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SMALLER WAR PLANTS CORPORATION

Maurry Maverick
Chairman

ECONOMIC REPORT

TAXATION



September, 1945

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BY

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1. SUMMARY OF TAX PROPOSALS

1. Effective for the tax year 1944, increase the specific exemption under the excess profits tax from \$10,000 to \$25,000.
2. Effective January 1, 1945:
 - (a) Remove small business from liability under the excess profits tax.
 - (b) Repeal the tax on capital stock and declared value excess profits.
 - (c) Repeal the carry-back of unused excess-profits credit.
 - (d) Extend the carry-forward of losses to at least seven years.
 - (e) Permit accelerated depreciation.

S E C T I O N I

A TAX PROGRAM

3. Effective January 1, 1945 repeal the carry-back of losses.
4. As soon after the war as permitted by budgetary and economic requirements:
 - (a) Modify the corporation income tax.
 - (1) Graduate rates up to \$100,000 of net income (with no notch provision) as follows:

<u>Bracket</u> (thousands of dollars)	<u>Rate</u>
0 - 10	10%
10 - 20	15
20 - 40	20
40 - 60	25
60 - 80	30
80 - 100	35
100 and over	40

- (2) Provide optional partnership treatment.
- (b) Modify the individual income tax.
 - (1) Increase exemption to \$200 for a single person, \$500 for a spouse, and \$500 for each additional dependent — these exemptions to apply to both the normal tax and the surtax.
 - (2) Provide more liberal deductibility of capital losses.
 - (3) Reduce rates with particular attention to effects on consumption and investment. The following rate schedule is suggested.

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I. SUMMARY OF TAX PROPOSALS

1. Effective for the tax year 1945, increase the specific exemption under the excess profits tax from \$10,000 to \$25,000.
2. Effective January 1, 1946:
 - (a) Remove small business from liability under the excess profits tax.
 - (b) Repeal the taxes on capital stock and declared value excess profits.
 - (c) Repeal the carry-back of unused excess-profits credit.
 - (d) Extend the carry-forward of losses to at least seven years.
 - (e) Permit accelerated depreciation.
3. Effective January 1, 1948 repeal the carry-back of losses.
4. As soon after the war as permitted by budgetary and economic requirements:
 - (a) Modify the corporation income tax.
 - (1) Graduate rates up to \$100,000 of net income (with no notch provision) as follows:

<u>Bracket</u> (thousands of dollars)	<u>Rate</u>
0 - 10	10%
10 - 20	15
20 - 40	20
40 - 60	25
60 - 80	30
80 - 100	35
100 and over	40

- (2) Provide optional partnership treatment.
 - (b) Modify the individual income tax.
 - (1) Increase exemption to \$750 for a single person, \$500 for a spouse, and \$400 for each additional dependent -- these exemptions to apply to both the normal tax and the surtax.
 - (2) Provide more liberal deductibility of capital losses.
 - (3) Reduce rates with particular attention to effects on consumption and investment. The following rate schedule is suggested.

I. SUMMARY OF TAX PROPOSALS

Surtax net income (000)	:	Proposed bracket rate
0 - 2	:	18%
2 - 4	:	20
4 - 6	:	23
6 - 8	:	26
8 - 10	:	29
10 - 12	:	32
12 - 14	:	36
14 - 16	:	40
16 - 18	:	44
18 - 20	:	47
20 - 22	:	50
22 - 26	:	53
26 - 32	:	55
32 - 38	:	57
38 - 44	:	58
44 - 50	:	59
50 - 60	:	60
60 - 70	:	61
70 - 80	:	62
80 - 90	:	63
90 - 100	:	64
100 - 150	:	65
150 - 200	:	65
Over 200	:	65

- (c) Reduce the yield from excises to about \$2 billion, with the taxes applied so far as possible to luxuries rather than to commodities consumed by the low-income classes.
- (d) Strengthen the estate and gift taxes by increasing rates, reducing exemption, and integrating the death and gift taxes.
- (e) Retain present payroll taxes without increase, providing for enlarged social security benefits out of general revenues.

II. INTRODUCTION

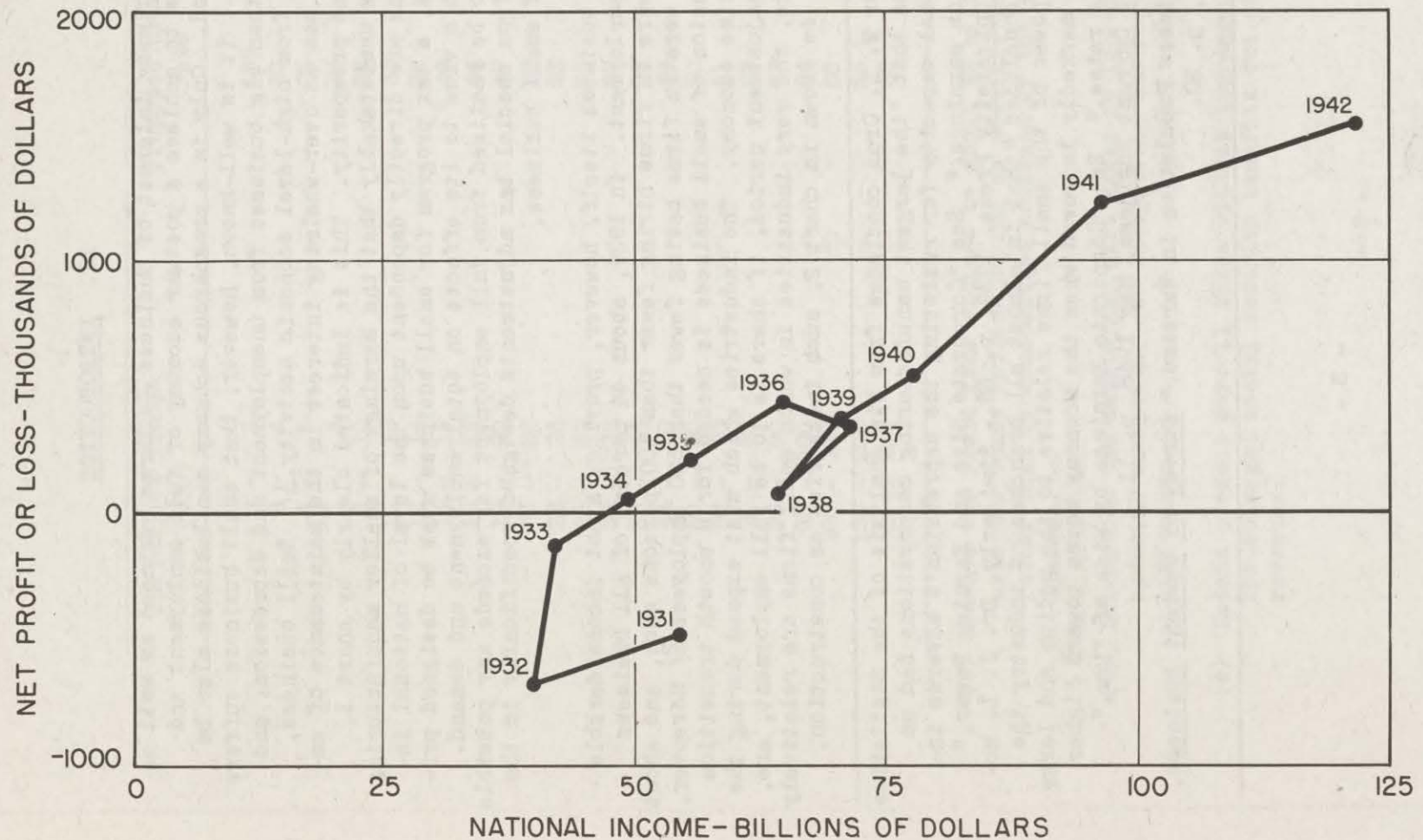
The primary interest of business — large business as well as small -- is to achieve a postwar economy of full employment and brisk demand. Only in a prosperous economy can business also be prosperous. It is well-known, however, that small business suffers even more than big business from unemployment and depression, and gains more from high-level economic activity.^{1/} Small business, therefore, has an over-whelming interest in the maintenance of employment and prosperity. This is indicated clearly by chart 1, which shows unmistakably that the earnings of smaller manufacturing corporations are directly dependent upon the level of national income. Thus, a tax program for small business must be designed primarily with a view to its effects on total employment and demand. The gain to be realized from full employment far exceeds any possible advantage from special tax adjustments designed specifically in the interest of small business.

Small business itself, however, provides a not inconsiderable amount of employment. In 1939, about 44 percent of all business employees were in firms hiring fewer than 100 persons each, and about 60 percent were in firms having fewer than 500 employees.^{2/} Moreover, rapid expansion of small business is needed for a smooth transition to a peacetime economy. The industries which must expand during the postwar readjustment period, if there is to be full employment, are, by and large, the very industries in which small firms are relatively important. As shown in chart 2, such industries as construction,

^{1/} Professor W. L. Crum concludes from his analysis of the Statistics of Income that "the largest manufacturing corporations had an exceptional capacity for resisting the depression's adverse influence on earnings." See "Corporate Size and Earning Power," Harvard University Press, 1939, p. 55. Similarly, Dr. J. L. McConnell concludes "that in almost all branches of industry the earning power of the small firms relative to the medium and large firms is markedly improved when the economy moves toward higher operating rates." See "Corporate Earnings by Size of Firm," Survey of Current Business, May 1945, p. 11.

