he may be referred to our corporation. In many cases, we have merely gotten those things in shape for financing, always taking them back to that bank and many times have secured the funds required through better presentation; but the thing that I have not stressed and which is basic to the whole thing is that the classification and needs of small business in financing should be the stress on the needs of small business for management, for better management, for better counsel, for arranging of their products so that they are bankable and financeable and the real problem is to give them help and service in some way to that end because the majority of sound ventures can finance themselves.

We follow through after we diagnose the problem by acting with them in negotiating for the funds required and finally, we follow through with services to those industries, service oftentimes required by the investor to supervise their operations and the carrying out of the policies that they established and said could be done.

Briefly, the results of the corporation's operations in its first 25 years—I have not taken any statistics since then because we have been in a war period and a different cycle—were that we secured approximately $22,000,000 of new money in refinancing of small businesses in that period of time, 25 years in Baltimore and that area.

Mr. KEFAUVER. That is new business and additional capital?

Mr. PORTER. That is right, additional capital and refinancing which is, in effect, the replacing of capital that may be due to the fact that during the depression companies had gotten into difficulty.

Mr. EASTWOOD. Mr. Porter, is that $22,000,000 just equity capital, or does it include bank loans?

Mr. PORTER. That would include everything that we had brought in the way of credit or capital to businesses.

Mr. EASTWOOD. Can you break that down?

Mr. PORTER. I can send that to you. I did not bring any figures because I thought it would be boring because principles are essential.

In other words, what are the lessons in this 30-year experience?

I personally have been with the corporation 23 years of these 30 years. I have, during that period, been privileged to study all of the other operations in other cities that have been in any way similar to ours or for the same purpose. I have sat on a number of committees and different groups that have studied the thing in order to try to bring Baltimore anything that we had not gotten out of our own experience, so I am somewhat familiar with all of the things that have been done in the country.

As to statistics during that period of time, we have paid a little bit over 2 percent return on our capital, maintained our capital and paid a little over 2 percent return on that to the stockholders, which was a tremendous surprise to them because the money was not put up with that thought. In other words, our belief is if you are going to advise other people how they are going to run their business you should keep your own in balance.

The lessons are these to us: That ample private funds are normally available to small businesses. That would certainly not be true during the war period. You would have to supplement those to the extent that those businesses are made to expand and need increased amounts.

The second thing is that new cash is not always the best solution of a small business problem. It is the universal thing that small business wants and seeks but it is not always the best solution because to put more cash into something that is merely losing money when you have not changed the trend of its operation is only going to go in the same direction and is only sending good money after bad.

The third thing is that while we believe the present pools of funds that are made available through normal bank credit and have been announced recently are a perfectly sound thing because they tend to concentrate interest and attention of bank funds for their availability to small business we believe that the establishing of private funds such as we originally did, a little private fund of local money, is a somewhat dangerous thing because it tends to discourage itself in a short time with the losses that you have to take.

In other words, you poison the pool in a sense by the fact that you have got to take losses with profits in those things and it soon becomes discredited and we do not feel from our experience that our fund ever was functioning in a way that was sound or through which we produced. We thought it was the care with which we approached the problems, the intelligence with which we selected the logical sources to finance and the care with which we followed them up.

I will outline the source of our funds and how we have been able to maintain them.

Finally, we do not believe that Federal funds, as such, should be needed to any great extent in peacetimes for small business, and to make an exception to that idea, I wish to say I am not talking about a transitional period which was mentioned before, because that is a special problem after the war and will have to be dealt with in a practical manner, but in normal times we believe that statistics will show that by far the preponderant majority of funds that small business has gotten and through which industry has been built up in this country during our lifetime has been supplied from private sources and that it is still available.

I would like to mention at that point there has been great discouragement to small business financing by the S. E. C. regulation starting at $100,000 because that did impose on those businesses undue costs of capital. The one thing we have always done is to try to keep the costs of capital to the business down to a minimum because they think that is essential and we think that has made artificial and improper costs and we have gone on record in the belief that nobody in the country would really lose if that were raised to $1,000,000. That is our own idea.

I am familiar with the fact that there is some attempt to change that and to raise it up to $300,000, but we have long ago said that up to $1,000,000 in actual cases there would be no damage done.

Mr. KEOGH. You are referring to exempting them from the registration requirements?

Mr. PORTER. That is right, of the S. E. C. It would merely be more red herring to say that the tax burden is a hardship but I won't burden you with that.

Finally, we think there is one thing that is overlooked by the majority of agencies, and I must say that includes the normal sources of financing and that would have to include banking investors, and so forth, and that is the fact that the best judgment with regard to the supplying of funds for a small business has to do with the honest future outlook of that business based on its past experience, true, but looking beyond and around the corner. So many people constantly try to look back as the only foundation for supplying capital.

I realize that is the easiest thing to do. I realize that is the conservative thing to do and still it does not always prove conservative because sometimes the trend of those businesses at that particular time is just about to go absolutely down so that we try, with all our experience, to consider the past and the future in our organization and our organization includes experienced men in all these different fields.

The sources of our funds have been these: We receive nothing for the preliminary investigation. We receive a fee to cover the costs of investigation when we determine we think we can do something with it. If the company receives the funds it is seeking, we receive a nominal amount from the funds received by them, no advance payments or anything; and finally we receive fees for counseling services for those corporations as they go on and sometimes that will last for a period of a few months, sometimes for a year and in some cases it has lasted for 5 to 7 years where we have been a useful part of continuing that particular company so that I sum up finally, before you give me any other questions, with the idea that by all odds experience has proven that counsel rather than cash is the first essential and that full information which can be gotten in advance if you know all your sources of research and experience and also that the job cannot be regimented. You cannot lay down any pattern. You cannot set up any fixed form to solve these things. Each one must be judged on its own merits and needs.

Thank you.

Mr. KEFAUVER. Mr. Porter, undoubtedly the service you have rendered has been of great assistance to both established businesses in the Baltimore area and to securing new businesses for that area but Baltimore is a city with a population of more than a million people. How about any city like LaCrosse, Wis., from which the distinguished member, Mr. Stevenson, comes or Everett, Wash., from which Mr. Jackson hails, cities of 40,000 or 50,000? They do not have the finances or the people to establish an organization like yours to counsel small businesses.

Mr. PORTER. That is a very interesting question, and I am glad you brought it up.

Mr. KEFAUVER. What can they do?

Mr. PORTER. Three years ago, I think it was, I appeared before the New England Council who were studying what to do in that area up there of many different-sized cities. We suggested at the time that if you will take New England as a whole there probably need be only one corporation such as ours in that area, completely staffed to carry itself but that in Providence and in New Haven and in Hartford and that in the other areas up there, there should be similar groups of public-mined citizens to join themselves into a committee to lend their time and effort with maybe only one individual on the pay roll to assist in these problems and when they came to the point of investigation, that that nearby city or regional office would be the logical place to draw on for experience and, in other words, to pool the research organization in the major centers of the country and to deal with every city on its own basis because there is no substitute for local knowledge of the approach to financing small business. If a man cannot get his financing at home, there is something wrong with him.

Therefore, the problem must come right back to the individual's community and there has to be a committee in that area that knows the industry and knows the problem and then he can seek the financing. It may be that they would have to go to another city in case the resources of that city were not sufficient. They might have to seek funds through other banks and, of course, the American Bankers Association program now is contemplating that need of dealing through their correspondent banks.

Mr. KEFAUVER. In saying that local financing can, in most cases, be secured, do you include termination financing and reconversion financing?

Mr. PORTER. No, sir. I have said that I thought that was a war aftermath and would have to be dealt with on that basis.

Mr. KEFAUVER. So I feel that it is the duty of the Government to assist with that type of financing and that it would have to be continued?

Mr. PORTER. I do not think I am qualified to answer that. After all, I have said my perspective is Baltimore and that area. We have served cities within 100 miles of Baltimore because they are easy to reach.

Mr. KEFAUVER. Mr. Keogh, do you have any questions?

Mr. KEOGH. I would like to ask Mr. Porter a question in connection with that. Mr. Porter, out of your 23 years' experience in this work, do you know a sufficient number of instances where small business, otherwise economically justified, was unable to obtain capital funds from private sources? Do you know enough instances like that to justify the Government stepping in and supplementing private sources?

Mr. PORTER. My direct answer is "No," and may I give my reason?

Mr. KEOGH. I would like to have it.

Mr. PORTER. You especially brought in the perspective of 23 years. In the course of things that are submitted to us, and of course they run into hundreds and thousands while we only have dealt specifically with perhaps several hundred in that period, our observation has been that things we turned down were, 2 or 3 years later, out and our judgment was vindicated in the majority of cases. In other words, there has been no need for other sources than the regular existing sources of the country to supply capital for the sound projects.

I also said earlier in my testimony that we did use the Federal Reserve bank, we did use the R. F. C. and we did secure funds from those at a time when we could not get them from existing bank and private sources so I cannot damn the Federal funds that have been made available. I can only say that they have been very much in the minority.

Mr. KEFAUVER. But you think those three agencies you mentioned should still be there to help with the minority of the problems where you cannot secure proper financing?

Mr. PORTER. I think with the reawakening, if I may put it that way, of the banks of the country through the American Bankers Association's efforts and the investment bankers to the fact that small business does need their help, which I do not think they have ever given much thought to in any volume, I think that they may supplement much of that and I will be specific. We did not know what a 5-year term loan was before this war out of a bank. Therefore, we had to go to the Federal Reserve or the R. F. C. to get it and small business does need term loans, if they cannot get capital because they must use the money over a period of time. Obviously, if they were qualified to get current bank service they would get it in a bank. Therefore, now that the banks have, during the war, had so much experience in supplying term loans and are now publicizing that as a source I think that a great amount of the money that used to be supplied by the Federal Reserve bank and the R. F. C. will be now supplied by the regular banks.

Mr. Eastwood. Isn't it true that investment bankers could not participate in small financing because of the excessive costs of creating an issue? In other words, they were obliged to put the percentage of their dealer's mark-up on the front of their S. E. C. prospectus and that looked excessive to an investor in the case of a small issue where the originating costs were proportionately high.

