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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date May 25, 1945.

To Chairman Eccles

From Mr. Hopkins and Mr. Musgrave

Subject: Preliminary Study for Chairman's presentation

The present is a strategic time for formulating a sound program for meeting the long-term needs of small business. Small businesses at present are prosperous, but small business as a type of enterprise is under serious pressures.

As long as we have taken the individual approach, we have dealt only with the surface aspects and fringes of the problem. During the depression, it was assumed that if we could only pump out more and more credit to small business borrowers, all would be well. We conceived of the problem in terms of credit and relief. Circumstances now permit us to take a more rounded approach.

When we speak of small business, we have something else in mind besides smallness in the business size. We have in mind the independent individual enterprise, which is usually small. It is fortunate for the economy that, along with the growth of a few thousand large business collectives in the last half century, enterprises of the individualistic type remain very numerous, about three million in number. The small businesses have much to do with preserving competition, with adding variety to the standard of living, and with supporting independent communities. Also they tend to develop the type of individual that backs his own judgments and has the spirit of enterprise and venture. The more bigness we have -- big industry, big government, big labor -- the more we need such individualistic offsets as small business, small farming, and independent professional life. It may be, in the last analysis, that democracy depends upon the maintenance of an adequate amount of individualism. If a democratic government had to subsidize individualism to keep it alive, it would only be subsidizing its own foundation.

This type of enterprise has tremendous vitality. We need not take an alarmist view. Many small businesses that disappeared during this war will revive, and more will be founded as demobilization proceeds. This process is already on; since May, 1944, the number of business births has exceeded the number of discontinuances. After dropping from 3,398,000 in September 1941 to 2,840,000 in December, 1943, the total number of business firms was 2,938,400 last September and undoubtedly exceeds 3,000,000 today. This phenomenon would be gratifying if the environment could assure that the new business births would not be compensated by a rise in business deaths.

Small business ~~also~~ is especially important to employment. In 1939 eight million wage-earners and two million proprietors were employed in enterprises having less than 50 workers each, which was about equal to the total employment in all concerns having 1,000 workers or more. Perhaps we need not be especially alarmed by the fact that from 1939 to the end of 1943, employment in the less-than-50-worker concerns declined by 1.7 per cent, whereas employment in the more than 1,000-worker enterprises increased by 95 per cent. This wartime distortion will tend to rectify itself if only the conditions are right. But conditions are not right in certain basic respects, and we cannot have either the desired restoration of individualism in enterprise, or full employment in the nation, unless conditions are made favorable for the small enterprise.

What, then, is the small business problem? There are financial problems, but these are a visible symptom only. We may reach behind the financial problems and ask: Why, in a nation that has abundant investment capital, should small business have difficulty in commanding capital? Why, in a nation that has vast credit resources, should small business complain of unfavorable differentials in credit, especially term credit? Taking an historical view we may ask: Why did the problem of small business become serious during the 1920's when investment capital was extremely active? Why did small business do reasonably well before the first World War, when credit was scarce and high priced, but encounter trouble during the present war when credit was abundant?

Technological basis of the problem

The basis of the problem, it seems to me, is not financial, but technological. Invention, during the 19th Century, provided small machines to supplement the work of individual craftsmen; the sewing machine, the linotype, the typewriter, small woodworking and metalworking machinery, and the like. Small business seized upon these small-unit machines and still utilizes them in the lines where mass production has not extended. But in recent years, these machines have become more refined and more costly, and in addition, the mass producing type of machinery has been vastly developed and applied. As a result of both these trends, the minimum capital requirement for successful operation in nearly all fields of enterprise has considerably increased. It has become increasingly difficult to start a new business on a small scale, or to continue in business, unless the capital investment is fairly large.

For example, in former years a man in the contracting business could bid successfully for contracts, and perform them successfully, on a pick and shovel basis, with very little need of capital. Today, in order to find work and compete, a construction firm must have costly bulldozers, heavy trucks, machine-drills, and other expensive equipment. In former years in the lumber industry, even the largest trees were cut down by axes, logs were coasted down to water, sawmills were fairly simple, and finished may be found lumber was dried in the sun. These conditions still obtain in the Southeastern lumber industry, but West Coast lumbering today is a matter of power-driven logging, haulage by railroad, elaborate sawmills and kiln drying of finished lumber. ~~In former years a beet-sugar refinery might represent as little as $500,000 in capital, but invention has been added to invention so that today the minimum investment in a sugar refinery is around $2,500,000.~~ This situation has, of course, varied considerably among different industries, but even the small corner store today must have its refrigeration plant, and the small beauty parlor its elaborate electrical devices.