^{2/} "The Business Population in Wartime," Survey of Current Business, May 1944, p. 20.

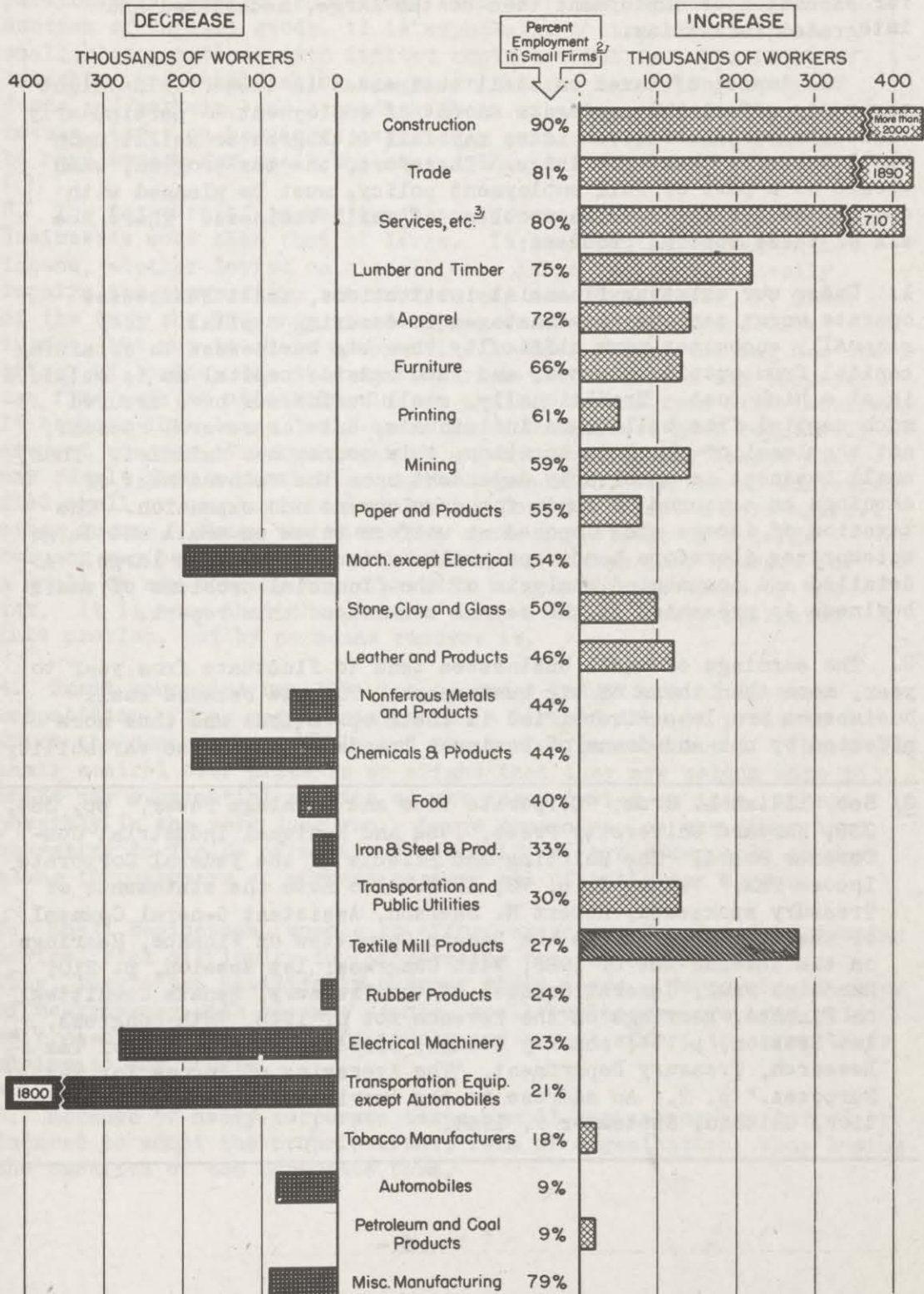
SMALLER MANUFACTURING CORPORATIONS* NET PROFIT OR LOSS RELATED TO NATIONAL INCOME 1931-1942



* With total assets under \$1,000,000

Sources: Compiled Net Profit or Net Loss—"Statistics of Income, 1931-1942" (Including Source Book and Worksheets), prepared by Bureau of Internal Revenue.
 National Income—"Survey of Current Business, April, 1944 and February, 1945," Department of Commerce.

NON-AGRICULTURAL INDUSTRIES
ESTIMATED EMPLOYMENT^{1/} CHANGE IF 55 MILLION WORKERS
WERE TO BE EMPLOYED IN 1947
1944-1947



^{1/}Source: U. S. Bureau of Labor Statistics (Preliminary Unpublished Estimates subject to substantial revision. Made available to the Smaller War Plants Corporation exclusively to indicate the general concentration of increases in industries with many small employers. The B. L. S. warns that until revised data are available these figures should not be used as estimates in individual lines of employment.) ^{2/}Percent of Industry's Total Employment in 1939 in Firms Engaging less than 500 Employees (Source: U. S. Department of Commerce). ^{3/}Services, Finance, Insurance, Real Estate, Miscellaneous.

trade, service, lumber, textiles and apparel, etc., with a high percentage of employment in small firms, offer greater opportunity for expansion of employment than do the large, mechanized and integrated industries.

The impact of taxes on small businesses in these fields might seriously affect the aggregate amount of employment -- particularly since the burden of given taxes may fall with greater weight upon small concerns than upon large. Therefore, the tax program, when viewed as a part of full employment policy, must be planned with due regard for the special problems of small business. There are six of these special problems:

1. Under our existing financial institutions, small businesses operate under serious disadvantages in securing capital. They generally encounter more difficulty than big businesses in obtaining capital from outside sources, and such outside capital as is obtained is at a high cost. Traditionally, small businesses have secured much capital from well-to-do individuals, but for several reasons, not the least of which is taxation, this source has dwindled. Thus, small business is peculiarly dependent upon the reinvestment of earnings as a source of funds for development and expansion. The taxation of income when imposed at uniform rates on small and large enterprises therefore handicaps small business more than large. A detailed and documented analysis of the financial problems of small business is presented in the second section of this report.

2. The earnings of small businesses tend to fluctuate from year to year, more than those of big businesses. This is because small businesses are less diversified in their operations and thus more affected by ups-and-downs of business trends.^{3/} While the variability

^{3/} See William L. Crum, "Corporate Size and Earnings Power," pp. 334, 335, Harvard University Press, 1939 and National Industrial Conference Board, "The Shifting and Effects of the Federal Corporate Income Tax," Volume I, p. 78, 1928. Also note the statements of Treasury spokesmen, Robert H. Jackson, Assistant General Counsel of the Treasury, before the Senate Committee on Finance, Hearings on the Revenue Act of 1935, 74th Congress, 1st Session, p. 210; Randolph Paul, General Counsel of the Treasury, Senate Committee on Finance, Hearings on the Revenue Act of 1943, 78th Congress, 1st Session, p. 44; and Roy Blough, Director of Division of Tax Research, Treasury Department, "The Averaging of Income for Tax Purposes." p. 7. An address to the American Accounting Association, Chicago, September 9, 1944.

of earnings characterizes corporate enterprise in general and particularly certain industries, such as those engaged in the production of capital goods, it is especially noticeable among the smaller corporations with limited capital which face the risks of launching and establishing new undertakings, developing new products and markets, and expanding their existing operations. As a result, taxes on earnings, especially on excess profits, tend to be more severe for small businesses than for big ones.

3. The taxation of income tends to increase the riskiness of small businesses more than that of large. It is true that a tax on net income, whether levied on a small or a large business, directly impairs the prospective return from any new investment. By means of the tax, the Treasury stands ready to share any prospective income, but not to share prospective losses. Thus, the tax has the effect of loading the dice against risk-taking unless the taxpayer can find ways of offsetting losses against income from other sources. It happens that large, well-established businesses have relatively assured sources of income against which to offset any losses that may result from a particular capital expansion, whereas an undiversified small or new business can seldom hope to offset a loss against other income. Thus, the risk from a new investment by a large company may be virtually unaffected by an income tax, whereas for a small or new company the risk will be greatly increased by the tax. It is true that the present carry-over of losses mitigates this problem, but by no means removes it.

4. Small companies usually operate under conditions of intense competition. They may specialize in a limited line of products for which the demand is variable and the market is restricted. Therefore, their control over price is so slight that they are seldom able to shift any substantial portion of the taxes levied on them, except possibly in the very long run. Large companies, on the other hand, operating in fields of moribund competition, are often able to pass along to customers or workers part or all of their tax burden.

