BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

FOR THE PRESS

For immediate release June 1, 1945

STATEMENT BY CHAIRMAN ECCLES BEFORE THE SELECT COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES FRIDAY, JUNE 1, 1945

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 handicaps.

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. We now know that a broader approach is necessary.

Small business in practice means independent individual enterprise. It is fortunate for the economy that, along with the growth of a few thousand large businesses 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. In a democracy small business, small farming, and independent professional life are important offsets to big enterprise. It may be, in the last analysis, that democracy depends upon the maintenance of an adequate amount of individualism.

This type of enterprise has tremendous vitality. Many small businesses that disappeared during this war will revive, and more will be founded as demobilization proceeds. This process is already underway; 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 offset by a rise in business deaths.

In particular, small business is 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. 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, however, will tend to rectify itself if conditions are favorable. But conditions are not favorable in certain basic respects, and we can hardly hope for either the desired restoration of individualism in enterprise, or full employment in the Nation, unless conditions are made favorable for the small enterprise.

Technological basis of the problem

What, then, is the small business problem? The basis of the problem, it seems to me, is not financial, but technological. Over the years, machines have become far more productive and hence far more costly. The mass producing type of machinery has been greatly developed and applied. As a result of these trends, the minimum capital requirement for successful operation in nearly all fields of enterprise has greatly increased.

This higher capital requirement has had the effect of making it more difficult to start a business. The higher capital requirements have meant higher overhead costs and fixed charges. The higher costs have required a larger volume of business and broader markets. This, in turn, has increased sales costs and required larger amounts of working capital. Investment funds have preferred the enterprises with the broadest market base in order to reduce the risk.

Three approaches to the problem of small business

I should like to discuss briefly the problem of small business from three general aspects; first, from the standpoint of technological and managerial assistance; second, from the standpoint of adjusting the tax structure; and third, from the standpoint of supplying credit and capital.

I. The technological approach

The first item in such a program would be to provide a means for placing small business in closer 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 in touch with 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.

A central place should be established within the Government, to which the small business may send in a query on any problem connected with management, such as technological or production problems, sources of materials, use of by-products, methods of personnel administration, accounting standards, market opportunities, etc. The central bureau would, in effect, do for business and industry what the Department of Agriculture does for agriculture.

II. The taxation problem

The second, and perhaps the most important, approach to the small business problem is in the tax field. The tax structure should be revised so that, in effect, it will put a premium on funds invested in new ventures and a penalty on funds that are put into existing ventures for speculative capital gains.

What would greatly encourage small business after the war is ended would be, first, to reduce the excess profits tax from the present 95 per cent maximum to, possibly, 65 per cent, and to make the corporation tax, say, 25 per cent instead of 40 per cent as it is now with the surtax. Secondly, to exempt from the 25 per cent corporate tax all profits paid out in dividends which would be taxed in the hands of the recipients. This would avoid the double taxation that is so great a deterrent to the investor in productive enterprise. It would also have the desirable effect of inducing corporations to pay out rather than to retain profits. Third, to give an exemption of $25,000 to all corporations under the excess profits tax. This would be of little moment in the case of a large corporation, but it would be a tremendous benefit to the smaller and medium sized concerns.

(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 weakest corporations.

It should not be forgotten that excess profits in the next few years will be as direct a result of the war as are the excess profits of today. I can see no justification for failing to tax those war profits then, as now. Beyond that, however, complete elimination of the excess profits tax will make it impossible to provide the tax benefits that I have mentioned for the smaller enterprises.

(2) Corporation Income Tax

Among various adjustments that need to 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 equity 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 tax credit 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 as that given to distributed profits.

Adequate provision for carry-over of losses is also vitally important to the small corporation, which is not in a position to spread its risks over a wide variety of products and markets and is, therefore, more likely to have a fluctuating income. 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.

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 complex and difficult of solution.

III. The financial problem

Undoubtedly, there is a lack of an adequate mechanism today for providing equity capital for the smaller ventures. The exemption from SEC requirements for financing up to $300,000 should be of help to the smaller concerns in obtaining equity capital. However, even with this exemption, costs of new financing will still be high on small flotations.

The Investment Bankers Association of America has presented a plan which is directed toward filling a gap in our investment institutions. 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 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 IBA plan that are less convincing. The required additional funds under this plan would 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 funds that the IBA plan proposes to use would not be available if the Wagner-Spence Bill is enacted, as I hope it will be. Federal Reserve funds are not appropriate for this purpose because there should be no mandatory requirement for their creation which might conflict with over-all credit and monetary policy. Hence, if the plan is not to be supported by private funds, a Government appropriation will be necessary.

There are some other features of the IBA plan which I think should be modified, but I shall not undertake to discuss them here.

Turning to the credit problem as it affects small business, I feel that it 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 compete with them in the lending field.