Mr. Porter. That is absolutely a fact since S. E. C. Prior to that, I do not think that they needed to do it because there was plenty of business for them without it and nobody came down to the level of wanting to worry with the difficult cases. I do not think we would have been formed had the established sources done it. I think we were merely an answer to a need and the fact we have survived 30 years doing it is evidence of the fact there has been some need for our work.

Mr. Keogh. Mr. Porter, you laid considerable stress upon the need of what might be described as competent management, especially in small instances. Have you given any thought as to how the Congress might assist in generating or creating that type of competent management which your experience indicates is necessary?

Mr. Porter. I think unless the cities are aroused—you will have to interpret how Congress could arouse the cities—but I think unless the cities are aroused to the fact that that is a local need, that there is some nucleus there to do it, it won't get very much stimulus. I think it needs to be done on a national basis. I think consideration is being given to that by both banks and investment bankers but I would warn that by the same token, the industrial corporation was never a part of the local chamber of commerce or the Association of Commerce while at the same time our functions and objects were semicivic in that we did not hold profit as our first motive but the bringing of industry, the matter of running our business with the money to keep it going without capital or of subscriptions. I do not think the thing that we have done could have been done by the Association of Commerce because the people do not look to the Association of Commerce for the type of service we render and by the same token they do not look to the Federal Government for business advice. It becomes sort of a private enterprise. You look to your legal counsel for advice on legal matters. You look to your banks for financial things and, therefore, I think it would be a mistake for the Government to establish any agency that tried to do that thing because they would discourage many of the men on my board of directors.

I have 12 manufacturers on my board but the board is composed now, instead of 31, of 21 members and originally we only had 6 manufacturers. We changed that to 12 because we found the manufacturers understood the problems of manufacturers, were sympathetic and would help with them more than other types we had on the board. Originally, we had 4 bank presidents and we had 4 investment bankers Now we have 1 bank president and he constitutes all we need in that way because we try to get to the people who try to understand and help with the problem and I think it has to be a private agency.

Mr. STEVENSON. I appreciate the broad view which Mr. Porter has given us here which shows what can be done in your large cities but after this war, an attempt is going to be made to bring better business into the country and into the small cities and not little business into the bigger cities. We want to get the people away from the big cities and we want to get the money out into the country so how would a group such as you represent be formed to help get the people out of Baltimore into the small towns of Maryland?

Mr. PORTER. Of course, that is your problem but, sir, not to be facetious there are two elements in the thing that you mention. One of the virtues of that stems from the standpoint of its value as a place for manufacture, for living, for production of goods and distribution, and so forth, and the small centers have many advantages for that type of thing and there are types of industries that are much better located but it has a second element which is the financing and that must be kept perfectly separate, that cannot be added to the mere enthusiasm of wanting to do it because I do not believe there is very much that is sound in the way of donations of tax exemption and a lot for the company to build the place on. Those things are trivial in the long cycle of the soundness of that business. If it cannot afford to pay its way, it is a warning that it may not be a good addition and, therefore, when you come to the matter of where that company is going to get its working capital requirements or capital investments, that must be dealt with responsibly under our present system of government, free enterprise, separately. Therefore, you do need a committee in your area to give special time and thought and it must be very competent and a very influential group who must lend their time and effort to try to solve that problem and secure the funds that may be needed because in this country, as we have developed, enterprises have been developed around individuals and while some of them have gotten to look institutional and formidable, if you go back you will find they were based on the energy of some individual and a good sound idea. It is always there. It is not hard to seek out. If it is not evident, we are afraid to back that enterprise. I mean if there is not a driving power, a source of management, we try to find it and add it to that picture but you do need, sir, in your own city and in every other small city in the country someone who gives special thought to how you are going to get the funds to finance it.

Mr. STEVENSON. My point is that such a group as you represent could well take over an entire State; could it not?

Mr. PORTER. That is true, sir.

Mr. STEVENSON. And recommend to any small business who wanted to settle in Maryland and you could give the same advice?

Mr. PORTER. That is true. We have done that without announcing it. While we are in Baltimore, we have served Cumberland and Easton and other cities.

Mr. KEOGH. Mr. Porter, in response to my question as to what, if anything, Congress could do to arouse the people with respect to the need for competent management you indicated that our problem was to arouse the cities. If I recognize the trend accurately, I think that the only way the cities want to be aroused by us is to have us relieve them of their problems too.

Mr. PORTER. I think I was careless in saying cities. I should have said the interested leadership in the metropolitan areas because they are different. I did not mean the corporate city.

Mr. KEOGH. I am wondering if that trend on the part of the States and the local subdivisions, of forever turning to Washington for assistance in their own fundamental problems does not result, not in arousing them, but rather anesthetizing them.

Mr. PORTER. I think so. I have been begging, if I may put it that way and I won't name them, but I have been begging certain private groups in the country to go out front and take a position on the formation of these things in the major cities on a national basis where they would bring it to the attention of all the same class of people in each group in a city who were selfishly interested in seeing it formed and I believe that would be the best way to do it and I hope it will still be done in that way and I believe, sir, if it was done the Federal Government would be relieved of taking any specific action.

Mr. KEOGH. You do believe, do you not, Mr. Porter, that it is advisable for the Government to have in existence during these normal or during what we hope will be normal peacetime years some supplementary source of capital funds for economically justifiable small business?

Mr. PORTER. I think this, sir, and I will say "yes" but I must add that I think the type of thing that the Federal Reserve and R. F. C. did prior to the war was a sound addition. I believe there will be less need for that with the awakening of the other sources but I would not eliminate anything because it is always an escape gap for the thing plus the fact that the second you try to do that you arouse a lot of the attitude of "what is the difference." I mean you arouse opposition between two sides or groups. The statistics will show that by far the greater amount of capital and credit comes to small business through private sources.

Mr. KEOGH. Do you think that the Federal Reserve System and the Reconstruction Finance Corporation were sufficiently small-business minded to be of definite and constructive help?

Mr. PORTER. Particularly the R. F. C.

Mr. KEFAUVER. Was the R. F. C. small-business minded until the Smaller War Plants Corporation came along and channeled some small loans into the R. F. C.? Wasn't it the Smaller War Plants Corporation that really came along to render financial assistance to small business rather than the R. F. C.?

Mr. PORTER. The R. C. F. did a tremendous amount.

Mr. KEFAUVER. Maybe we are talking about different kinds of small businesses. I am talking about the smaller small businesses.

Mr. PORTER. I think you are saying that the record will show that the S. W. P. C. had supplied small loans.

Mr. KEOGH. I do not believe that is what Mr. Kefauver meant. The Smaller War Plants Corporation seemed to be the force that impelled the R. F. C. to make more small-business loans.

Mr. PORTER. I would not know, sir. You must remember that by the same token that we, during the war, have devoted our attention to a lot of collateral things but we have not had to do nearly as much toward supplying capital because if a company had work on contract they had ample money. That will come back in great wealth when the war is over and they again have to base those things on a private basis.

Mr. KEOGH. And I presume your own organization is prepared to render assistance and advice with respect to conversion problems?

Mr. PORTER. Yes. We follow the cycle around. I mean whatever business is doing and now there is one thing that I have not brought out and I would like to put that in. While we were formed for the purpose of aiding manufacturers, we have not limited our activity to that alone, but we have been active in the field of distribution and real estate and other things and we have had problems that have gone all the way across the board. We were formed, by the very name, for industry, but our experience and our staff has been broadened to handle problems of small business.

Mr. KEFAUVER. Mr. Porter, I wanted to ask this question. We have gotten a good many complaints that during normal times it might be possible for a large business to get investment capital at a reasonable rate of interest or a low rate of interest but it has been very difficult for the small businesses to do that and the large companies have been in a better situation by virtue of the fact that where there isn't private means of obtaining capital at low rates of interest there were Government agencies from whom they could obtain capital and in perhaps some instances that has inspired or maybe forced the private lending agencies to give them capital at low rates of interest. Do you feel that the situation is such now that in the post-war period small businesses are going to be able to get their investment capital at low rates of interest which they can afford to pay?

Mr. PORTER. I think there will always be. I think the cost of financing small business will be larger by the very nature of the competence of the people. There are more people in the market who have wide distribution and ready market building because the only solution is marketability.

Mr. KEFAUVER. The record shows, I believe, that in a great many instances private lenders have been willing to come in provided some Government agency like the Smaller War Plants Corporation would participate with them.

Mr. PORTER. Yes.

Mr. KEFAUVER. Whereas they were unable to assume the burden alone but they felt, in the first place, if a Government agency was willing to bear part of the burden maybe their supervision and maybe the inspection they made would be something of a recommendation that the loan was worthy and then, of course, in some instances the loans have been more than the private lending agency would want to assume, so don't you think that on that philosophy the supplemental governmental lending agency has been of some benefit to small business?

Mr. PORTER. Certainly, during the war, but I believe your question was as to whether after the war?

Mr. KEFAUVER. Yes.

Mr. PORTER. You can hardly avoid the practical fact of the influence of that kind of thing in encouraging money to come in, and so forth, but, at the same time as I stated originally, I believe there are ample private sources that would solve it if that were not available.

Mr. JACKSON. Even prior to the war, wasn't that one of the largest sources for small business, the R. F. C. participating with the banks?

Mr. PORTER. That is right.

Mr. JACKSON. What percentage of the people you have assisted, Mr. Porter, have failed? Do you have any record of that?

Mr. PORTER. No; I do not have any percentage on that. The interesting thing about our situation is that we take them at that point and reestablish them and cull out the things that are unsound and get them back on their feet. That cannot be universal but by far the majority of things, because we choose them so carefully and follow them up, can be reorganized and continued and, of course, some of the largest corporations here are a result of failures along the road.

Mr. KEFAUVER. We are very grateful to you, Mr. Porter, and we appreciate your statement. Mr. Eastwood has some points he thinks you could give us information on and he informs me he will send you some questions he would like you to answer.

Mr. STEVENSON. I would like to see some such committee cover the whole State of Wisconsin, as far as I am concerned.

Mr. KEFAUVER. We want to give anyone who wishes to make a statement an opportunity to do so. Is there anyone here who would like to make a statement for the benefit of the committee?

Mr. LEHMAN. I would like to, if I may.

Mr. KEFAUVER. What is your concern, Mr. Lehman?

Mr. LEHMAN. I am a business counsel in New York.

Mr. KEFAUVER. Could you be here in the morning at 10:30?