5. Small businesses, unable to afford expensive legal and accounting advice, find difficulty in interpreting tax law and regulations. Thus, they often unwittingly overpay their taxes. Moreover, in cases of controversy with revenue agents, small businesses are less able to present their cases effectively and cannot afford to carry their claims to the courts.

6. Because of heavy corporate taxes, small businesses are forced or induced to adopt the proprietorship form of organization, thus losing the benefits of the corporate form.

When taxes were relatively low, as during the twenties, these problems could be safely ignored. But with the heavy tax rates of recent years and with the heavy rates that will almost certainly prevail in postwar years, it is urgent that the tax system be planned so that these special problems of small business may be overcome or their effects offset. Otherwise the capacity of small business for production and employment during reconversion and later will be endangered.

Federal taxation discourages risk taking and the birth and growth of small business. It has become too complex and it imposes burdens in wartime which cannot be endured in times of peace.

In order that small firms in manufacturing and other lines of business may thrive and increase the income of consumers, expand employment, and attract investment, tax planning is essential. It is particularly important that small businessmen know in advance the essential features of taxation which will become effective after the war so that they may plan now for postwar production and employment.

III. THE SETTING OF POSTWAR TAX POLICY

In the postwar revision of the tax system, the attainment and maintenance of full employment should be the primary objective. At the same time it is essential that the tax system provide adequate revenue, that it encourage competition, and that it be equitable in its effect on various classes of individuals and businesses. In order that the tax system may be easily-understood and simple in administration and compliance, there should be no sharp break with past tradition. The new tax system should be developed by an orderly modification of past and present practices rather than through a drastic upheaval of long-established and habitual forms of taxation.

1. Taxation and Employment

In framing a tax system designed to facilitate the achievement of stable full employment, it is necessary to consider the effects of taxation upon the amount of and timing of investment and consumption. The object is to stimulate investment and consumption and to limit saving to those amounts which can be usefully invested.

Tax policy designed to encourage employment is faced with a serious dilemma. Any attempt to increase consumption, involving moderate taxes on the lower-income groups and heavy taxes on the upper-income classes, reduces the prospective return to capital and impairs the incentive to take risks. On the other hand, any attempt to encourage investment, involving moderate taxes on the upper-income classes and heavy taxes on the masses, increases savings and reduces consumption. The problem is to find a way around this dilemma, i.e., to discover a technique by which both investment and consumption can be increased.

In the current debate on tax policy, many business groups have been preoccupied with investment incentives and their "plans" have called for sharp tax reductions for corporations and for upper-income individuals. The weakness of these schemes is that they tend to underemphasize the need for large consumption. Other groups have argued that a high level of consumption is itself a strong incentive to investment, since capital is always willing to provide expansion to meet an evident increased demand. Accordingly, they have argued that by reducing taxes on the lower-income classes, consumption and investment are simultaneously encouraged. A weakness of this position is that it tends to underemphasize the fact that heavy taxes on

corporations and upper-income classes tend to offset the incentive to invest that would otherwise result from the increased consumer demand.

In view of the consumption-investment dilemma, the strategy of tax planning for full employment is to neutralize so far as possible the effect of the tax system upon the incentive to invest; then to plan the types of taxes, rates, exemptions, etc., in terms of their effects upon consumption and in terms of equity considerations. In order to obtain needed revenues with moderate rates and thus to minimize the repressive effect of the tax system, it is also highly important to close certain loopholes now present in the tax system.

2. Taxation and Competition

In the design of the postwar tax system, the achievement of more effective competition should be one of the major goals. This requires that special consideration be given to the problems of small and new businesses. Present features of the tax system which discriminate against small and new businesses must be removed, and the tax system must be designed to neutralize, so far as possible, the handicaps to small business that are inherent in our financial and industrial structure. The measures needed to accomplish this are in no way incompatible with those required to stimulate employment. On the contrary, measures designed to further competition will aid greatly in the attainment of full employment.

3. Budgetary Policy

There are three fundamental rules of budgetary policy:

1. In periods when employment can be maintained at a reasonably high level without a deficit, the budget should be balanced. In such a situation, a deficit would serve no useful purpose and would be inflationary; a surplus, on the other hand, would be deflationary and harmful to employment.
2. In periods when there is inflationary pressure, the budget should not only be balanced, but tax rates should be increased and a surplus should be created for the retirement of debt. Such a surplus would tend to counteract inflation.
3. In periods when employment cannot be maintained at a reasonably high level without a deficit, a deficit should be

created by increasing public expenditures and by reducing revenues.

These rules imply that tax rates should be increased in periods of inflation and reduced in periods of deflation. There are strong practical arguments, however, against flexible tax rates. To increase rates during inflation would introduce an unnecessary element of uncertainty into the plans and calculations of individuals, and to reduce rates in depression would be inexpedient because it would be politically difficult to restore the rates once lowered. Moreover, there are general objections to flexible tax rates on the ground that we do not have adequate political and administrative machinery or technical knowledge for manipulating the rates promptly and wisely. Also, there is an irrational but nevertheless important prejudice against lowering rates in the face of declining revenues or raising rates in the face of increasing revenues. All things considered, a policy of flexible tax rates does not now seem practicable.

In view of the problems involved in tax flexibility, it is expedient at this time to follow a single rule of budgetary policy: tax rates should be relatively stable, and should be set so that the budget will balance whenever reasonably full employment can be maintained without a deficit. Although rates would not be flexible under this rule, the revenue derived from fixed rates would be flexible. Revenue would vary according to economic conditions, declining in periods of depression and rising in periods of inflation. In view of the advantages of revenue flexibility (as distinct from flexibility of tax rates), the fixed tax system should contain a minimum of taxes of the type which yield a stable revenue through varying economic conditions; for example, excises on necessities of life.

4. Definition of Full Employment

To implement the suggested budgetary policy, it is necessary to define "reasonably full employment". Most careful studies of the postwar economic potential of the United States reach a conclusion that the labor force of the United States in 1950 will consist of about 61 or 62 million persons. Reasonably full employment would be achieved if, say, 58 or 59 million of these persons were employed (including the armed forces), leaving a "labor float" of perhaps 3 million persons. With 58 or 59 million jobs, the gross national product (in terms of 1944 prices) would approximate 200 billion dollars. The national income corresponding to this gross national product would be perhaps \$170 billion -- the precise amount depending upon the kind of corporate

taxes imposed. The level of activity represented by these figures would be about equal to that of 1944, and about 70 percent greater than that of 1939.

5. The Budget

Many comprehensive postwar tax plans presented during the past several months have assumed annual Federal expenditures of less than \$20 billion. Available evidence indicates that these budget estimates are far too low. Indeed, much of the attractiveness of these plans is due to the fact that an inadequate revenue goal has been set.

At this stage of tax planning it is wise to count on large expenditures, so that taxes will not be cut prematurely and too far. If, later, expenditures prove to be less than originally estimated, it will be easy and pleasant to cut taxes further than planned. But if expenditures turn out to be larger than anticipated at first, it will be unpleasant and perhaps politically impossible to increase taxes to meet budgetary requirements. Thus, at this time, a budget of no less than \$27 billion (including Social Security benefits) should be the basis of tax planning.

6. Potential Revenue Reductions

The present tax system would yield in a postwar year of full employment about \$46 billion. With the repeal of the wartime excess-profits tax, the declared value excess-profits tax, and the capital stock tax, and with the increase of the personal exemption under the individual normal tax to \$500 per capita, this revenue would be reduced by about \$9 billion, leaving a total revenue of \$37 billion.

With the estimated yield of the present tax system at \$37 billion after the reductions indicated, further tax cuts of considerable magnitude will be possible in postwar years, the amount depending upon the size of the budget to be financed. For example, with a postwar revenue goal of \$27 billion, further reductions involving a revenue loss of \$10 billion would be possible. With such potential reductions, a unique opportunity is provided for revising the tax system in conformity with sound economic policy. The problem is to carry out the reductions selectively so that the resulting postwar tax system will be favorable to economic activity or at least deter it as little as possible. The question is: What taxes should be reduced and how and when should the reductions be carried out?

IV. TAXES ON CAPITAL STOCK AND DECLARED VALUE EXCESS PROFITS

Among the taxes that are particularly onerous upon small corporations are those levied upon capital stock and declared value excess-profits. These taxes yield relatively little revenue, discriminate against small concerns with fluctuating earnings, penalize heavily and unfairly inaccurate guesses of future income and losses, are levied largely without regard for net income, and are annoying to tax payers. Moreover, they discourage small concerns from adopting the corporate form of organization with its manifold advantages.

No taxes paid by small corporations have been more roundly denounced than the capital stock tax and its companion, the tax upon declared value excess-profits. They engage the unwary and unlucky taxpayers in a losing game of chance with a Government whose advantageous position in the tax lottery assures it of certain winnings. Repeatedly the Treasury has urged their repeal. Nevertheless they remain, lacking any logical foundation, discriminating against numerous small concerns with fluctuating earnings and deficits, and continually annoying taxpayers.