This higher capital requirement has had the effect of discouraging venture. The higher capital requirements have meant higher overhead costs and fixed charges. The higher costs have required a larger volume of business, and created a more rigid break-even point. The necessity for larger volume has involved an expansion of the market, and the break-even point has required a broadly spread market so that the fluctuations in one area would be compensated by the fluctuations in another. This, in turn, has increased sales costs and required larger amounts of working capital. ? Finally, the larger the enterprise, the greater the meaning of the adjective "risk" in the term "risk capital". Investment funds; in turn, have preferred the enterprises with the broadest market base, in order, as it has been generally assumed, to reduce the risk.

<u>Opportunity for a threefold attack</u>

Nothing can be done to reverse the technological trend. Large enterprise represents one type of progress, and we cannot turn back the clock. But the process has had certain byproducts which, it seems, are not essential, and can be changed. 1. Small enterprises as well as large can be technologically efficient in their fields, and many of them are so. But as a general condition the small business has a defieient contact with the findings of modern technology, while the large enterprise has thorough-going contact. This seems susceptible of remedy. 2. The small business has a sharply fluctuating earning position, but the ups and downs generally average up with time; the taxation system, however, has failed to gear itself to the fluctuating incomes and has placed a penalty against venture investments and risks. 3. As to investment, there seems no valid reason why, in creating elaborate mechanisms for supplying the capital needs of 5 per cent of American enterprises, it should so completely have neglected all institutional provision for the 95 per cent. Insurance, finally, has failed to provide protection behind the extensions of credit in the area involving risk. In summary, small business has lacked certain facilities essential to the proper conduct of business under modern conditions, and the problem on its practical side comes down to that of designing and providing the necessary facilities. Under the circumstances of general neglect that have existed, it is remarkable that independent enterprise has managed to survive.

Some elements in the small business problem are doubtless beyond reach. But at least facilities can be established, and it would probably pay the government to establish them, in view of the desired contribution of small business to freedom of enterprise and to employment.

I. The Technological approach

The first item in such a program would be a facility for placing small business in better touch with modern technology and, in general, with the best management information and technics of every type. The big organizations have their own laboratories, some 2200 in number, and large companies and associations covering the major portions of their industries are constantly represented at the National Bureau of Standards. The larger businesses also have their own economic and marketing experts and staffs. Not only is the small business unable to support such services, but its management often does not know where to write for the most reliable type of information of the desired kind.

What is here suggested is that one central place be established within the government, to which the small business may send in a query on any difficulty connected with management, that is hampering its efficiency. The queries might deal with technological problems, production "bugs," sources of needed materials, use of byproducts, methods of personnel administration, accounting standards, market opportunities -- any matter within the accepted range of management problems. The central query bureau would not directly answer these queries but would serve as a clearinghouse and source-finding agency. It would have to build up cooperation with all scientific and economic agencies of government, technological societies, universities, any private organizations that would consent to help. The task would be to run down the sources of the needed information and put the small business directly in touch with those sources, leaving the rest to the small business itself. An informational clearinghouse service of this type seems an appropriate function for the Department of Commerce. Much scientific information and "know-how" is public and open, and public-minded agencies would work for small business if they had the chance.

The nucleus of this idea already exists, having been developed in private banking circles in 1936, by a Buffalo bank~~er~~ in cooperation with the National Research Council of the National Academy of Sciences. The system developed by this bank was adopted by the Smaller War Plants Corporation when General Johnson was its Director, and applied to problems of small plants in war production. A much more extended use of the same system seems entirely practicable, especially if it had no connection with a government lending agency.

II. The approach through taxation

The second approach to the small business problem is in the tax field. This is a matter about which there has been much discussion and much pussy footing of the real issue. Adjustments in the law are needed to eliminate certain provisions which are especially detrimental to small enterprise, but this is not enough. To do the job well we must formulate the tax law to give the small business unit direct encouragement and preferential treatment. I shall consider this briefly with regard to (1) the excess profits tax, (2) the corporation income tax and (3) the personal income tax.