Mr. LEHMAN. I could stay over but I have appointments in New York tomorrow.

Mr. KEFAUVER. How long will your statement take?

Mr. LEHMAN. It will only take about 2 minutes.

Mr. KEFAUVER. We could give you 5 minutes, Mr. Lehman. The Congress is now in session. If I had known you wanted to make a statement we probably could have worked you in earlier. Identify yourself for the record and tell the organization you represent.

STATEMENT OF CHARLES H. LEHMAN, BUSINESS COUNSEL, NEW YORK, N. Y.

Mr. LEHMAN. I represent no organization. I represent merely businessmen as counsel.

Mr. KEFAUVER. What is your full name?

Mr. LEHMAN. Charles H. Lehman.

Mr. KEFAUVER. Who are you with?

Mr. LEHMAN. I am in my own business as a business counsel.

Mr. KEFAUVER. We will be glad to have you make your statement, but try to finish it in 5 minutes, please.

Mr. LEHMAN. Yes; I will do it in less than 5 minutes.

Since the beginning of the war period and the small business problems, I have followed through as I am counsel to a large number of small industries, all of which have been affected in some way by this war effort. I have divided them into three parts, the present situation and condition of small industries under our present war economy. Next would be the situation under the conversion period and the third under our normal civilian period.

I have submitted to your committee informally, through Mr. Eastwood, some ideas on financing of industry during the normal period. I am talking about small industry without recourse to Government financing and Mr. Eastwood informs me that there will be some meetings in New York later of this committee at which time I will be prepared to submit, through responsible institutions and as far as ideas and methods on financing to private industry instead of calling upon governmental agencies for the financing of going small businesses, not for the institution of small industry or the starting up of any new projects which is outside of my particular line of work or studies but my idea would be also that during the studies of this committee we study the disadvantages that small businesses have now in trying to conform to the requirements of some of our present Government agencies in priorities, some of the problems that they have in the committees of industry which meet and in which various problems of the general industry are discussed but small business is at a great disadvantage because they are not informed of what goes on at these industry committee meetings which is a very, very serious disadvantage to small business attempting to carry on at the present time.

During the conversion period, that is another complete course of study which we have made as business counsel in New York, independently however, and that I will be very happy, if I am permitted at your New York meeting, to submit a brief on or a formal statement.

That is all.

Mr. KEFAUVER. We would like to have you attend the New York meeting and submit your formal statement at that time, Mr. Lehman.

Mr. LEHMAN. Thank you.

Mr. KEFAUVER. Do you have anything else to add now?

Mr. LEHMAN. No.

Mr. KEFAUVER. Is there anyone else who would like to have the opportunity of testifying tomorrow? (No response.)

On tomorrow we had arranged to have Dean Donham appear who is head of the Graduate School of Business Administration of Harvard University but, because of a conflicting engagement, he is not going to be able to testify so the scheduled meeting for tomorrow will not be held. The members will receive further notice as to the next meeting.

The meeting is now adjourned.

(Whereupon, at 12:10 p. m., the committee adjourned, subject to call of the Chair.)

(The following was submitted for the record:)

EXHIBIT A

HOUSE OF REPRESENTATIVES OF THE UNITED STATES,
SELECT COMMITTEE ON SMALL BUSINESS,
Washington, D. C., March 20, 1945.

Mr. C. C. FICHTNER,
Vice President and Treasurer, Wales-Strippit Corporation, Buffalo, N. Y.

DEAR MR. FICHTNER: Pursuant to permission granted by the chairman for submission to you of additional questions relative to the financial problems of small business, we should like to submit the following question to you for reply at your convenience:

> Question. An article entitled "Wartime Earnings of Small Business" was published in the Federal Reserve Bulletin for January 1945. This article, by F. C. Dirks of the Division of Research and Statistics, has been reprinted and apparently given wide publicity. The theme of this article is apparently expressed in the first paragraph in it from which we quote as follows:
>
> "In most manufacturing and trade lines the position of small and medium size concerns has improved rapidly during the war, and in fact more sharply than that of the larger companies."

Are you familiar with Mr. Dirks' article and the conclusions it reaches? If so, would you be kind enough to submit us your comments with respect to the article?

Sincerely yours,

DAN W. EASTWOOD,
Chief Investigator, House Committee on Small Business.

P. S. A copy of Mr. Dirks' article is attached for your ready reference.

[From Federal Reserve Bulletin for January 1945]

WARTIME EARNINGS OF SMALL BUSINESS

(By F. C. Dirks, Division of Research and Statistics)

An important factor in the outlook for small business concerns after the war is the effect of the wartime experience on their financial position. In most manufacturing and trade lines the position of small- and medium-size concerns has improved rapidly during the war, and in fact more sharply than that of the larger companies. This has not been uniformly true; many one-man businesses have been interrupted by the owners' service with the armed forces, and some of the businesses which have continued in operation have been adversely affected by wartime restrictions on certain civilian activities.[1] With the possible exception of the very small firms, however, unfavorable experience does not appear to have been typical of the small-business picture.

Previous information on small-business finance has been very limited. The data in this article are part of a more comprehensive compilation made with a view to securing specific information on the effect of wartime experience on the financial position of business, both large and small. This is in the form of financial statements covering the years 1940–43 for nearly 2,000 concerns—1,260 in manufacturing and 681 in trade—ranging in size of total assets from about $10,000 to over $1,000,000,000 and distributed among 130 lines of manufacturing and trade. Statements for small- and medium-size concerns were secured from bank credit files under a cooperative arrangement between the Robert Morris Associates and the Federal Reserve System, while statements for large manufacturing companies were obtained from Moody's Manuals.

The present article summarizes the evidence as regards sales and earnings during the war. A comparative analysis of changes in assets and liabilities is in preparation.

SUMMARY OF WARTIME EARNINGS EXPERIENCE

The general picture that emerges from the data for these 2,000 concerns is that in most manufacturing and trade lines, the earnings experience of small- and medium-size businesses has been better during the war than that of the larger companies. This comparison may not apply to the very small firms—those with less than $50,000 assets and fewer than 10 or 20 employees —for in this area the sample statistics are too limited to be conclusive.

Looking at earnings before income taxes, the comparatively greater increase in small company earnings from 1940 to 1943 was clearcut among manufacturing industries, particularly those with a large war interest. Here, all sizes of business experienced large increases in sales, those of the smaller concerns being exceptionally large and accompanied by rapidly widening profit margins per dollar of sales. Although in 1940 the earnings (before income taxes) of small- and medium-size concerns had represented a lower percentage of net worth than obtained for the larger companies, the wartime improvement brought them to a level much higher than that of large companies. The sample of 147 small manufacturers, with assets under $250,000 each, had pretax earnings in 1943 averaging 56 percent of net worth, as compared to 28 percent earned by 333 large companies with assets over $10,000,000. In the field of trade, earnings have risen less sharply and the pattern by size classes has been less regular, with earnings before taxes generally increasing more for small wholesalers and for large retailers than for concerns in other size classes.

[1] See, for example, the analysis by the Department of Commerce of "Small Retail Store Mortality," Economic Series No. 22 (June 1943) and "Impact of the War upon Smaller Manufacturing Plants," Survey of Current Business (July and September 1943).

The effect of Federal income and excess-profits taxes, both before and during the war, has been less severe on the earnings of the smaller concerns than on the larger ones. For manufacturers with assets under $250,000, income taxes have absorbed 10 to 15 percent less of pretax earnings than in the case of large manufacturers; in wholesale and retail trade, the difference by size of concern has averaged over 25 percent. To a large extent, this experience reflects the more favorable treatment accorded smaller companies by the tax law.

The combined result of differences in sales, in profit margins, and in effective tax rates has been that net profit (after taxes) in 1943 was a higher percentage of net worth among small companies than among medium-size companies, and the latter in turn had higher profit rates than the large companies. This result has obtained in trade as well as in manufacturing, and in war lines as well as civilian lines. It contrasts with the common impression that the concentration of prime war contracts among large companies has benefited them inordinately. In view of the attention sometimes given to contingency reserves, it is worth noting that the accounting treatment of these reserves does not appreciably affect the earnings comparisons between small and large companies.

RELEVANCE OF THE PRESENT ANALYSIS TO NEEDS OF SMALL BUSINESS

In drawing inferences from the present statistics for manufacturing and trade concerns, there are two limitations of scope which need to be borne in mind. These relate to size of business and pre-war financial status. As regards the former, the sample is broad enough to be statistically significant from the very largest companies down to those with assets of about $250,000. Below this size the sample thins out rapidly, and it includes only 36 concerns with assets under $50,000. Thus most of the discussion about "small business" in this article should be understood to refer to concerns with assets of between $50,000 and $250,000. In some instances, manufacturing companies with assets up to $1,000,000 are included also in the "small" category.

Underrepresentation of the firms with assets under $50,000—which are called here "very small"—is a major gap as regards retail trade, since such firms accounted in 1939 for about 64 percent of all retail sales. In wholesale trade and in manufacturing they were relatively less important, accounting for about 20 and 7 percent, respectively, of all sales. The corresponding percentages were somewhat lower in 1941, the reference year for classifying the size of concerns in the present sample.

As regards pre-war financial status, the statistics include comparatively few firms reporting a deficit for 1940. Both among large and among smaller businesses, the proportion of the sample with a deficit in 1940 was less than the proportion of all corporations reporting no taxable income to the Bureau of Internal Revenue. This "bias" is probably not of major importance except for the group of concerns with assets under $250,000. In this group, the fact that only 13 percent of the sample were running deficits at the beginning of the war, in contrast to 49 percent of all comparably small corporations [2]—and an unknown percent of small unincorporated firms—means that the present statistics definitely do not represent a cross section of all small business. Whether the trend of the sample statistics also is not representative of all small business, is another question. It is shown later in this article that the trend of wartime sales and earnings of the sample firms which had deficits in 1940 was not much different from that of firms which had net income.