Because these taxes are economically unsound, inequitable in their burdens, and unnecessary as revenues, they should be repealed as soon as possible, effective for the year 1946.

1. Operation of These Taxes

The taxes on capital stock and excess-profits imposed during World War I were abandoned because of their administrative complexities, their difficulties in tax payer's compliance, their inequalities, and their burden to corporations.

In 1933, as revenues suffered from depression, Congress adopted a pair of related taxes on capital stock and declared value excess-profits in preference to increasing the rate of the corporation income tax. It was argued that this combination of taxes, based upon the value of capital stock as declared by the corporation, would obviate the colossal problems of valuation which had arisen in connection with the capital stock and excess-profits taxes of World War I. Since each tax would act to check the avoidance of the other, it was thought that a successful system of taxing excessive monopoly profits might result. This 1933 tax has evolved by a series of changes into the present levy on capital stock and declared value excess-profits.

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The capital stock of corporations is now taxed at a rate of \$1.25 on each \$1,000 of declared value. Income in excess of 10 percent but not over 15 percent of that value is taxed at a rate of 6.6 percent, and income in excess of 15 percent of that value is taxed at a rate of 13.2 percent.

Capital stock tax returns must be filed by July 31 each year for the year ending on the preceding June 30 regardless of when the corporation's fiscal year ends. The returns for the declared value excess-profits tax, on the other hand, are filed at the same time and for the same current year as those for the corporate income tax. This ordinarily requires a corporation to forecast its future earnings in attempting to place a value on its capital stock which will avoid excessive tax payments. A corporation using the calendar year for income taxation will therefore be compelled to estimate by July 31 the earnings which it anticipates during the full calendar year. Fiscal year corporations are required in some cases to estimate earnings for a period up to 12 months in the future.

A minimum tax is incurred if a corporation is able to declare a value on its stock equal to ten times its earnings. This obviates the payment of the declared value excess-profits tax, which applies to earnings above 10 percent of the declared value of the stock.

If too low a value is named for the capital stock, the ratio of income to that value will exceed 10 percent and an excess-profits tax will have to be paid. On the other hand, if the stock is valued at more than ten times the earnings, the excess-profits tax will be avoided at the cost of a higher capital stock tax. In this guessing game, each tax acts to check the avoidance of the other, although the low capital stock tax tends to impose a lighter penalty for poor guesses than the excess-profits tax.

2. Revenue Importance

The annual gross revenues of the taxes upon capital stock and declared value excess-profits have increased during the war to a sum surpassing \$500 million. Of the \$627 million estimated by the Treasury to come from these taxes in the fiscal year 1945, approximately \$372 million will be derived from the capital stock tax and \$155 million from the tax on declared value excess-profits.

The gross collections of the capital stock and declared value excess-profits taxes exaggerate their revenue importance because these taxes may be deducted by the corporations paying them in determining the income subject to the wartime excess-profits tax and the corporate net income tax. If the taxes upon capital stock and declared value

excess-profits were abandoned, a substantial portion of the revenue would be recaptured by the excess-profits and corporate net income taxes.

3. A Burden on Deficit Corporations

A part of the total revenue, approximately 11 percent of the total in 1942, is obtained from deficit corporations not paying other corporate taxes. Those deficit corporations which are able to anticipate their deficits declare the value of their capital stock as zero and pay no tax. Thus, only the unfortunate deficit corporations which fail to foresee their plight are trapped. The great majority of these are the small corporations least able to pay the tax.

4. Unsound Theory of These Taxes

The capital stock tax is often justified on the theory that it is a payment for benefits received by a corporation from the Federal Government. It is argued that all corporations benefit from Federal activities and that all should be taxed whether or not they have any net income. The function of the declared value excess-profits tax is solely that of protecting the revenue from the capital stock tax, though it is sometimes naively suggested that this tax is a device for capturing monopoly profits.

The declared value of the capital stock of a corporation is a capricious and inaccurate measure of the value of Government benefits received. If a small corporation is lucky in forecasting its earnings or deficits it will escape with a minimum tax or no tax; if it is unlucky, it may suffer a heavy penalty. A tax which is so much a matter of chance can never be a satisfactory measure of benefits received and has no place in a logically constructed revenue system.

The argument that the income of a corporation is a rough measure of the value of Governmental services is a reasonable one. However, the taxes on capital stock and declared value excess-profits are not income taxes and, in fact, bear only a fortuitous relationship to the income of many corporations.

The actual value of a corporation's investment, if it could be determined with any accuracy, might also be taken as a rough measure of the value of those benefits. But the declared value of capital stock is only a synthetic value. It is a very poor substitute for actual value.

The capital stock tax cannot even be justified on the theory that every corporation, however small and whether or not it has any income, should pay a Federal tax. The implication that the tax on capital stock will necessarily fall on every corporation is false. If a corporation anticipates a deficit, it may escape the tax by declaring that its capital stock has no value. Only those deficit corporations will be taxed which fail to foresee their deficits. Treasury statistics indicate that during the fiscal year 1944 there were 133,000 capital stock returns filed indicating no tax liability or over one-fourth of the total of 510,000 corporate returns.^{4/}

5. Discrimination Against Small Corporations

The capital stock and declared value excess-profits taxes discriminate particularly against smaller corporations because the earnings of such companies are particularly difficult to forecast. The difficulty of forecasting is due partly to the fact that the earnings of small companies are irregular, and partly to the fact that small companies lack the statistical aids necessary for accurate forecasts. These penalties for errors in forecasting are accentuated by the graduated rates of the declared value excess-profits tax.

If we desire to encourage risk-taking in new and small business ventures, it will be necessary to abolish after-the-war taxes which are loaded against the small risk takers. The taxes upon capital stock and declared value excess profits are such taxes.

^{4/} Roy Blough, Director of Division of Tax Research, Treasury Department, SIMPLIFICATION OF CORPORATE TAX STRUCTURE, p. 4. An address to the American Institute of Accountants at St. Louis, October 19, 1944.

V. THE EXCESS-PROFITS TAX

An excess-profits tax is a fiscal and political necessity during wartime. It provides a vehicle for capturing unusual wartime profits and for raising large Federal revenues. It also gives psychological palatability to high individual income taxes, wage ceilings, rationing, selective service, and other wartime economic controls. However, the excess-profits tax in its present form tends to be repressive, complicated, and especially severe in its application to small corporations. Therefore the present tax should not be a part of the permanent postwar revenue system. Consideration should be given, however, to the possible use of a drastically modified form of excess-profits tax as a device for capturing monopoly profits.

1. Provisions of the Present Excess-Profits Tax

Excess profits are defined as total profits minus the excess-profits credit. The excess-profits credit is determined, with various adjustments, either as the average profit earned during the base period 1936-39 or as a percent of invested capital (specially defined). At present, the first \$10,000 of excess-profits are specifically exempt from the excess-profits tax. This specific exemption has been increased by a recent Act of Congress to \$25,000 effective for the year 1946.

The rate of the tax on excess-profits is nominally 95 percent. With the postwar credit of 10 percent of the tax, which credit can now be taken currently, the net rate is 85.5 percent. This rate applies to that portion of total earnings which is defined as excess-profits. The remainder of the earnings are taxed under the corporation income tax.

2. Present Excess-Profits Tax not Suited to a Peacetime Economy

The present excess-profits tax, which takes 85.5 percent of all profits above the excess-profits-credit, would be unsuited to a peacetime period. It would tend to stifle business initiative, discourage plans for new investment and expansion, and encourage waste and extravagance. Moreover, the tax would tend to prevent profits from serving their function as a guide to entrepreneurs in the choice of new fields, and would thus discourage prompt adjustments to changing market and cost conditions.

Even if the rate were more moderate, the tax would still be of doubtful value, because of difficulties in achieving a reasonable definition of excess-profits.

The base period method of determining the excess-profits credit suffers from the defect that the base period often has not represented

a normal period in the life of a corporation. This is especially likely among small businesses having fluctuating earnings. Even if the base period is normal, the earnings of a company during this period may nevertheless have been excessive or deficient from the point of view of a reasonable return on capital. Under this method, it is difficult to take account of investments made subsequent to the base period or to make provisions for new companies.

The invested capital method, on the other hand, raises the many problems involved in evaluating capital and determining what is a reasonable rate of return for any given industry. These problems would be overwhelming if the tax were to apply to thousands of small companies.

3. The Excess-Profits Tax and Small Corporations

With the present specific exemption of \$10,000, it has been estimated that perhaps 30,000 corporations will be subject to the excess-profits tax for the year 1945. With the increase in the specific exemption to \$25,000 in 1946, as provided by law, about 11,000 corporations would be removed from all excess-profits tax liability, leaving perhaps 19,000 still subject.^{5/} Moreover, with the increased exemption, the burden of the tax would be substantially smaller on those companies still subject. However, even with the increase in exemption, several thousand companies with capital of not over a few hundred thousand dollars would still be required to pay a heavy excess-profits tax.