(1) Excess Profits Tax

I am in accord with the recent proposals of the Joint Committee for Internal Revenue Taxation and the Treasury Department for raising the specific exemption under the excess profits tax from $10,000 to $25,000. This will reduce the number of excess profits tax paying corporations greatly and will do much to render investment in the smaller business unit more attractive. Similarly, small corporations will profit from the accelerated carry-back and amortization provisions included in the Committee's proposal.

For the duration of the war this will be a satisfactory arrangement, but what shall be done thereafter? There is a tendency in current tax discussions to consider the excess profits tax as a tax to be discarded immediately, once the last shot is fired. I disagree. Some reduction in business taxes will be possible and helpful, but we should not give all the benefit to the corporations with excess profits. Elimination of the excess profits tax, while retaining corporation income tax rates at their present level, would give the greatest tax relief to those who need it least. This would be a tax differential unfavorable to the smallest corporations.

Instead, I should favor a gradual reduction in both the excess profits and corporation income tax rates. We may well consider a further increase in the excess profits tax exemption later on, say from [illegible]. It may be mentioned in this connection that the excess profits tax after World War I was continued through the income year 1921, or for three years after the cessation of hostilities. Surely there is likelihood of large profits to some enterprises in the early postwar years, and these should not be ~~permitted to go tax free~~ given special tax relief.

(2) Corporation Income Tax

Among various adjustments that need be made in the corporation income tax, the treatment of dividends and of losses are of particular importance to the small corporations.

Under present and prewar practice, equity capital is taxed under the corporation income tax, and again, under the personal income tax, when distributed in the form of dividends. Income from fixed debt forms, on the other hand, is not taxed at the corporate level, interest payments to bondholders being taxed but once, under the personal income tax. The resulting discrimination against income from earning capital is serious, particularly for the small enterprise which needs new capital. Numerous schemes have been proposed to give tax relief to equity capital. I should prefer to give the relief at the corporate level, and exclude from taxable income such part of corporate profits (or a fraction thereof) as is distributed in the form of dividends. This would take care of the problem of double taxation and, in addition, would exert a healthy pressure for the distribution of dividends. Also, it would be a good deal simpler than some of the other methods which have been suggested. To protect small corporations in need of funds for capital expansion, it might be well to provide that some minimum amount of retained income, say $50,000, receive the same favorable tax treatment otherwise given to distributed profits.

Adequate provision for carry-over of losses is again vitally important to the small corporation, which is not in a position to spread its risks over a wide variety of ventures and which is likely to have a more fluctuating income. The small firm can be less certain that its losses may be charged against other taxable income than its bigger competitor. If a 5 or 6 year period for the carry-forward of losses is allowed, combined perhaps with a 2-year carry-back period, this disadvantage of the small firm will be reduced.

Apart from these provisions which would make for a general improvement in the corporate tax structure, I believe that special relief should be given to the small corporations. This should be done either by granting a substantial exemption, or by providing some progression in the rate schedule. Also, the possibility of giving small corporations the option of paying taxes under the partnership form should be fully explored.

(3) Personal Income Tax

The great mass of truly small business units, however, are unincorporated. Their tax problem therefore is under the personal, rather than the corporation income tax. From a social point of view these are the very units which it is most important to encourage. But at the same time the technical problems of providing encouragement under the personal income tax are the most serious.

Proposals have been advanced to provide some credit under the personal income tax for funds which are invested in small business units. But I fear that this would involve serious problems of tax evasion. A more feasible approach perhaps would be to give some favorable treatment under the personal income tax, not for amounts invested, but for income derived from investment in business units with assets of less than, say $50,000. This credit might be given along the lines of the old earned income credit, or rather the old earned income credit might be reintroduced and be supplemented by a credit for income from small enterprise. Such a provision without doubt would greatly increase the attractiveness for investment in small business units to those who have to pay high surtax rates. It would thereby somewhat reduce the progressiveness of the tax structure, but would be most effective in attracting capital into small business from exactly those sources best in the position to assume the risk of investing in small firms. While a plan of this kind would undoubtedly involve difficulties, it should be given serious consideration.