The underrepresentation of previously unprofitable business in the sample statistics brings up a distinction that is highly important in using these data to gauge the post-war financial needs of small business. In 1940 a majority of all small corporations in manufacturing and trade lines reported a net profit (after taxes) which, in relation to the owners' equity, compared very favorably with that of larger companies. The problem of financing these firms which are established and operating profitably is one that is presumably soluble by private financial institutions, without loss to investors and without aid from the Government. The comparisons in this article make it evident that small size in a business is not

[2] As reported for income tax purposes. Due to differences in accounting practice in statements prepared for tax purposes and for bank credit, the above percentages probably overstate the actual disparity between the sample and all comparably small companies.

itself such an obstacle as to preclude profitable operations, and the effect of wartime experience has probably been to lessen whatever financing problem may have existed among the more healthy small firms before the war. This is an important fact which has not always been appreciated in discussions of small business finance.

The data in the present article have only limited relevance for the other part of small business, which reported no net income even in a year of favorable business activity such as 1940. This may represent a more or less pathological area in which private financial institutions may understandably have been reluctant to provide (or to continue providing) credit. The problem of financing such business, however, is not a problem entirely peculiar to small business as such; it is a problem of distressed business in general, large as well as small. Since the basic situation here is likely to be one of unsatisfactory costs in relation to sales, this part of small business presents a special and distinct problem from that of the more or less healthy part. While the wartime experience may well have lessened the proportion of small business still in the unprofitable category, the problem may recrudesce after the war. High rates of mortality among small business firms have historically prevailed among newly established firms, and the initiation of many new enterprises is likely to mean a considerable increase in the number of unprofitable small businesses.

TRENDS IN SALES

While there has been considerable variation in the trend of sales as among different industries, and also considerable variation among individual groups of companies within each industry, the average wartime expansion in sales has been about the same for small as for large businesses.[2] This is shown in table 1 which summarizes the sales increases over the 3-year period of 1940–43 for 1,260 manfacturing concerns and 681 trade concerns.

In more industries than not, however, the greatest increases in sales occurred among the smaller concerns. In the list of 28 major industries in table 2, there are 15 in which the greatest sales increase occurred among small concerns, 8 industries where it occurred among medium-size companies, and only 5 where the increase was greatest for large companies. Comparison of the percentage increases shown in the table for each size group indicates that the superior advance of small companies in the first group of 15 industries was larger, and hence statistically more significant, than that of the medium and large companies in the second and third groups.

TABLE 1.—*Percentage increase in sales, 1940–43, for sample of manufacturing and trade concerns, by size of business* [1]

Asset size (in dollars)	Manufacturing		Trade	
	Number of concerns	Percentage increase in sales	Number of concerns	Percentage increase in sales
Under 50,000	14	50	22	58
50,000 to 100,000	33	150	51	81
100,000 to 250,000	100	115	140	53
Under ¼ million	147	117	213	56
¼ to 1 million	296	116	260	45
1 to 5 million	389	120	161	62
5 to 10 million	95	107	24	47
10 million and over	333	121	23	55
All sizes	1,260	121	681	55

[1] The classification of business in terms of total assets in this and following tables indicates size as of the end of 1941.

[2] Possible exceptions to this statement are the average increases for the two smallest size classes shown in the table. It is doubtful how typical the averages for these classes are because of the very small percentage of firms sampled. (See table 9.)

TABLE 2.—*Percentage increase in sales, 1940 to 1943, for sample of manufacturing and trade concerns, by industry and size of business*

Industry	Asset size (in millions of dollars)		
	Under 1	1 to 10	10 and over
Manufacturing:			
1. Greatest sales increase among small concerns:			
Textile mill products	116	99	104
Apparel	78	60	----------
Paper and products	79	43	44
Chemicals and products	95	72	75
Stone, clay, and glass products	105	28	46
Steel and products	131	102	99
Electrical equipment	474	334	195
Machinery	318	259	183
Transportation equipment	701	381	246
2. Greatest sales increase among medium-size concerns:			
Food	89	98	82
Lumber and furniture	55	61	54
Printing and publishing	44	51	42
3. Greatest sales increase among large concerns:			
Beverages	89	54	148
Leather and products	53	59	66
Petroleum and rubber	62	77	86
	Under ¼	¼ to 1	1 and over
Trade:			
1. Greatest sales increase among small concerns:			
Wholesale: Food, beverages, tobacco	93	63	70
Steel and products	53	47	14
Electrical equipment	74	−4	(1)
Machinery and equipment	181	89	92
Retail: Automobiles	−67	−76	(1)
Furniture	30	4	16
2. Greatest sales increase among medium-size concerns:			
Wholesale: Paper and products	62	67	(1)
Automotive	−39	−25	(1)
Retail: Food, beverages	47	87	54
Department stores, dry goods, apparel	55	62	60
Lumber, fuel, ice	31	66	47
3. Greatest sales increase among large concerns:			
Wholesale: Lumber, coal	26	6	76
Textile products, apparel	101	80	105

[1] Less than 5 companies tabulated.

NOTE.—A different definition of small, medium, and large is used for trade than for manufacturing, in recognition of the greater proportion of the trade business done by concerns with small assets and the comparative scarcity of concerns in the largest asset classes.

An important aspect brought out by table 2 is that the more rapid expansion of small companies occurred in war industries—chemicals and metal products—as well as in civilian goods industries. This suggests that the concentration of prime war contracts among large companies has not been entirely adverse to the smaller companies as has sometimes been supposed. Apparently, subcontracting of war business together with continued output of civilian goods has sufficed, on the average, to keep the smaller companies more fully occupied than in 1940.

Another interesting aspect of the wartime experience concerns the possibility that concentration of war contracts among large companies may have given them an initial advantage, and that it was only through special Government efforts that small companies were subsequently able to expand their business. This possibility is suggested by the index numbers of sales for individual years shown in table 3. Expressed in terms of 1940 as 100, it appears that sales of the smaller manufacturing companies were relatively lower in 1941 and 1942 than sales of the larger companies, but by 1943 they had virtually caught up. Upon examining the figures for individual industries, however, it becomes evident that the lag in small company expansion was not associated with the allocation of war contracts. The lag pattern for small companies appeared in the predominately civilian industries of food, textile mill products, apparel, lumber, printing, and stone, clay, and glass products; but it did not obtain in such war industries as chemicals, steel and steel products, and machinery. In the latter groups, the smaller companies exhibited higher rates of growth from the outset. Among companies making transportation equipment there appeared to be no significant difference in growth, except that the large auto companies expanded less rapidly than others.

TABLE 3.—*Sales, 1941–43, for sample of manufacturing and trade concerns*

[Indexes, 1940=100]

Industry and asset size (assets in millions of dollars)	1941	1942	1943	Industry and asset size (assets in millions of dollars)	1941	1942	1943
Manufacturing:				Wholesale trade—Continued.			
Under ¼	127	159	217	5 to 10	134	145	141
¼ to 1	133	174	216	10 and over	[1] 135	[1] 157	[1] 184
1 to 5	140	182	220	Retail trade:			
5 to 10	139	183	207	Under ¼	122	109	118
10 and over	138	175	221	¼ to 1	119	116	132
Wholesale trade:				1 to 5	120	139	166
Under ¼	124	143	171	5 to 10	117	137	151
¼ to 1	123	139	151	10 and over	119	144	153
1 to 5	126	145	160				

[1] Represents less than 5 companies.

In the case of wholesale trade, all sizes of business experienced their largest percentage gains in 1941, with companies in the two largest-size classes showing somewhat greater increases but probably not significantly so.[4] In the case of wholesalers of metal products, sales of medium and large companies fell off in 1942 and 1943, while sales of the smaller wholesalers continued to rise. In the field of retail trade small food and apparel stores lagged slightly behind the larger companies in 1941, while small furniture stores experienced more rapid increases than larger ones. The 1942 slump of small retailers, revealed by the sales indexes in table 3, is due to the greater importance of automobile dealers among the small companies than among the large.

PROFIT MARGINS ON SALES

During the war the amount of net profit per dollar of sales has risen considerably more among small industrial concerns than among medium and large-size companies. Since Federal income and excess-profits taxes have exerted a major influence on the level of profit, and since taxes differ from other costs in not being subject in the same degree to managerial control, it is useful to discuss their effect separately from other costs. The term "profit margin" is used here to designate the percentage of earnings before income taxes to sales.

TABLE 4.—*Earnings before income taxes as percentage of sales, 1940 and 1943, for sample of manufacturing and trade concerns*

Asset size (in millions of dollars)	Manufacturing		Wholesale trade		Retail trade	
	1940	1943	1940	1943	1940	1943
Under ¼	2.7	8.1	1.6	3.5	2.5	6.0
¼ to 1	3.1	9.0	1.8	4.1	2.6	7.5
1 to 5	5.9	10.3	2.4	5.4	3.5	8.9
5 to 10	8.1	12.4	4.2	6.0	2.9	8.0
10 and over	11.6	11.6	[1] 3.1	[1] 11.1	3.3	5.4

[1] Represents less than 5 companies.

Accompanying the increase in sales of manufacturing and trade companies during the war, profit margins have on the average tended to widen. This is reflected in table 4, which shows profit before taxes as a percentage of sales for the years 1940 and 1943. Among wholesale and retail groups, the proportionate advance of profit margins over the period has not been consistently different for small than for large companies. In manufacturing, however, profit margins increased about

[4] Only 14 companies were sampled from these 2-size classes.

three times for the small companies, and progressively less among medium- and larger-size companies; for those with assets over $10,000,000, pretax earnings averaged the same percentage of sales in 1943 as in 1940.

A small part of this difference by size of business has been attributable to lack of uniformity in accounting. Large companies, more than small ones, appear to have followed the practice of earmarking a part of wartime earnings for costs and losses which are not yet incurred but may ultimately be attributable to the wartime experience. In relation to sales, allocations to contingency and other special war reserves in 1943 averaged 0.9 of 1 percent for the larger size of manufacturers shown in table 4, and 0.2 of 1 percent for the smallest. This factor is evidently not a major element in the earnings comparisons.

Underlying this net result for the 3-year period as a whole, are significant year-to-year differences between war industries and civilian goods industries. In such war lines as chemicals and metal products profit margins of large companies declined after 1941, while those of medium-size companies declined after 1942, and some small concerns continued to increase their profit margins through 1943. The result was that margins of the large companies in most war industries were lower in 1943 than 1940, in contrast to the considerable increase experienced among small companies. This difference in trend by size of company was not evident in such civilian goods lines as food, apparel, leather, and printing, where profit margins of both small and large companies continued to widen through 1943, although the increase was considerably greater in the case of small companies. In other industries such as lumber, paper, and textile mill products, no consistent pattern is discernible as between small and large companies.