Many small businesses, which are not in need of long-term credit, have satisfactory short-term credit relations with their banks, and for them no credit problem exists. The problem is how to bring the commercial bank loan further over into the area of the marginal credit risk, particularly for long-term credit.

The technique of the so-called V-loan, which has provided billions of dollars of credit for war production, is a logical answer to the problem. The idea was by no means new. It was an outgrowth of the credit plan adopted by Congress in 1934 in adding section 13b to the Federal Reserve Act. That legislation authorized Federal Reserve Banks, under narrow restrictions, to make direct loans to business and industry, participating, however, with local banks wherever possible in these loans and commitments.

The Wagner-Spence Bill, which is pending before the Banking and Currency Committees, would carry over into the reconversion period and, specifically, until the end of 1949, unless further extended by Congress, this guarantee principle of governmental aid which has worked out so successfully in FHA financing and in the so-called V and T loaning operations for war production and for transitional reconversion purposes.

Instead of setting up governmental lending agencies financed out of taxes or deficits to supplement or, as so often happens in fact, to compete with banks or other private lending institutions, it would be far better, if we are to preserve a free enterprise system, to aid the banks and similar institutions to function more effectively in meeting the varied and changing needs of business, industry, agriculture and individuals in the communities they serve. Where oppressive and restrictive regulations beyond those required for public protection cripple private lending institutions, they need to be liberalized and amended in the light of modern needs and conditions.

Some progress has been made in that direction, notably in the revision of bank examination policy in 1938. The revised procedure, under which appraisals of bank assets are based on intrinsic worth rather than on fluctuating current market values, has been adopted in principle by the three Federal bank supervisory authorities and by those of practically all of the states. If it has not been carried out adequately in practice, it is largely because old habits die hard.

Similarly, the Banking Act of 1935 liberalized the authority of the Federal Reserve Banks to lend to member institutions. Nevertheless, additional provision should be made for encouraging the flow of local bank credit by a mechanism such as is provided in the Wagner-Spence Bill. This measure would repeal the restrictive provisions of 13b. The loans would be made by private banks. To the extent that the banks made them without reliance upon the guarantee, so much the better. For borderline or marginal risk loans, a guarantee in part, that is, up to 90 per cent, would be available. As in the V and T loans, the fee which the lending banks would pay for the guarantee would increase with the percentage of the loan guaranteed. Hence the inducement would exist for the banks to assume as much of the risk as they felt they safely could. No appropriation would be required from Congress, since the fund originally provided under section 13b, amounting to approximately 139 million dollars derived from the gold increment, would be made available. This would permit upwards of one-half billion dollars to be loaned through this mechanism. While it is my opinion that many of the estimates of the amount of credit that would be needed by small business after the war are exaggerated, to the extent that the need does exist, this mechanism would go far to meet it.

The loans, of course, would be made by local banks to local people whom they know and with whose character, capacity and reliability they would be familiar. Loans by governmental institutions, unfamiliar with local conditions, are a very different matter. It is obvious that there can be no justification for giving easy Government credit to competitors of existing and established small businesses who have relied upon private credit and who could not compete against what in effect would be governmentally subsidized newcomers in the field.

The Wagner-Spence Bill, if enacted, would serve an all important need in the reconversion period by bridging the gap between termination (T) loans and those needed especially by smaller business enterprise to acquire plant, machinery, inventory, etc., that otherwise would be taken over and disposed of by the appropriate surplus disposal agencies. As you know, the V-loan program enabled the Reserve Banks to act as guarantors for the Army, Navy and Maritime Commission in war production loans made by private banks to war contractors and subcontractors. Similarly, the T program was developed to finance contract cancellation pending settlement by the Government. When settlement is made, the money has to be applied to the T loans, and the Army, Navy and Maritime Commission have no further authority whereby loans that will then be needed to finance purchase of surplus property could be guaranteed. The Wagner-Spence Bill would supply this deficiency, and would facilitate and simplify disposal of surplus property. War contractors and subcontractors desiring to acquire government-owned plant, machinery, inventory, etc., would be enabled to finance such purchases through the same channels using the same guarantee mechanism with which they are familiar, and the Government's interest would be safeguarded as it has been in the V and T loans. Contractors in possession of surplus property would be able to negotiate for purchase at the time of contract settlement, thus avoiding delay, expense and other complications that would arise if the property had to be removed and disposed of elsewhere. It would be most unfortunate to let this mechanism lapse. It can be most effective in facilitating reconversion, in disposal of surplus property, and in meeting credit needs, particularly of small business, after the war.

Summary

The small business program should be three-fold -- making available technological and managerial information that small business can readily use; readjustment of the tax system so as to favor particularly the smaller enterprises; and continuance of the V-loan mechanism to enable the banking system to extend credit.

Nothing that I have said is intended to reflect a mere sentimental interest in small business. It is an economic fact that the backbone of this Nation has been the small enterpriser and that our entire economic system and its survival depend upon fostering individual, not collective, enterprise.