III. The financial approach: (a) Equity investment

The third major problem is that of a direct attack upon the problem of supplying adequate capital and adequate credit for small business. Tax adjustment would help the restriction of equity investment in small business indirectly, but some new form of investing institution is also needed. Traditionally, the individual small enterprise was capitalized by the individual investor, and this unorganized source of capital apparently worked with success until shortly before the first World War. It is an interesting fact that community funds for the capitalization of small businesses, in which local investors pooled their funds for joint investment instead of taking individual risks, were founded in a few localities between 1910 and 1916. Evidently, the risk-taking individual was beginning to vanish at that time. Some of these early community funds are still in existence and one, the Louisville Industrial Foundation, founded in 1916, has become to some extent the model on which the new small business plan of the Investment Bankers Association of America is largely based. I am not fully in accord with that plan. However, it is directed toward filling a gap in our investment institutions that has never been adequately filled, and certain features impress me as sound. The local investment company, directed by local business leaders and locally administered, is the best replacement for the individual investor, and unquestionably better than any central or large-scale investing institution, private or governmental. Local business leaders know their localities and the enterprises in them, and community patriotism is a force that should be brought to bear.

The plan is also sound in clearly recognizing that additional ~~outside~~ funds will also be needed, by such local investment companies, if the job is to be properly done. But there are other features of the I.B.A. plan that are less convincing. The required ~~outside~~ funds under this plan are to be borrowed direct by sale of debentures to the Federal Reserve Banks, whereas it seems to me that the private investment market, or such pools of private capital as the credit pools recently formed by commercial banks throughout the United States, would be a more appropriate source. The makers of the plan condemn government lending, then propose to borrow government funds, which is inconsistent. Government funds should be the last, not the first, resort.

Furthermore, this plan provides that a local investment company, after investing in an equity of a local small business, may resell that equity in the public market -- a feature which might go far to destroy small business itself. If the equity were resold to a competitor, to a chain store concern, or to a large manufacturing company in search of an affiliate, the independence would be gone and the investment company would become an instrumentality of business concentration. This by all means is to be avoided. The Louisville Industrial Foundation has never resold its paper, but has held it for amortization by the benefited enterprise.

Finally, there is a considerable question whether such local investment companies would develop a sufficient volume of investments to enable them to live. A good many of them might fail. Their charges for money and for business services apparently would be somewhat high, so that if term loans from commercial banks were available, the proposed investment companies, particularly the smaller ones, could hardly compete with banks. However, small business urgently needs a type of institution that will channel local investment funds back into each locality, and perhaps this plan could be modified so as to eliminate its undesirable features and to make it more workable.

The financial approach: (b) Credit

The credit problem of small business, finally, should be clearly conceived of as one of stimulating the flow of private credit to small business, as opposed to direct governmental lending. The great majority of all banks are themselves small businesses, and government should encourage them, not undermine them by its competition in the lending field.

Very many small businesses have satisfactory credit relations with their banks and for them no credit problem exists. But we want that number to increase. The problem is how to bring the commercial bank loan further over into the area of the marginal credit risk. The commercial banker is not a risk-taker by training or profession, and if he were, his responsibility to his depositors would act as an inhibition. Yet the banker is identified with his community, knows its problems and exists to serve its enterprises. The problem, accordingly, comes down to finding some means of enabling the banker, without undue risk to his depositors, to broaden the scope of his credit operations and assume greater risks.

The technique of the V-loan system, which has provided 9-1/2 billion dollars' worth of credit on the high-risk margin of war production, provides the answer to this problem. No system ever devised in history for extending the margin of the bank credit risk without risk to depositors has ever worked as successfully as the system that was installed by Presidential order in March 1942, and implemented by Regulation V. Under that system, banks accepted war production credit risks that could not possibly have been accepted in any other way, and with rare exceptions those credit risks proved sound. To credit applicants that were fundamentally acceptable, the plan permitted the authorization of much larger sums in credit than could otherwise have been provided. The private initiative of bankers was not invaded, and business on its part found bankers exploring new means and methods of extending credit, rather than denying or unduly restricting credit. It would be detrimental indeed if, at the very beginning of the readjustment period, the credit mechanism that has created the most favorable small business credit situation on record should be indifferently flung aside.