The fact that profit margins per dollar of sales have tended to widen during the war means that the increase in dollar volume of sales was not accompanied by a proportionate increase in all costs and expenses (not counting income taxes). In this tendency, the economies of fuller utilization of facilities have probably been a prevalent factor, augmented in some lines by a reduction in selling expenses and in others by rising prices. In the latter connection it appears significant that the principal instances of narrower profit margins occurred among the medium- and larger-size companies in war industries, where the pricing process was one of negotiation and renegotiation that emphasized increasingly a governmental policy of limiting the profits in war contracts.[5]

EARNINGS IN RELATION TO NET WORTH

Because of differences in type of product and in the degree of integration, the description of earnings as a percentage of sales is not always a meaningful way of indicating whether earnings are "high" or "low." More meaningful is the relation of earnings to net worth, since this reflects the success of business management in its particular objective of earning a return on the invested capital of the owners.[6] This capital consists partly of amounts paid in and reflected in balance sheet figures for stock, and partly of reinvested earnings from past periods, which are called surplus. This distinction between stock and surplus is not without exception, nor does their sum necessarily represent the liquidation value of the owners' equity. The sum of stock and surplus, called net worth, is however a reasonably satisfactory basis for relative comparisons of profit.

During the war there has been little change in outstanding capital stock of most industrial companies. In manufacturing some relatively large increases of stock by war concerns have been more or less offset by numerous small requirements of preferred stock in civilian lines. In wholesale trade there have been scattered increases among some groups of companies. Sizable additions to invested capital were made in the form of reinvested profits in both manufacturing and trade, however, especially among smaller companies. As a result, net worth of small manufacturing and trade companies increased 25 to 50 percent from 1940 to 1943; the increases were progressively smaller among medium and large companies, averaging around 12 percent for those with assets over $10,000,000.

Notwithstanding the larger increases of net worth among small manufacturing companies, the combination of more rapidly expanding sales and wider profit margins during the war has resulted in pushing up the earning capacity of small manufacturing business much more than that of large manufacturing.[7] This is

[5] War contracts or subcontracts of less than $100,000 were not subject to renegotiation.

[6] An exception to this statement is the case of small firms in which earnings are largely a return on personal skill or competence. Unfortunately there is considerable diversity of accounting practice among unincorporated business with respect to the owners' compensation; in many cases it is not deducted in reckoning net profit. Unincorporated firms comprise about 25 percent of the sample concerns with assets under ¼-million dollars.

[7] The term "capacity" is used here in the sense of earnings attributable to business operations, before taking account of income taxes which are outside managerial control. No reference is intended to potential earnings.

shown in the first two columns of table 5. In wholesale and retail trade, the rate of earnings (before taxes) on net worth in 1943 appeared about the same for small as for large concerns.

TABLE 5.—*Earnings before income taxes as percentage of net worth, 1940 and 1943, for sample of manufacturing and trade concerns* [1]

Asset size (in millions of dollars)	Manufacturing		Wholesale trade		Retail trade	
	1940	1943	1940	1943	1940	1943
Under ¼	12.1	55.6	11.7	31.6	11.5	26.8
¼ to 1	9.6	46.6	9.7	28.4	10.0	30.6
1 to 5	13.3	40.6	11.0	33.3	10.5	37.9
5 to 10	14.4	37.1	12.6	22.4	10.3	37.7
10 and over	14.1	28.0	[2] 5.1	[2] 31.3	21.1	27.9

[1] Earnings stated as percentage of net worth at beginning of year.
[2] Represents less than 5 companies.

EFFECTS OF CORPORATE INCOME TAXES

The Federal income-tax law as applied to corporations has been amended repeatedly with a view to drawing on excessive profits from war production to finance Treasury war expenditures. In this process smaller concerns have been subject in effect to lower tax rates than large concerns and this policy has permitted more of the increasing earnings to filter through as net profit. The normal and surtax rates payable since 1940 by companies with taxable incomes under $50,000 have been below those payable by larger companies; also growing companies and those with total assets under $5,000,000 have had a smaller proportion of their taxable income subject to the excess-profits tax.[8] Unincorporated businesses, of course, have not formally been subject to Federal income taxes, although the personal tax of partners appears to be reported as an expense on the financial statements of some firms, and in other cases a careful appraisal of the relative tax burden of unincorporated and incorporated business would require that account be taken of the difference in incidence of personal taxes.

These differences in the tax law are reflected in the percentages of taxes to pretax earnings which are shown in table 6 for concerns reporting net income. It will be observed that the difference in average effective rates for small and large companies in 1943 was less in manufacturing than in trade. This reflects the very large increase in pretax earnings of small manufacturing companies—about 540 percent—which has made a substantial portion of their income subject to excess-profits taxes. Apparently, the rise in earnings before taxes of 265 and 185 percent, respectively, for the smaller wholesale and retail trade firms over the 3-year period has meant that a smaller proportion of their income was subject to excess-profits taxes.

TABLE 6.—*Income taxes as percentage of earnings before taxes, 1940 and 1943, for sample of manufacturing and trade concerns with net income*

Asset size (in millions of dollars)	Manufacturing		Wholesale trade		Retail trade	
	1940	1943	1940	1943	1940	1943
Under ¼	14.4	57.4	7.7	38.6	12.6	38.0
¼ to 1	23.0	63.4	19.5	49.8	17.9	57.4
1 to 5	26.9	71.5	25.9	65.3	25.4	71.5
5 to 10	26.5	72.6	30.4	63.0	26.2	66.3
10 and over	26.6	65.7	[1] 13.8	[1] 74.1	28.4	66.4

[1] Represents less than 5 companies.

[8] In 1942 and 1943, for example, the normal tax rate was 15 percent for corporations with net income under $5,000, and was graduated upward to 24 percent for those with incomes over $50,000. Surtax rates were 10 percent for corporations with income under $25,000 and were graduated to 16 percent for those with incomes over $50,000. With respect to excess-profits taxes, companies using the invested capital method were allowed an "excess profits credit" of 8 percent on the first $5,000,000 of invested capital, but lower percentages on amounts above this sum. Companies using the "base period" method were allowed a credit greater than the base period average if their income had an upward trend. In addition, a specific exemption was allowed on the first $5,000 of income falling in the excess-profits bracket.

THE BALANCE: NET PROFIT

The comparative increase in net profit after taxes for small and large industrial businesses reflects the combined effect of the differences described above for sales, profit margins, and average tax rates. As appears from table 7, the over-all result has been a significantly larger increase during the war in net profit for small companies than for large, in wholesale and retail trade as well as in manufacturing. If charges for special reserves were counted with net profit, the percentage increases would be higher for all sizes of business without appreciably affecting the relative status of each size.

Among individual industries and for individual years the results differ as between war products and civilian goods industries in somewhat the same way as was re-marked for profit margins on sales. That is, in civilian-goods lines profits of small companies increased more or less steadily from 1940 to 1943, whereas those of large companies declined slightly after 1941. In some lines of war industries, such as machinery, electrical equipment, and transportation equipment profits of small companies increased steadily throughout the period, while in other lines, such as chemical and steel products, small-company profits in 1942 and 1943 were below the 1941 level, although still above 1940. Large-company profits (in war industries) declined after 1941, and by 1943 were generally below the level of 1940. Thus large-company profit trends were less favorable in war- than in civilian-industries and, in all lines, the large companies averaged less well than the smaller companies.

TABLE 7.—*Percentage increase in net profit (after taxes), 1940–43, for sample of manufacturing and trade concerns*

Asset size (in dollars)	Manufacturing	Wholesale trade	Retail trade
Under 50,000	410	109	135
50,000 to 100,000	574	197	106
100,000 to 250,000	178	132	97
Under ¼ million	225	144	102
¼ to 1 million	212	123	98
1 to 5 million	53	72	65
5 to 10 million	19	9	96
10 million and over	4	[1] 111	19

[1] Represents less than 5 companies.

In wholesale and retail trade, distinctions among major lines tended to follow the pattern of sales. The small companies in food and textile lines had steadily rising profits from 1940 to 1943 while those in certain durable goods lines, where sales fell off after 1941 or 1942, experienced somewhat lower profits. With few exceptions, however, small-company profits averaged higher in 1943 than in 1940; this was true even among automobile wholesalers and retailers. As indicated by the average figures for broad groups in table 7, profits of the larger trade concerns did not increase to the same extent.

In general, the significance of mere percentage increases over time is more or less conditioned by the relative level from which the increase is measured. That is, the concerns with the largest percentage increases in wartime earnings do not necessarily have the most favorable earnings experience, relative to invested capital. For the present sample of nearly 2,000 concerns, however, the figures in table 8 indicate that net profit in 1940 was on the whole as large in relation to net worth for the smaller concerns as for the larger. The greater subsequent increase in profit among the smaller concerns has thus meant considerably higher rates of return on their net worth. In the manufacturing and wholesale trade group, there is some suggestion that profit rates may not have been quite so favorable for the very small concerns as for those slightly larger, but the size of the sample makes this a tentative rather than definitive conclusion.

TABLE 8.—*Net profit (after taxes) as percentage of net worth, 1940 and 1943, for sample of manufacturing and trade concerns* [1]

Asset size (in dollars)	Manufacturing			Wholesale trade			Retail trade		
	1940	1943	(2)	1940	1943	(2)	1940	1943	(2)
Under 50,000	7.7	28.3	....	9.0	12.2	....	24.2	41.0	....
50,000 to 100,000	10.7	41.4	....	14.2	28.0	....	12.5	19.3	....
100,000 to 250,000	10.3	20.8	....	10.2	17.9	....	9.0	14.8	....
Under ¼ million	10.2	23.7	(25.1)	10.7	19.4	(19.4)	10.0	16.6	(16.8)
¼ to 1 million	7.0	17.0	(18.8)	7.7	14.2	(14.4)	8.1	13.0	(13.0)
1 to 5 million	9.5	11.6	(12.7)	8.0	11.5	(11.8)	7.7	10.8	(11.1)
5 to 10 million	10.5	10.2	(11.0)	8.8	8.3	(9.0)	7.3	12.7	(12.6)
10 million and over	10.4	9.6	(10.8)	4.1	8.1	(8.0)	8.7	9.4	(11.0)

[1] Profit stated as percentage of net worth at beginning of year.
[2] Figures in parentheses represent 1943 profit plus current allocations to reserves, as percentage of net worth plus reserves.