A tax on excess-profits at a rate as high as 85.5 percent (net) is peculiarly disadvantageous and onerous for many smaller corporations. There are a number of reasons for this.

A heavy excess-profits tax impairs the principal source of small business expansion; namely, the reinvestment of earnings.^{6/}

The excess-profits tax is inherently complex and baffling because of the formidable difficulties in determining excess profits and because of the numerous refinements and adjustments required to alleviate its harsh burdens. Especially is it difficult to define equitably the excess-profits of small corporations that had low and fluctuating incomes before the war, of small corporations which came into existence during or just before the war, and of small corporations with incomes expanding rapidly during the war.

^{5/} The precise number would depend on the level of national income.

^{6/} See the discussion of the Treasury economists, E. Gordon Keith and E. Cary Brown, THE IMPACT AND BURDEN OF WARTIME CORPORATION TAXES, Law and Contemporary Problems, Winter, 1943, pp. 121-132.

Young, growing enterprises are penalized in comparison with stable or declining enterprises. This is well illustrated in the study of Professors Butters and Lintner on the effects of Federal taxes upon the Polaroid Corporation.^{7/}

Many small corporations have earnings that are high in relation to their investment.^{8/} This is frequently due to the fact that the earnings arise chiefly from the efforts of the management in successfully utilizing a small investment. Consequently, so-called excess-profits are often a return for personal exertions rather than for invested capital. Because the earnings of such corporations may fluctuate considerably from year to year, they suffer the disadvantage of being penalized by either the invested capital or the base period income method of determining excess-profits.^{9/}

While many small corporations have had to pay the excess-profits tax because their earnings were found to be excessive, as interpreted by the definition of excess-profits for tax purposes, other corporations with earnings ratios to investments as high or higher have paid no excess-profits tax because the latter enjoyed high earnings ratios before the war.^{10/}

The relief from the burdensome and unequal application of the excess-profits tax on small corporations, which theoretically could be obtained through the application of Section 722, has, in fact, generally been unavailable. Few petitions for relief have been granted and it has been difficult for small firms to develop data

^{7/} J. Keith Butters and John Lintner, EFFECT OF FEDERAL TAXES ON GROWING ENTERPRISES, Study No. 2, Polaroid Corporation, p. 58. Division of Research, Graduate School of Business Administration, Harvard University, 1944.

^{8/} For example, analyses of corporation returns made to the Bureau of Internal Revenue show that those with assets under \$500,000 had gross receipts to net worth ratios approximately 2 to 3 times the same ratio in businesses having \$1 million or more of assets.

^{9/} See the statement of Randolph Paul, General Counsel of the Treasury, Hearings before the Senate Committee on Finance on the Revenue Act of 1943, p. 44, 78th Congress, 1st Session, 1943.

^{10/} Note the observation by Secretary of the Treasury Morgenthau, Senate Finance Committee, Hearings on the Revenue Act of 1941, p.3, 77th Congress, 1st Session.

to support their claims.^{11/}

For all these reasons, the present excess-profits tax, even with the specific exemption of \$25,000, tends to place an undue burden on many small businesses. If the excess-profits tax is continued beyond 1945, the specific exemption should be greatly increased.

4. Increase in the Specific Exemption for 1945

In the Tax Adjustment Act of 1945, the specific exemption under the excess-profits tax was increased from \$10,000 to \$25,000 effective for the year 1946. This Act was passed before the end of the Japanese war in the expectation that V-J Day would occur sometime in 1946 rather than in 1945.

In order to give effect to the intent of Congress to relieve the burden of many smaller corporations under the excess-profits tax, it is now necessary to provide that the increase in the specific exemption be made effective for the year 1945. This action is strongly recommended as a means of improving the financial position of smaller firms.

5. Possible Revision of the Excess-Profits Tax

In view of the difficulties and disadvantages of the excess-profits tax, outright repeal as of January 1, 1946 has been widely recommended. There are dangers, however, in hasty action. The immediate postwar period is likely to be one of inordinately high profits — especially for giant, well-intrenched corporations. These large profits will be in the nature of war profits in the sense that they will be derived largely from supplying of goods and services for which demand has been deferred during the war. Such profits, it may be argued, are properly subject to excess-profits taxation. If they are not taxed, the Government will lose an important source of much-needed revenue, and enormous funds will be made available for the expansion of big business or will be paid out in dividends to the upper-income saving class, thus accentuating the investment problem. It should be recognized, moreover, that excess-profits taxation provides one effective method of curbing monopolies or of preventing them from exploiting their monopoly powers. The present tax is quite evidently not well-suited to this purpose. Nevertheless, those interested in adding

^{11/} Up to January 1, 1945 approximately 35,000 petitions had been filed with the Bureau of Internal Revenue by 16,000 corporations. Only about 10 percent of the 35,000 petitions had been settled. A majority of all petitions processed consist of those in which no excess-profits tax liability existed and those withdrawn by petitioners before hearings began.

another weapon to be used to curb the power of giant monopolies would do well to examine the possibility of an excess-profits tax designed to distinguish legitimate profits from monopoly profits and to recapture the latter. Indeed, an excess-profits tax to accomplish this purpose could be constructed through revision of the present tax. It would be necessary to eliminate the base period method of determining the credit, to increase the specific exemption to perhaps \$500,000, to allow a very long carry-over of losses and unused excess-profits credits, to increase the permitted rate of return on invested capital to perhaps a flat 10 percent, and to reduce the rate of the tax to about 65 percent.

Such an excess-profits tax would affect only very large companies with earnings over a long period that were clearly excessive in relation to invested capital. Such companies could reasonably be presumed to have monopolistic power. The taxation of their excess earnings would discourage them from holding their monopoly power, or would encourage them to desist from monopolistic pricing practices.

VI. CARRY-BACKS

In order to permit the charging of war-induced postwar costs and losses against wartime income and to achieve an averaging of incomes -- thus to prevent the overstatement of income subject to wartime rates -- the two-year carry-back and the two-year carry-forward of losses and unused excess-profits credits were provided as a part of the wartime tax structure.

One important question in tax policy for the reconversion period and later is to decide on the best treatment of carry-backs and carry-forwards. This is an immediate issue because, with the repeal of the excess-profits tax, the carry-back of unused excess-profits credits would be automatically repealed unless it were specifically provided otherwise. 12/

The repeal of the excess-profits tax would not automatically affect the carry-back or carry-forward of losses. However, it is generally agreed that ultimately the carry-back of losses should be eliminated and the carry-forward of losses lengthened. Thus, a second problem is to decide when this change should be made.

Superficially, it would seem desirable to continue the carry-back of unused excess-profits credits and of losses for a year or two after the repeal of the excess-profits tax. This would enable businesses to recover part of their heavy wartime taxes by carrying back unused credits and losses arising from war-induced postwar costs and from the reduced earning power of the unsettled reconversion period. There are important reasons, relating to the interests both of small business and of the nation as a whole, for caution in extending the carry-backs beyond the date of repeal of the excess-profits tax. After weighing all the factors, it is recommended (1) that the carry-back of unused excess-profits credits be discontinued January 1, 1946; (2) that the carry-forward of losses be extended to at least 7 years, beginning January 1, 1946; and (3) that the carry-back of losses be discontinued January 1, 1948.

12/ The carry-forward of unused excess-profits credits would also disappear with the tax, but that of course is of no consequence since the carry-forward would then be useless.

1. Description of the Carry-backs and Carry-forwards

The carry-back and carry-forward of unused excess profits credits provides that if the excess-profits credit of a given company is greater than the excess-profits net income for any year, the difference can be carried over to reduce the amount of income subject to the excess-profits tax in the two preceding years or two succeeding years.

The operation of the carry-back and carry-forward of unused credit may be illustrated as follows: Suppose Company A has an excess-profits credit of \$100,000 (determined either by the base period or invested capital method). In each of the years 1943 and 1944 the company earned \$125,000, \$25,000 of which was subject to the excess-profits tax. In 1945, it earns \$20,000, leaving an unused credit of \$80,000. This unused credit can be carried back to increase the credit of the two preceding years, and, if any balance remains, may be carried forward to increase the credit of the two succeeding years. In this case, \$25,000 would be carried back to 1943 to wipe out the excess-profits tax liability for that year; an additional \$25,000 would be carried back to 1944 to wipe out the excess-profits tax liability for that year. The company would then be entitled to refunds on taxes paid for 1943 and 1944. The remaining \$30,000 of unused credit would be available for carry-forward to the two succeeding years in case the company then became subject to the excess-profits tax. It should be noted that when the carry-over of unused credits reduces the amount of income subject to the excess-profits tax, the amount subject to the corporation income tax is correspondingly increased.

The carry-back and carry-forward of net loss provides that a net loss in any year may be carried over and deducted from the net income earned in the two preceding or two succeeding years.