The V-loan plan was not a new plan. It was a development of a credit plan adopted by Congress in 1934, in adding section 13b to the Federal Reserve Act. That legislation authorized the Federal Reserve Banks, within somewhat narrow limits, to make loans to business and industry, and also, within the same limits, to make commitments in regard to loans made by banks and other lending institutions. While the limits themselves went far to hamper the purposes of the act, the experience demonstrated that the commitment feature was superior to the direct lending feature, or to the participating loan feature, in practice. The commitment proved unexpectedly popular, so that 40 per cent of all 13b loans and more than 50 per cent of the total amount of credit authorized proved, after 6 years' time, to be commitments. When the war came, shortly after Pearl Harbor, the President authorized the procurement agencies to make similar commitments, naming the Federal Reserve System as the administrating agency.

The commitments in question are known as deferred participations or "take-out" agreements. A bank or other private lending institution sets up, makes and services the loan. But before doing so, the bank may apply for an agreement with the Federal Reserve Bank of its district, under which agreement the Federal Reserve Bank stands ready to take a participation in the loan at some later time, if requested by the bank. Ordinarily, if all goes well, the bank will keep the entire loan until it is retired in due course. But if trouble threatens, the bank may ask to be taken out, up to the proportion stipulated in the earlier agreement. In that case the Federal Reserve Bank purchases the stipulated percentage of the loan. What was formerly a bank loan now becomes a loan in participation, and if loss actually occurs, the Federal Reserve Bank takes its stipulated percentage of that loss. For this assurance that it can rid itself of part of a losing transaction if it desires, the bank pays a part of its interest receipts to the Federal Reserve Bank as a premium or fee.

Private initiative and enterprise in banking are fully preserved under this commitment plan. Certainly the independence of banks was not invaded in lending 9.5 billion dollars under Regulation V. From 3 billion to 3-1/2 billion dollars in war production loans has been outstanding from commercial banks at all times since the beginning of 1943. More than half of this amount has been represented by V-loans. On June 30, 1944, when $3,153,000,000 of war production loans were outstanding, $2,064,000,000 or 66 per cent were V loans. This does not resemble an invasion of the banking function. Rather, it greatly increased the volume of profitable bank loans.

The plan was equally beneficial to small business. Although the V loan protection was open to enterprises of every size, the record shows that 62 per cent of all V loan borrowers were small manufacturing and construction enterprises with less than $500,000 in total assets. To these small war plants the commercial banks under this protection loaned $835,000,000, an amount many times as large as was loaned by any government agency directly to small war business. The average amount of credit extended to these smaller enterprises was generous; the very small concerns, with less than $50,000 in total assets, received an average V loan authorization of $96,900, while the slightly larger enterprises with assets between $50,000 and $500,000 received an average V-loan authorization of $409,700. The effectiveness of the commitment plan in assuring small business of adequate bank credit has been demonstrated beyond all question by the V-loan experience.

It would be a serious blow indeed to small business in the reconversion period if this form of guarantee behind its credits were discontinued. Rather, the plan that worked so successfully in war should be applied to the credit needs of the postwar period. But the V-loan system at present is beginning to lapse. The system applies, legally, only to war production, and is disappearing piecemeal as war loans are paid up and retired. Foreseeing a year ago what this lapsing of the V-loan system would mean to the credit rating of small business, the authors of the Baruch-Hancock report recommended the extension and adaptation of the V-loan plan to the bank credit relations of small business after the war. A bill embodying this recommendation was prepared, and introduced into the Senate by Senator Wagner and into the House by Representative Spence. This bill has been reintroduced ~~before~~ during the present session of Congress, but so far without action. Meanwhile, small enterprises, retiring from war production, are due to suffer a decline in credit rating at their banks because the partial guarantee behind their credit risks is removed. Some protection can be afforded under the old 13b, but the former unworkable limits remain. I regard the passage of the Wagner-Spence bill as the central item for meeting the financial problem of small business, and believe it should be passed without delay.

<u>Summary</u>

The small business program, then must be three-fold -- a central system of technological and managerial information that small business can readily use, readjustment of the tax system so as to favor independent enterprises and ventures, and the continuance of the V-loan method of extending the credit margin of commercial banks. Some new form of capital investment institution is also needed. No item in this program amounts to the coddling of small business, and none invades private enterprise. Small business has every right to the existence of the normal facilities that would tend to put it on an operative par with big business, and it is to the interest of government to establish those facilities. If we merely provide equal opportunity to small business, we can probably depend upon it to seize upon that opportunity.