Inspection of the figures for individual industries shows that in all but four of the 28 industries in which comparisons by size are possible, the smaller concerns experienced a higher rate of return on net worth than did the medium- and larger-size companies. In the four exceptions—manufacturers of beverages, chemicals, stone and clay products, and wholesalers of steel products—the differences are small enough to be attributable to sampling variation.

In view of the prevalence of allocations to contingency reserves, especially among the larger companies, there is considerable interest in seeing how these affect the profit comparisons. If current allocations to such reserves are added to reported net profit, and if the accumulated reserves are counted as surplus in computing net worth, the rates of earnings on net worth for 1943 are as shown by the figures in parentheses in table 8. The effect of the adjustment is more noticeable among the large manufacturing and trade concerns than among the smaller, but it is evidently not a major factor in the over-all picture.

APPENDIX

NOTE ON SCOPE OF THE SAMPLE STATISTICS

The foregoing analysis of wartime sales and earnings of nearly 2,000 companies has brought out several findings of major importance in assessing the financial position of small business. The fact that some of these findings may be unexpected, raises a question as to the scope and representativeness of the present statistics.

On the whole the present data appear reasonably representative of the over-all situation in manufacturing and trade with the exception of the two areas mentioned at the outset of this article. These are the very small firms with assets below $50,000, and the sizable body of small companies which reported a net deficit in 1940. The following comparisons indicate the limits of the present statistics in these two areas.

In proportion to the sales of all manufacturing and trade corporations which submitted balance sheets to the Bureau of Internal Revenue in 1940, the sales of the present sample were distributed by industry and size of company as shown in table 9. As regards mere size of sample, the sampling proportions appear adequate for companies with assets above $250,000 in the three broad groups—manufacturing, wholesale, and retail trade—with the exception of wholesalers in the largest-size class. When the classification is broken down by major industry, however, there are several instances where the absolute size of sample in individual classes is so small—less than 10 companies—as to be somewhat unstable.

The much smaller percentage sampling obtained for concerns with assets under $250,000 is likely to entail considerable sampling variation in any ratios computed for individual industries. This means that in interpreting the figures for any one industry, too much importance must not be ascribed to small differences or to occasional erratic fluctuations in the experience of particular size groups. However, when consistent differences by size are obtained among whole groups of industries, as has been the case for the earnings experience discussed in this article, it may be concluded that the consistency of results more than offsets the sampling uncertainties, and some confidence can be placed in the representativeness of the findings.

TABLE 9.—*Relative size of sample in 1940: Sales of the sample concerns as percentage of sales of all manufacturing and trade corporations submitting balance sheets to Bureau of Internal Revenue*

Industry	Asset size						
	In thousands of dollars			In millions of dollars			
	Under 50	50 to 100	100 to 250	¼ to 1	1 to 5	5 to 10	10 and over
Manufacturing	0.1	0.3	1.0	3.3	10.1	13.6	74.0
Wholesale trade	.1	.4	1.4	4.2	8.0	9.0	1.9
Retail trade	.04	.1	.7	3.6	10.3	18.8	18.4
Major manufacturing lines:							
Food		0.8		4.2	10.9		71.7
Beverages		...		2.1	8.0		88.6
Tobacco		...		...	...		81.5
Textile mill products		.5		3.1	14.9		55.6
Apparel		.8		6.5	25.2		
Leather and products		.8		11.2	42.5		112.4
Lumber and furniture		.5		2.8	3.9		25.1
Paper and products		.9		1.2	16.2		78.0
Printing and publishing		.6		3.1	10.2		27.5
Chemicals and products		.7		3.1	10.3		57.3
Petroleum and rubber		1.8		1.8	7.9		77.9
Stone, clay, and glass		.2		1.4	5.0		57.9
Steel and products		.5		3.3	13.1		73.2
Nonferrous metals		...		...	...		136.5
Electrical equipment		...		4.1	9.4		62.0
Machinery		.6		1.5	9.4		74.7
Autos and parts		.3		3.7	9.6		88.3
Other transportation equipment							71.1

NOTE.—The percentages shown for the smaller sizes somewhat understate, and the percentages shown for the larger size overstate, the relative size of the sample owing to the use of consolidated statements for the sample study whereas statements submitted to Bureau of Internal Revenue were unconsolidated. Representation of the largest size of manufacturing is also overstated through the inclusion of some mining activity in the consolidated statements of petroleum, steel, and nonferrous metal companies.

Associated with the matter of sampling variation is the inadequate coverage of the sample for very small concerns and for deficit concerns. The percentage sample would appear not too seriously thin in the group with assets between $100,000 and $250,000; while the absolute number of statements tabulated in several individual lines is too small to be stable, the total of 240 is sufficiently large and diversified by industry to be reasonably typical for such broad groupings as all manufacturing, wholesale, and retail trade. However, the group with assets between $50,000 and $100,000, containing only 84 concerns, is probably subject to considerable sampling variation, and little reliability can be attributed to the experience of the 36 concerns with assets under $50,000.[9] This limitation is not of great importance in the case of manufacturing, where only 7 percent of the total sales is by firms (unincorporated as well as incorporated) with assets under $50,000. In retail trade, however, where nearly two-thirds of all sales are by such firms, it is a different matter. It is therefore important to bear in mind that the present analysis contains little evidence on the wartime experience of the very small concerns.[10]

[9] These are offhand judgments and, for careful estimating on some subjects, they would need to be supported with analysis of the variance in experience among individual companies.

[10] The size of firms with assets under $50,000, which are called here very small may be described alternatively in terms of sales volume or number of employees. The $50,000 asset size corresponds approximately in manufacturing to annual sales of $100,000 and 20 employees, in wholesale trade to sales of $200,000 and 10 employees, and in retail trade to sales of $150,000 and 15 employees. These figures relate to all manufacturing and trade in the aggregate, as of 1939; there is, of course, considerable variation among individual lines and from year to year in the relation of assets to sales and to number of employees.

As a rough check on the representativeness of the sample for the present discussion of earnings, table 10 presents an interesting comparison of the percentages in 1940 of earnings (before taxes) to net worth, as reported by all corporations with taxable income submitting balance sheets to the Bureau of Internal Revenue, and by the present sample reporting income to banks for credit purposes. Representativeness of the sample in 1940 is not necessarily equivalent to representativeness in subsequent years, but it creates a presumption in that direction.

Two points in the comparison deserve especial mention. Among all corporations in the three smallest-size groups, there was very little difference in the rate of profits earned by very small firms as compared with the next larger sizes. Unevenness in representing these three classes in the sample statistics for "under one-fourth million" therefore did not detract from the correctness of the sample profit rate in 1940. Second, there is no evidence of the sample being biased in the direction of having better than average experience in 1940. In fact, in more instances than not, the sample average was slightly below the average for all corporations. This is the more significant in view of the incentive for corporations to minimize income for tax purposes, while stating it optimistically for purposes of bank credit.[11] On the whole, considering the variation in representation by individual industries, the earnings ratios for sample companies with net income are probably as close to the averages for all companies with net income as might be expected in an unbiased sample.

TABLE 10.—*Earnings of sample compared with all corporations: Earnings before income taxes in 1940 as percentage of net worth, for the sample concerns with net income, and for all manufacturing and trade corporations with net income* [1]

Asset size (in dollars)	Manufacturing		Wholesale trade		Retail trade	
	All	Sample	All	Sample	All	Sample
Under $50,000	15.7	14.9	14.8	13.8	11.0	12.2
$50,000 to $100,000	15.0		12.7		10.9	
$100,000 to $250,000	15.5		12.1		10.9	
¼ to 1 million	15.9	12.7	12.8	10.1	10.6	11.3
1 to 5 million	16.0	14.8	14.0	11.8	11.8	10.9
5 to 10 million	15.0	14.6	14.6	12.1	9.3	12.8
10 million and over	12.7	14.2	9.5	5.1	12.5	11.8

[1] Earnings stated as percentage of net worth at end of year.

In this connection it is worth adding that about one-fourth of the sample statistics for concerns under $250,000 represent unincorporated firms. The use of earnings before taxes in comparing the sample with all corporations in table 10 avoids the difference in tax status by type of organization, but earlier tables on net profit after taxes reflected, of course, the fact that part of small business is not subject to corporate income taxes. The present sample reflects this inadequately, since it includes disproportionately few unincorporated firms.

TABLE 11.—*Deficit concerns in sample and in all corporations: Percentage of concerns with net deficit in 1940, for the sample concerns, and for all manufacturing and trade corporations*

Asset size (in dollars)	Manufacturing		Wholesale trade		Retail trade	
	All	Sample	All	Sample	All	Sample
Under 50,000	61	7	54	11	59	8
50,000 to 100,000	37	15	30	6	31	6
100,000 to 250,000	28	16	21	14	23	10
Under ¼ million	49	15	43	12	51	9
¼ to 1 million	21	17	14	6	17	12
1 to 5 million	14	11	11	6	13	6
5 to 10 million	10	5	7	0	14	14
10 million and over	7	3	11	0	9	0

[11] Another factor tending slightly to exaggerate the rate of return for the sample as compared to all corporations is the definition of net worth. This includes intangibles in the case of all corporations, but not in the case of the sample.

The third respect in which the scope of the present statistics is limited is the proportion of the sample that was incurring a deficit at the beginning of the war. In the entire population of manufacturing and trade corporations, it appears from table 11, the proportion of concerns with unfavorable earnings experience in 1940 varied inversely with the size of business. (Presumably the experience of unincorporated firms varied in much the same way.) The table shows that the present sample includes disproportionately few deficit concerns in all size classes, and the disparity is most marked in the case of small businesses.

Furthermore, in most of the size and industry classes represented in the table the average rate of deficit, expressed as a percent of net worth at the end of the year, appears to be less adverse among the sample concerns than among comparable sizes of all corporations. Table 12 shows that this disparity is most substantial in the area of business with assets under one-fourth million dollars. That the sample appears not to include statements for businesses with larger deficits, may reflect in part the sampling requirement that each statement included should be continuous throughout the war period. These two characteristics of the sample—the inclusion of relatively few deficit companies and their less-than-average rates of deficit—mean that the tables and the discussion of earnings in this article cover primarily that part of small, medium, and large business which was in a more or less healthy condition in 1940.