To illustrate, suppose Company A earned \$125,000 in 1943 and again in 1944, but in 1945 suffered a loss of \$300,000. Of this loss, \$250,000 would be carried back to wipe out the net income of the years 1943 and 1944. The remaining \$50,000 would be available to be deducted from any income which might be earned in 1946 or 1947. In this case, the entire tax paid by Company A for years 1943 and 1944 would be refunded and, from any income earned in 1946 or 1947, a deduction of \$50,000 would be allowed. The carry-forward and carry-back of net loss affect liabilities both under the corporation income tax and the excess-profits tax.

2. Possible Abuses Resulting from the Carry-backs

The extension of the carry-back of unused excess-profits credits into the reconversion and postwar period would give rise to a number of serious abuses: (1) it would permit a company to obtain substantial income through tax refunds without exerting itself to produce and provide employment; (2) it would encourage "war babies," which fully intend to liquidate, to cash in on tax refunds merely by keeping the corporate shell alive for a few years; (3) it would provide a dangerous weapon for use by corporations in breaking the strength of labor unions since the corporations would be able to secure tax refunds to compensate partially for loss of earnings due to strikes; (4) it would discriminate against new businesses, since it would reduce the risk from the new investments of established companies by providing a partial refund of losses, but would provide no such aid to new companies; (5) it would enable some companies which were profitable during the base period to earn substantial or even unreasonable incomes during the postwar period and still receive tax refunds; and (6) it would needlessly jeopardize Federal revenues and would create serious administrative problems.

The carry-back of losses is subject to some of the same abuses, particularly (2), (3), and (4). However, tax refunds for companies which have actually suffered losses can be much more easily justified than for companies whose earnings are simply less than during the base period or less than a stated percentage return on invested capital.

Despite the potential abuses likely to result from the carry-backs, there is validity in the contention that many companies will face postwar costs and losses that are justifiably attributable to wartime production. It now appears, however, that these costs and losses will be incurred largely within a year after the defeat of Japan. Thus, a compromise solution to the problem of the carry-backs, a solution which would be acceptable to any businessman who considers the national interest, would be to lengthen the carry-forward of losses to at least 7 years beginning with 1946, continue the carry-back of losses until January 1, 1948, and repeal the carry-back of unused credits as of January 1, 1946. The lengthened carry-forward is discussed in greater detail in Chapter IX.

VII. ALTERNATIVE SOURCES OF REVENUE

With repeal of the taxes on capital stock and declared value excess-profits, and repeal or modification of the excess-profits tax, the principal sources of revenue available to the Federal Government would be: the corporation income tax, the individual income tax, excises, payroll taxes, estate and gift taxes, customs, and miscellaneous receipts. The remaining problem of postwar tax policy, then, is to find a combination of rates and provisions for these taxes which will raise the required total revenue and which will be economically desirable.

Since there is a given revenue goal -- assumed here to be \$27 billion at full employment -- reductions in any one of these taxes will require that more revenue be raised from other sources. Thus, in planning the tax system, it is not enough to work out the provisions and rates of each tax separately and in terms of its independent effects. It is necessary also to evaluate the effects of the adjustment of any one tax on other taxes in the system. For example, the many proposals for reducing the burden of the corporation income tax must be considered not only on their own merits but also in terms of the effects of the other taxes (e.g., excises), which must be heavier by reason of a reduced corporate burden.

With a revenue goal as high as \$27 billion, there is amazingly little scope for choice in determining how this revenue should be divided among the several available sources.

Customs and miscellaneous receipts may be counted on for not more than \$1 billion; estate and gift taxes, even if strengthened (as they should be), would likely yield not more than another billion; and payroll taxes, if retained at present rates, would yield about \$1½ billion under present popular pressures.

Congress is unlikely to adopt individual income tax rates yielding more than \$14 billion. This, in fact, would be a very large yield from the individual income tax and, as will be pointed out, would require heavy rates.

It may be argued, of course, that more than \$14 billion should be derived from the individual income tax, thus permitting greater reductions in corporate and excise taxes. Indeed, a very good theoretical case can be made for obtaining the bulk of all

Federal revenue from individual income. The political impracticability of this is clearly evident from the strong popular pressure for reduced individual taxes. To obtain, say, \$16 billion from the individual income taxes would require a first bracket rate of about 20 percent; or to obtain \$20 billion would require a first bracket rate of perhaps about 25 percent -- actually more than the present combined rate of 23 percent. Altogether, from customs and miscellaneous receipts, estate and gift taxes, payroll taxes, and the individual income tax, it would be utter folly to count on more than \$17½ billion. Thus, at least \$9½ billion of the \$27 billion revenue goal would be left to the corporation income tax and the excise taxes.

The tax problem largely resolves, then, into the question of the treatment of corporate income and excises. For example, if the present corporate rate of 40 percent were retained (with some modifications to be recommended) and no new provisions for dividends were adopted, about \$7 billion would be obtained from corporation income tax. About the same amount might be raised if a moderate dividend credit were allowed and the proposed monopoly tax were adopted. In either case, excises could then be reduced to yield \$2½ billion. On the other hand, if, through the reduction of corporate rates and/or the provision of a dividend credit, revenue from corporate income were reduced to \$4 billion, it would be necessary to obtain more than \$5 billion from excises. This would necessitate the retention of most present wartime excises. It is clearly evident that the position in the tax structure of corporation income taxes will determine in no small degree the amount of revenue which it will be necessary to derive from excises.

It is here recommended that revenue from excises be held to \$2½ billion, and that \$7 billion be obtained from taxes on corporate income.

To summarize, the revenue to finance the postwar budget of \$27 billion would be derived approximately as follows:

	Billions of <u>dollars</u>
Individuals income tax	14.0
Corporation income tax or taxes	7.0
Excises	2.5
Payroll taxes	1.5
Estate and gift taxes	1.0
Customs and miscellaneous receipts	<u>1.0</u>
Total	27.0

The following chapters indicate in some detail the reasons for recommending this particular apportionment of revenues.

VIII. EXCISE, PAYROLL, AND ESTATE AND GIFT TAXES

Preliminary to a discussion of the corporation income and individual income taxes, it is useful to reach conclusions concerning the position in the revenue system of the excises, payroll taxes, and estate and gift taxes.

1. Excises

Excises, including commodity taxes, stamp taxes, transfer taxes, etc., are notoriously bad taxes. Ideally, such taxes should be abolished. They run exactly counter to a major aim of the Smaller War Plants Corporation, which is to reduce prices and enlarge demand. These taxes restrict demand by directly raising the prices of the goods and services to which they apply. Since they are levied largely on consumers, they tend to reduce the effective purchasing power of the low-income groups who must be depended on to buy the bulk of America's products. They are inequitable in their effects on various classes and on various individuals within classes. Since they are usually collected from producers or sellers, they can be shifted much more readily by large monopolistic firms than by small competitive firms. In the shifting of these taxes from producer through middlemen to the final consumer, pyramiding is a common practice, with the result that a penny of revenue to the Government becomes two pennies out of the pocket of the consumer. Finally, these taxes tend to be a nuisance to businessmen who are in effect delegated to perform the role of tax collector for the Federal Government.

For all these reasons, suggested modifications of the corporation income tax and changes in the treatment of dividends must be scrutinized with special care if heavier excise taxes are to result. Benefits to corporate income may easily be obtained at too high a price.

It must be recognized, however, that excises are a well-established part of the revenue system and have long been relied upon for substantial revenue. It is highly doubtful if Congress would enact, or the country accept, income taxes sufficient to offset the loss of revenue implicit in complete repeal of excises. Therefore it is recommended, reluctantly, that excises be retained to the extent necessary for raising about \$2¹/₂ billion. This is a little more than was raised from excises before the war.

Many recent writers have proposed, largely on grounds of simplification, that excises be limited to liquor, tobacco, and gasoline. The taxes on liquor and tobacco are said to be justified for purposes of control over consumption, and the tax on gasoline as a charge for the use of the highways.

As excise system confined largely to these three commodities would be extremely unsound. All three are articles of mass consumption, the use of which is in no way related to ability to pay taxes. The only one of the three which should be retained is the tax on liquor, which would be imposed for regulatory purposes with relatively low rates for beverages consumed by the low-income groups and high rates on luxury beverages. There may be some validity in the benefit theory as a basis for the gasoline tax, but this is a tax which could well be reserved for the states.

Assuming that a half-billion to a billion dollars might be raised from liquor taxes, about \$1½ to \$2 billion would remain to be collected from other excises. The commodities to be taxed should be selected, so far as possible, to tax individuals who are above minimum subsistence levels. No attempt is made here to indicate in detail what commodities should be taxed. Admittedly, it would be more difficult to raise any given amount of revenue from excises of this type than from excises on gasoline or tobacco, but the economic effects would be much less damaging.

2. Payroll Taxes

The question of how Social Security should be financed is an immediate and urgent problem. Congress must decide shortly whether the automatic increases in the payroll taxes originally provided in the Social Security Act shall go into effect, and whether proposed extensions of Social Security benefits shall be financed through payroll taxes or other sources.