TABLE 12.—*Deficit rate in sample compared with all corporations: Deficit in 1940 as percentage of net worth, for the sample concerns with deficits, and for all manufacturing and trade corporations with no net income* [1]

Asset size (in millions of dollars)	Manufacturing		Wholesale trade		Retail trade	
	All	Sample	All	Sample	All	Sample
Under ¼	24	11	19	6	18	4
¼ to 1	11	10	8	6	10	5
1 to 5	8	8	7	7	7	8
5 to 10	6	3	5	(2)	3	7
10 and over	2	4	14	(2)	10	(2)

[1] Deficit stated as percentage of net worth at end of year.
[2] No deficit companies in sample.

What the wartime trend has been for concerns which were unable to operate profitably in 1940, is problematic. To the extent that the deficit condition in 1940 reflected managerial difficulties, these firms may have been unable to secure war business. On the other hand, the wartime shortage of goods has doubtless been a factor tending in many instances to lighten competitive pressure and to ease the problem of sales outlets. That the smaller concerns with poor pre-war earnings experience have shared in the wartime trends discussed in this article, is indicated tentatively by the figures in table 13, which shows separately the experience of the sample companies with deficits in 1940 and those with net income in 1940.

As regards sales, the small concerns with a deficit in 1940 averaged considerably larger increases over the 3-year period 1940–43 than the concerns with better pre-war earnings. The margin of superiority shown by the sample in this respect appears sufficiently large and consistent to be significant. With respect to net profit, also, the sample of concerns with pre-war deficits exhibit very favorable wartime trends. The fact that in manufacturing the average return in 1943 for the smaller "deficit" concerns was higher than for the firms with pre-war profit, while this did not obtain for the trade samples, is indicative of considerable variance in degree of earnings advance.

TABLE 13.—*Comparison of sales increase and return on net worth for 173 concerns with deficit in 1940 and for 1,412 concerns with net profit in 1940*

Industry and asset size (assets in millions of dollars)	173 concerns with deficit in 1940				1,412 concerns with net profit in 1940			
	Number	Percentage increase in sales, 1940 to 1943	Percentage return on net worth		Number	Percentage increase in sales, 1940 to 1943	Percentage return on net worth	
			1940	1943			1940	1943
Manufacturing:								
Under ¼	22	152	−10.9	27.0	125	112	12.8	19.7
¼ to 1	49	148	−10.1	15.4	247	111	9.8	15.0
1 to 10	47	114	−6.4	11.0	437	116	10.8	10.4
Wholesale trade:								
Under ¼	16	91	−6.2	8.3	117	69	12.8	18.6
¼ to 1	11	84	−6.3	9.0	163	49	8.1	13.6
1 to 10	5	103	−6.8	10.8	94	54	8.6	9.9
Retail trade:								
Under ¼	7	65	−3.9	7.5	73	17	10.7	16.1
¼ to 1	10	21	−4.6	8.8	76	34	9.3	12.6
1 to 10	6	57	−7.4	12.8	80	60	8.6	10.7

NOTE.—The rate of return on net worth is not entirely comparable as between concerns with deficit earnings and those with net income. Many deficit concerns have a net worth that is less than the book value of their capital stock, owing to the fact that surplus has become a negative figure. The rate of return on such a net worth may be misleading unless it is clearly understood that this is not the same thing as return on capital originally invested by the owners.

This supplementary analysis of the sample statistics at the fringe of their scope suggests that the very favorable experience observed in this review of the smaller healthy concerns may also have been shared by many of the very small firms and by those which were not so healthy in 1940. Because of the limited scope of the data, however, this evidence cannot be accepted as more than suggestive.

EXHIBIT B

WALES-STRIPPIT CORPORATION,
Buffalo, N. Y., March 22, 1945.

MR. DAN W. EASTWOOD,
Chief Investigator, House Committee on Small Business,
Washington, D. C.

DEAR MR. EASTWOOD: Replying to your letter of the 20th, I am indeed familiar with the article by Mr. Dirks in the Federal Reserve Bulletin for January 1945, and I appreciate very much the opportunity to comment on the article and its apparent conclusions.

I submit herewith several pages of analysis and comment on the Dirks article which you are at liberty to publish as a supplement to my verbal testimony of yesterday and the day previous if you so desire.

Sincerely yours.

C. C. FICHTNER,
Vice President and Treasurer.

[Published in the Federal Reserve Bulletin, January 1945, pp. 16-26]

WARTIME EARNINGS OF SMALL BUSINESS

(By F. C. Dirks)

Analysis and Comment

(By Charles C. Fichtner, vice president and treasurer, Wales-Strippit Corporation, Buffalo, N. Y.)

The effect of Dirks' article on the reader is to create the impression that the wartime earnings of smaller manufacturers have been more favorable than the earnings experience of large concerns. If the intent of the article's adroit phraseology were to persuade member bankers throughout the Nation to grant more favorable consideration to the loan applications of smaller manufacturers, the careful construction of an impression in sum much greater than the total of its factual parts might be condoned as a counterweight to the reluctance of some bankers to recognize promptly that many new and smaller enterprises have earned a meritorious credit standing by excellent management during the war years. If the study is to be used as evidence of a generally favorable financial situation among smaller manufacturing establishments or as a guide to public policy, protest must be filed as to its principal conclusion—that "in most manufacturing and trade lines the position of small- and medium-size concerns has improved rapidly during the war, and in fact more sharply than that of the larger companies." This and other generalizations are unwarranted within the nature of the sample which is, in addition, too small to be representative. The manipulation of the data (the use of percentages, for example, to measure changes in percentages) has the effect of leaving a distorted impression of the facts. Careful interpretation of the article's own data, inadequate as they are, does not support the favorable interpretation placed on the finances of small manufacturers. Before the inferences of this study, which if not erroneous are at least questionable, become the basis of policy, more comprehensive and representative information must be gathered in the field of small business finance.

DEFICIENCIES IN THE ROBERT MORRIS ASSOCIATES SAMPLE

Mr. Dirks, in the appendix to the article, has given many reasons why methods used in the study do not yield a basis for generalized statements about the whole of small business. In addition to his own reasons, there are additional factors which show that the sample is unrepresentative of small business.

The number of companies included in the analysis as representing small business is wholly inadequate. This is readily admitted in the article (p. 17) where it is stated that while "the sample is broad enough to be statistically significant from the very largest companies down to those with assets of about $250,000, below this size the sample thins out rapidly, and it includes only 36 concerns with assets under $50,000."

After making this admission as to inadequacy of data for drawing significant conclusions as to small business, the statement follows that "most of the discussion about 'small business' in this article should be understood to refer to concerns with assets of between $50,000 and $250,000." And then, further to confess the unreliability of the sample data from small business, it is admitted that "in some instances manufacturing companies with assets up to $1,000,000 are included also in the 'small' category." In spite of this transfer of larger concerns to the "small" category, presumably to strengthen statistical weakness, no information is provided as to how many such companies were included in the "small" category or how they were selected.

FALLACIOUS ASSUMPTION

Furthermore, from the point of view of the small businessman, the fallacy seems to have been incurred of assuming that because manufacturing and wholesale businesses of under $50,000 total assets accounted in 1939 for relatively minor proportions (20 percent and 7 percent respectively) of the sales in their industries, the thinness of the sample for such companies is thereby compensated for. This easy generalizing from a meager sample as to financial needs cannot be of much consolation or promise to the large numbers of small manufacturers and distributors (those with less than $50,000 of assets) comprising, by number in 1940, 63 percent of all manufacturers and 68 percent of all wholesalers. Thus, the author's ready admission of underrepresentation in its sample of retail firms with assets under $50,000 (those called "very small"), extends also to manufacturing and wholesale concerns of similar size. In other words, concerns of this size, comprising the bulk of all companies in their field of operation, cannot be typified by a handful of carefully selected companies.

SAMPLE HIGHLY SELECTIVE

Aside from the fact that the sample is far too small for any definite conclusions to be drawn about small business as a whole, a further serious deficiency lies in the fact that the subject companies are highly selective as to favorable credit connections and financial operating results. These facts are also set forth in the author's analysis, but apparently without invalidating the data for its purpose of drawing broad conclusions regarding financial condition of all small business. When it is considered that "statements for small- and medium-size companies were secured from bank credit files under a cooperative arrangment between the Robert Morris Associates and the Federal Reserve System," it may be concluded that such companies are well above the average in financial and credit ratings. Banks, in general, will lend money only to good risks, therefore the only firms which could have fallen into the sample were those with fairly high credit ratings. This is borne out by table 11 in the appendix which shows the proportion of deficit concerns in the sample as compared with all corporations in 1940. The earning power of the firms in the sample is far better than the earning power of the firms in the whole population.

INADEQUATE REPRESENTATION OF UNINCORPORATED ENTERPRISES

Another examination of the original list will show an inadequate representation of unincorporated concerns. Of the approximately 225,000 manufacturing businesses in the country only about 80,000 are incorporated and of the 1,450,000 trade concerns only about 125,000 are incorporated. The sample has a much greater proportion of incorporated firms than unincorporated and since there are great differences between these two forms of organization in the way cost and profits are figured, any biased sample in this direction might present a totally false picture of the financial condition of small business as a whole.

The author attempts to show the representativeness of the sample by relating the earning power of the firms in the sample to the earning power of the firms in the whole population in 1940. He arrives at the conclusion that the comparative earning ratios are relatively the same and, therefore, the sample is representative on this item for 1940 although it may not be for 1943. This reasoning has been shown to be fallacious in sampling technique in recent years since a biased sample may have many characteristics in common with the population as a whole and still yield biased results in the particular characteristic that is needed. The only adequate analysis of small businesses' earning power must be based on an unbiased sample of firms and not on a biased sample which is rationalized to represent the whole population.

Finally, the author, in table 12 of the appendix, attempts to show that deficit concerns in 1940 show more favorable earning ratios in 1943 than did concerns showing a profit in 1940, and therefore even if the sample is biased in favor of profit concerns, the conclusions would also hold for deficit concerns. From a sampling point of view and as far as Smaller War Plants Corporation is concerned this argument is somewhat irrelevant. In the first place, the fact that a concern lost money in 1940, a pre-war year, has very little relationship to its earning power in 1943, a war year of total production and ceiling prices set to yield a fair margin of profit. There is little argument with the statement that small business, in general, is making money during the war as well as is large business. If a small concern has been operating on a deficit for a number of years it owes money and must pay it back, or if a small firm had a chance of making profit on war contracts and needed an expansion of fixed assets, for which money had to be borrowed to carry out the contract, the ratio of net profit to working capital has little significance as related to financial soundness.

The serious defects of an extremely limited number and a highly selected group of concerns preclude their use in exemplifying recent trends in financial position of small business generally.

LAG PATTERN OF SMALL BUSINESS

Although the validity of the sample of smaller manufacturing establishments is extremely questionable, tables 1 and 3 indicate that the sales expansion of small business in 1941 and 1942 lagged behind that of large. This circumstance underlay the repeated reorganization of the Contracts Distribution Division of War Production Board and the founding of the Smaler War Plants Corporation. In 1943, happily, the volume of business of smaller units was brought to a level only slightly below that of large business. Tables 1 and 3, therefore, hardly justify the statement on page 18 that "the average wartime expansion in sales has been about the same for small as for large businesses," except in the limited sense of comparison of 1943 sales with 1940 sales.

To state that "the greatest increases in sales occurred among the smaller concerns" gives a misleading impression in that the statement is based on percentages and not on absolute increases of volume of business. Whether this is "statistically more significant" is questionable. The gain in weight of an infant from 6 pounds at birth to 24 pounds at age one is 300 percent, but a gain of a 4-year old child from 50 pounds to 75 pounds would be only 50 percent, and yet at the latter age, perhaps the increase in weight would be biologically more significant. There is no indication in the study, moreover, that the business infants of 1940 as classified in the article were not still classified as infants in 1943 although in fact they may have progressed to a higher asset size classification.

INTERPRETATION NOT SUPPORTED BY DATA

In the paragraph beginning on page 18 the possibility that the catching up of smaller with large manufacturers in sales expansion in 1943 after lagging earlier in the war period might have been due to "special Government efforts" is said to be refuted by contrasting "war industries" with "predominately civilian industries." In the war industries, it is stated that "the smaller companies exhibited higher rates of growth from the outset." As this statement has an important bearing on public policy, its validity merits careful examination. In the Morris Associates sample, machinery companies may be taken as typical of "war industries." The basic data on machinery industries show for companies of assets less than $1,000,000 the following record of sales expansion:

	Nonelectric machinery		Electrical machinery	
	Assets (millions of dollars)			
	Under ¼ (11 companies)	¼-1 (14 companies)	Under ¼ (none)	¼-1 (12 companies)
	(Sales in thousands of dollars)			
1940	2,272	10,146		9,750
1941	3,992	17,029		14,020
1942	6,800	25,885		28,082
1943	18,806	33,146		55,965

From this sample of 37 small companies typical of war industries, the total sales expansion from 1940 to 1943 was $85,749,000 of which $47,150,000, or 55 percent, occurred from 1942 to 1943. Less than half of the total rise in sales occurred in 1941 and 1942. Thus, it is clear that aside from the danger of drawing sweeping conclusions from an inadequate sample, the data do not bear out the interpretation of the lag pattern presented in the Dirk's article.

MISLEADING IMPRESSION OF PROFITS OF SMALL BUSINESS

A misleading impression is also given by the discussion beginning on page 20, "During the war the amount of net profit per dollar of sales has risen considerably more among small industrial concerns than among medium and large-size companies." The percentage rise in the percentage margin of small manufacturing supports the statement but it is only by consulting table 4 that the reader will realize that in 1940 the profit margin on sales of small business was 67 percent below that of large business and that even in 1943 was 30 percent below the rate of profit of large business.

GENERALIZATION ON PROFITS NOT SUPPORTED IN MACHINERY (METAL-WORKING) INDUSTRY

The misleading impression of greater financial success of small manufacturing as compared with large is furthered by the following statement: "Metal products profit margins of large companies declined after 1941, while those of medium-size companies declined after 1942, and small concerns continued to increase their profit margins through 1943. The result was that margins of the large companies in most war industries were lower in 1943 than in 1940, in contrast to the considerable increase experienced among small companies." The conclusion obviously sought in this quotation from the article may be tested from the data. The ratio of net profit to sales in the Morris Associates data on 11 companies in the nonelectric machinery class rose from 6 to 10 percent between 1940 and 1943 whereas the profit ratio of 15 largest companies rose from 8 to 17 percent. The decline from 1942 to 1943 was far greater for the smallest companies than for the largest. The profit ratio to sales of 11 small iron and steel products companies rose from 5 to 11 percent while the profit rate of 12 large companies rose from 8 to 17 percent in the same period. These examples from important war industry groups illustrate how an entirely false impression of small-business finance has been given by the generalizations cited.

The study does not present information on net profit after taxes and renegotiation to sales, although it does present the percentages of net profit on net worth and the percentage changes between 1940 and 1943 according to size classes. Net profit after taxes on the volume of business is one of the most significant factors in the financial management of a small business because its growth must come from that source. Unlike large concerns, the smaller manufacturer does not have access to investment banking assistance to meet longer term capital needs. The article gives the impression that narrower profit margins have been realized among larger-size companies in war industries than among small companies.

That this is an inaccurate impression is demonstrated by the Morris Associates data on the following important war industry fields.

Net profit (after taxes) to sales

	Iron and steel products		Nonelectric machinery	
	11 small companies, under ¼ million	12 large companies, $5,000,000 to $10,000,000	11 small companies, under ¼ million	12 large companies, $5,000,000 to $10,000,000
	Percent	*Percent*	*Percent*	*Percent*
1940	3.7	6.5	4.9	6.1
1941	5.0	6.6	5.6	8.3
1942	4.1	5.0	5.7	5.4
1943	3.4	3.9	2.1	3.4

RENEGOTIATION

There is an implication in the article that the large asset concerns are the ones chiefly affected by renegotiation. In view of the volume of business taken on by small-asset concerns and the tendency to measure excessive profits for renegotiation in terms of pre-war profits levels (lower for small business than for large) and in relation to invested capital (prejudicial by its very nature to small-asset concerns), many smaller firms have had their financial condition very seriously affected by the renegotiation procedures. After renegotiation of 1942 and 1943 business, manufacturers having less than $1,000,000 sales volume were left with a smaller margin of profit on sales than were companies in the $5,000,000 to $10,000,000 sales bracket. There is no available evidence that renegotiation has dealt less harshly with small companies than with large in spite of the greater risk and wide fluctuation in yearly income among small business units which should justify wider profit margins during war years.

It is difficult to agree with the article's theory that the rate of profit on net worth is more meaningful than the percentage of sales. Either measure along is inadequate. Applied to small manufacturing units, the measuring of profit by a ratio to net worth is extremely misleading because labor and management, rather than large invested capital, produce the results typically in small scale enterprise.

A company employing relatively little capital and requiring a relatively large amount of labor and managerial skill usually operates most effectively as a smaller unit. One that requires a relatively large amount of capital and hence a relatively small amount of labor, usually operates most efficiently as a large-scale unit. This is well illustrated in the contrast between women's shoe (small scale) and men's shoe (large scale) manufacture. To measure earnings of enterprises, which organically use widely different proportions of the factors of production, by the rate of profit on net worth or invested capital is by itself not a valid basis for relative comparison of profits. The measure tends to give an inflated picture of profitability of smaller manufacturers as indicated in table 5 of the Dirks article. Such an interpretation is erroneous. Because of this factor and also because of the risk inherent in small manufacturing enterprise, new capital would be more readily attracted to concerns of more than $10,000,000 with an earnings rate of 28.0 percent than to those of less than one-fourth million dollars in spite of the earnings rate (before income taxes) of 55.6 percent.

Exception is taken, therefore, to the following statement on page 21: "Notwithstanding the larger increases of net worth among smaller manufacturing companies, the combination of more rapidly expanding sales and wider profit margins during the war has resulted in pushing up the earning capacity of small manufacturing business much more than that of large manufacturing." The total impression is greater than the parts of the sentence will support. The phraseology is calculated to suggest that net worth of small business has expanded enormously whereas it can be true only in terms of relative percentages. The article gives no data on comparative net worth changes. Basic data are available, however, on changes in working capital.

SMALL BUSINESS MANAGEMENT NOT CONFIDENT OF ITS FINANCIAL STRENGTH

In 147 concerns with assets under one-fourth million dollars net working capital from 1940 to 1943 increased $4,757,000 whereas in 95 concerns with assets of five to ten million dollars working capital increased $79,730,000 in the same period. The huge additions to the working capital of large firms are less percentagewise than the little increases for small firms but are more significant in terms of strength to weather the shocks of recession. That the managements of the large firms entertain this view of their financial strength is indicated by dividend disbursements during the period of $84,000,000, or 105 percent of the increase of working capital, as compared with only $3,000,000 of dividends in the small classification, or only 60 percent of the increase in net working capital. Both large and small firms have increased their finances; the smaller concerns, however, have far less working capital to sales, have been able to distribute relatively less of their earnings in dividends and show that they are far less confident of the financial ability to cope with future difficulties.

SMALL BUSINESS ADVERSELY AFFECTED BY TAX STRUCTURE

The Dirks article seeks to establish the thought that smaller concerns have been subject to lower tax rates than large. Competent tax authorities believe that the contrary is true. The measures of excess profits, invested capital, and average earnings, all tend to discriminate against smaller concerns. The typically wide fluctuations of earnings of smaller concerns result in a relatively heavier tax over a period of years. The tax structure, as table 6 indicates, has absorbed a substantial portion of the earnings of the smaller manufacturing enterprises.

The foregoing instances are not a compendium of all the faulty generalizations from inadequate evidence in the article. The piece is a remarkable tour de force in that by phrase and sentence, statements are extremely guarded and careful, but by juxtaposition and combination they combine into a portrait of small business which, while flattering, would perhaps be unrecognizable by its subject.

Mr. Dirks began his article by stating, "Previous information on small business finance has been very limited"; this reviewer reluctantly must conclude that accurate information on small business finance is still very, very limited.

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