Extension of Social Security benefits is an essential part of full employment policy. However, it would be a serious mistake, both from the point of view of the national interest and the interest of small business, for the rate of the payroll taxes to be increased. Any benefits which could not be covered by the present payroll taxes, yielding roughly \$1½ billion, should be financed out of general revenues. This, of course, would increase the revenue load to be carried by other taxes.

In so far as payroll taxes are ultimately borne by workers, they directly impair the purchasing power of the low-income groups and therefore effectively reduce aggregate demand. In so far as payroll taxes are ultimately borne by the owners of business, they increase the cost of hiring labor and therefore directly discourage employment. However, it is probable that payroll taxes on business are shifted, at least in part. Large businesses, strategically situated to control prices, are undoubtedly able to shift these taxes more readily than small competitive businesses. Thus, payroll taxes tend to discriminate against small business.

3. Estate and Gift Taxes

Estate and gift taxes are not likely to a major source of revenue in a budget of the dimensions expected after the war. However, these taxes are extremely significant economically because they tend to deter saving without impinging directly upon investment incentives. Any revenue derived from these sources reduces correspondingly the amount of revenue to be obtained from taxes which directly deter consumption or production.

The present rate schedule, imposing rates up to 77 percent, is superficially drastic. However, except for the small minority of estates running into the millions, the rates are very mild. For example, the effective rate on an estate of \$100,000 is about 5 percent, or on an estate of \$1,000,000, less than 30 percent. Moreover, even these rates are often not practically effective because of loopholes.

It is recommended that these taxes be increased and strengthened. Specifically, the exemption should be reduced (with adequate safeguards for dependents) and the rates increased. In addition, loopholes should be closed. Particularly, the estate tax and the gift tax should be integrated so that gifts prior to death will not constitute an easy escape, and loose provisions with respect to trusts should be eliminated. With these changes, it should be practicable to secure \$1 billion from this source.

IX. THE TAXATION OF CORPORATE INCOME

A substantial corporation income tax should be retained because (1) the revenue is needed, (2) the tax tends to reduce funds available for both corporate and individual saving, and (3) there is no need to give windfalls in the form of drastic tax reduction on the income from past investments in well-established large businesses.

The principal valid arguments against the retention of a substantial corporation income tax are: (1) that it tends to discourage new investment, (2) that it discriminates against new and small businesses. The policy on the taxation of corporate income, therefore, should be one of retaining the tax with the present maximum rate of 40 percent while adopting provisions to reduce or eliminate its deterrent effect on investment and its discriminatory effect on new and small businesses.

Many current proposals for revision of the corporation income tax call for a sharp reduction in the rate combined with provisions for reducing the amount of the "double taxation" of dividends. With these provisions, the yield of the tax would be reduced to from less than \$1 billion to perhaps \$3 billion or \$4 billion. Under these proposals, the ill effects would be removed not by adjusting the tax but by virtually eliminating it. The need for obtaining large revenues from the corporation tax is so obvious and the advantages of the tax so evident, however, that such solutions are not acceptable.

Contrary to popular opinion and much current propaganda, the corporation income tax is not unduly burdensome to large, diversified, and financially powerful companies. The owners and managers of such companies naturally do not like the corporation income tax and find many arguments for lowering or eliminating it. But, in plain fact, the operation, development, and expansion of these corporations is not limited by the tax, so long as the rate is not confiscatory. The tax does not prevent such corporations from obtaining all the capital they can or are willing to use. It does not materially increase the risk involved in any new undertakings they may wish to enter, since losses from such new undertakings can be readily offset against income from other established sources of income.

The complications of the tax are of no consequence to large corporations since they can afford, and in fact have, highly trained lawyers and accountants. Large businesses tend to have relatively stable incomes, and are thus not often confronted with the disadvantage of taking expense deductions in years of net loss. Many such companies may be in a position to shift the income tax in the form of higher prices, though the question of whether or to what extent such shifting is possible is not a settled one. Finally, as is well-known, the owners of large corporations are, by and large, wealthy persons who

are well able to pay heavy taxes.^{13/}

With small corporations, the situation is reversed. A heavy corporate tax impairs their only important source of capital for expansion; namely, earnings. Small and new companies, because of their undiversified character, have little opportunity to offset losses against income. They generally cannot afford the legal and accounting advice required for overcoming the complications of the corporation income tax. Their income tends to fluctuate, and without a long carry-over of losses they are unable to charge all expenses against income. Their competitive position precludes any shifting of the tax. And, by and large, the owners of small businesses are less well-to-do and hence less able to bear the burden of corporate taxes than the owners of big businesses.

A sound corporate income tax must be designed to eliminate or offset the undue burden and competitive disadvantages which the tax would otherwise impose upon smaller enterprises. To accomplish this objective, the following measures are recommended:

- (1) Graduation of rates up to at least \$100,000 of net income;
- (2) Optional taxation of corporations as partnerships;
- (3) Carry-forward of losses for at least 7 years;
- (4) Accelerated depreciation.

The last two of these measures — carry-forward of losses and accelerated depreciation — would aid some large businesses as well as small ones. These two measures are, however, of particular concern to small enterprises. It should be noted that these two provisions are applicable not only to corporations but also to unincorporated businesses — even including farmers.

1. Graduation of Rates

The present corporation income tax is levied at graduated

^{13/} Distribution of Ownership in the 200 Largest Non-financial Corporations, T.N.E.C. Monograph No. 29, pp. xvi-xviii. It should be noted, moreover, that the impact of the corporate tax on a wealthy stockholder is much less than that on a low-income stockholder. This can be illustrated. Suppose a given \$200 of corporate income is subject to no corporate tax and that it is distributed in its entirety, \$100 each to stockholders A and B. Stockholder A is in the 60 percent bracket under the individual income tax and will retain \$40 net, and B is in the 20 percent bracket and will retain \$80 net. Suppose now a 40 percent corporation income tax is levied. A and B will each receive \$60, of which A will retain, after individual tax, \$24, and B \$48. Thus, the corporation tax has cost A \$16 and B \$32.

rates ranging from 25 to 40 percent, the top rate applying to corporations with net income over \$50,000. A "notch" provision eliminates any graduation with respect to corporate incomes in excess of \$50,000, but in so doing imposes a rate of 53 percent on the portion of the net income between \$25,000 and \$50,000. This "notch" provision permits a gradual rise in effective rate until it becomes 40 percent on incomes above \$50,000, but places a heavy penalty on any additions to income between the \$25,000 and \$50,000.

The principle of graduation is sound and should not only be retained but extended. The "notch" provision, however, should be removed so that no particular bracket of income is penalized and so that the effect of graduation would be felt on all corporate incomes regardless of size. Accordingly, the following schedule of corporate rates is recommended (comparisons with present rates are indicated):

Corporate net income bracket	: Rate of tax applying : to the portion of : net income within : bracket (percent)	: Total tax at top of : bracket	
		: Under : suggested : rates	: Under : present : rates
\$0 - \$ 10,000	10	\$ 1,000	\$ 2,600
10,000 - 20,000	15	2,500	5,300
20,000 - 40,000	20	6,500	14,700
40,000 - 60,000	25	11,500	24,000
60,000 - 80,000	30	17,500	32,000
80,000 - 100,000	35	24,500	40,000
Over 100,000	40		

Under this rate schedule, the effective tax would approach but never reach 40 percent, because the graduation would apply to the first \$100,000 of income regardless of amount of income. For very large corporations, however, the effect of the graduation would be negligible. This is shown in the following table of effective rates:

Amount of net income	Effective rate	
	Under suggested plan	Under present law
\$ 10,000	10.000%	26.000
20,000	12.500	26.500
40,000	16.250	36.750
60,000	19.167	40.000
80,000	21.875	40.000
100,000	24.500	40.000
150,000	29.667	40.000
200,000	32.250	40.000
500,000	36.900	40.000
1,000,000	38.450	40.000
5,000,000	39.690	40.000
50,000,000	39.969	40.000

This rate schedule may be objected to on the ground that the first bracket rate is lower than the proposed first bracket rate under the individual income tax. The idea that individuals and corporations should be taxed at the same rate in the first bracket has strong support. It is argued that to tax corporate income at a lower rate than individual income would be inequitable and would greatly stimulate the incorporation of present proprietorships and partnerships. Both of these arguments are unsound.

For two reasons, the equity argument is without validity. First, it overlooks the fact that the first bracket individual rate applies only after personal exemptions, whereas the corporate rate applies immediately without any exemption. Thus, if a small businessman, operating as a proprietor, earned \$4,000, perhaps \$2,000 or more would be exempt from taxation by reason of his personal exemptions. If he operated as a corporation, the entire \$4,000 would be subject to the corporate rate. Second, corporate income — to the extent paid out as dividends — is subject to the individual income tax as well as the corporate tax. The argument that the starting rates of the two taxes should be the same assumes that the business income is subject to one tax or the other — not to both.

The incorporation argument is equally specious. It assumes that the incorporation of small businesses is harmful, which is the reverse of the truth. Moreover, it overlooks the fact that present taxation penalizes incorporation and that a reduction of the corporate rate would merely remove the penalty.

2. The Partnership Option

If corporations were permitted optionally to be taxed as partnerships, the income of companies electing the partnership plan would be taxable to the stockholders, under the individual income tax, whether or not it was distributed as dividends. Under this plan, many small unincorporated businesses would be able to adopt the corporate form, and enjoy its many advantages, without submitting themselves to the Federal corporation income tax. Moreover, many small corporations would be benefited taxwise — especially those which normally distribute a large proportion of their earnings.

The partnership option is not without difficulties and problems. There is the question of what proportion of the shareholders and directors must approve the partnership method of taxation before the option is binding. If undistributed income is taxed in the same manner as cash dividends, the shareholders may have insufficient funds to pay the tax, and the corporation may find it necessary to increase its cash dividends or otherwise aid the shareholders if they are not to be forced to dispose of their stock. Difficulties may arise in pro-rating the undistributed income among the shareholders, especially if more than one type of stock is outstanding. If the stock is actively bought and sold it will be difficult to trace its ownership and it may be necessary to impose the tax arbitrarily upon those owning the stock at the close of a certain day. Presumably, corporations would have to report the names of their shareholders and their shares of undistributed income to the Treasury, and additional compliance labor would be entailed.

However, these difficulties are not insuperable. For small corporations with relatively few shareholders who are all in agreement on the desirability of being taxed as a partnership, with simple financial structures, and with shares of stock tending to remain in the hands of a small number of owners, there would be important advantages in being taxed as partnerships, and this privilege should be granted them. The partnership method would not be chosen by large, closely-held companies whose stockholders were in the upper-income brackets.

3. Carry-forward of Losses

The carry-forward of losses permits the charging of losses from any one year's operations against the income of succeeding years' operations. With an adequate carry-forward, discrimination, under the corporation income tax, against businesses with fluctuating incomes would be greatly reduced. In order to permit the fullest deduction of annual losses against income, it is recommended that the carry-forward be extended to at least 7 years. The privilege of

carry-forward of losses is particularly encouraging to a new business which expects losses during the early years of operation. Such losses can be offset against subsequent income when the enterprise gets on its feet. Without the carry-forward, no provision is made for the deduction of the excess of expense over income during loss years.

4. Accelerated Depreciation

The present treatment of depreciation, in the definition of income for tax purposes, is subject to widespread criticism. Many businessmen feel that present policy is excessively rigid and arbitrary. Small businessmen in particular feel that they are subject to discrimination in the setting of depreciation rates, since they do not have the legal and accounting service necessary to press their claims with the internal revenue agents. Accordingly, considerable sentiment has developed in favor of "greater latitude" or more "discretion" on the part of the taxpayer in determining depreciation rates.

The mere granting of latitude in depreciation, without specific controls and standards, would pose serious administrative problems for the Bureau of Internal Revenue and would give rise to abuses. Moreover, latitude would in fact be a form of accelerated depreciation, since what businessmen really want is permission to take more rapid rates of depreciation than the Bureau now allows. There are few cases on record where a taxpayer has asked for a slower rate of depreciation.

Since a vague policy of allowing more latitude raises serious problems and since businessmen are, in any case, really after more rapid rates of depreciation when they call for "latitude," the proposal has been made that depreciation rates should be increased by means of a definite formula which would lend itself to tight and equitable administration. This proposal has come to be known as accelerated depreciation.

Accelerated depreciation is a thoroughly sound measure and should be adopted. Businessmen have been quite right in their resistance to the traditional method of computing depreciation for tax purposes — usually straight-line depreciation extending over the expected useful life of depreciable assets. There are many reasons why a relatively large portion of the depreciation on any given asset should be concentrated in the early years of the expected useful life of the asset.

There are many possible formulas for accelerating depreciation, and it is not possible to demonstrate that a particular one is preferable to all others. A principle to be followed, however, is that the formula should make possible the recovery of a large portion of the cost of a newly acquired asset in a

reasonably short period, say 5 years. Indeed, 5-year amortization, as practiced during the war, is an extreme type of acceleration since it makes possible recovery of the entire cost in 5 years. A more moderate plan, for example, would be to permit the charging off of 50 percent of the cost of a newly-acquired asset in the first 5 years of its life and the remaining 50 percent over the entire normal life, including the first 5 years. In effect, under this scheme, 5-year amortization is applied to the first 50 percent of the value, and ordinary straight-line depreciation is applied to the second 50 percent. This plan is simple, requires a minimum of administrative change, and gives substantial acceleration. In the first 5 years, for example, 81 percent of a 10-year asset would be written off, 66 percent of a 20-year asset, and 56 percent of a 50-year asset.

It would be a mistake to put accelerated depreciation into general effect before the repeal of the present excess-profits tax. The tax advantage of making investments in time to charge accelerated depreciation against income subject to the wartime excess-profits tax would be so overwhelming that an unwholesome bunching of investments would occur. It is suggested, therefore, that, pending the repeal or revision of the excess-profits tax, accelerated depreciation be applied only to the first \$100,000 of assets acquired by any company in any year and that acceleration be made general only with the repeal or revision of the excess-profits tax.

Accelerated depreciation would be particularly important to small and new businesses because it would materially reduce their risks in connection with capital investment and would significantly alleviate their problems of obtaining capital. It would be desirable for businesses of all sizes and for the economy as a whole because it would encourage investment, provide a system of depreciation more conformable to actual wear and tear and obsolescence than the crude, straight-line method, provide a more realistic definition of income for tax purposes, and eliminate a source of irritation in tax administration.

The essence of investment is risk. This is true because the recovery of capital and the derivation of income from it depends upon more or less uncertain future conditions. The uncertainties of the remote future are always greater than those of the more immediate future. Thus, when businessmen are considering investments, they are likely to concern themselves with the probabilities of recovering their capital in a reasonably short period in the future, and they are extremely reluctant to make commitments the success of which depends on the fulfillment of conditions in the remote future. Rapid depreciation enables them to recover their capital more quickly than otherwise. It means that the charges for depreciation during the early years of the life of any newly-

acquired asset will be large, so that the income subject to taxation will be relatively small. In view of the reduced tax liability during this period, the chances of recovering the capital are increased. Putting it another way, accelerated depreciation increases the probability of recovering capital during the reasonably foreseeable future and avoids the necessity of postponing the recovery of capital until the distant and totally unfathomable future.

At the same time and for the same reasons, accelerated depreciation would help to lighten the financial problems involved in capital expansion. It would tend to improve the credit position and enlarge the borrowing power of businesses contemplating capital expansion, since it would increase the probability that firms would be able to pay their debts and would reduce the necessary duration of capital loans.

The reduction of risk and the improved financial position resulting from accelerated depreciation would be extremely important to small and new businesses.

With accelerated depreciation, most of the conflicts and irritations arising from present depreciation policy would disappear, since taxpayers would no longer feel that they were being penalized by illiberal depreciation rates.

Moreover, accelerated depreciation conforms more closely than straight-line depreciation to the pattern of actual physical depreciation. For example, an automobile depreciates in value much more rapidly in the early years of its life than later. Machines and buildings depreciate in the same way, partly because they are more efficient or desirable when new and partly because the expense of maintenance rises and the competition of newer and more modern assets increases through time. The typical pattern of decline in the value of an asset is not a straight line but a curve sharply dipping at first and then gradually declining.

Finally, with accelerated depreciation the corporate income tax would be more equitable, because the income base would conform more closely to economic income after allowance for all costs (including capital costs) than is now true when the recovery of capital costs is postponed into the remote future.

For example, suppose two enterprises, A and B, start out at the same time with like assets subject to conventional depreciation allowances. They are equally successful during the first 5 years and pay the same taxes. Thereafter A becomes unprofitable but B continues to be successful. A's losses wipe out its earlier profits, but it can obtain no tax adjustment in recognition of

this fact. A has been required to pay taxes on tentative income which, as things turned out, it did not ultimately earn; i.e., on fictitious income which was the product of accounting conventions and not of economic reality. On the other hand, with accelerated depreciation, A and B both would have charged off a large part of their capital investments during the early years of their operation and hence would have shown little or no profit during this period. Later when A became unprofitable, it would still have no taxes to pay. But B, now that it was a prosperous, well-established company, would be required to pay taxes on its income. This income would be relatively large because its depreciation allowances would be very small, due to the fact that its capital had already been charged off. The tax levied on B would be based on genuine — not fictitious — income.

Accelerated depreciation does raise certain difficulties. It is more complex than the present method of depreciation. It involves technical problems in the computation of capital gains. If it is applied to used facilities, abuses might arise from the transfer of assets merely for the purpose of increasing depreciation rates — the same asset might be charged off against income several times over. Accelerated depreciation might be adopted by a taxpayer as a way of manipulating his taxes to take advantage of fluctuating tax rates. Most of these difficulties are of a technical nature and can be overcome. However, to overcome them will add to the complexity of the plan.

In many cases, small or new companies may be reluctant to adopt accelerated depreciation because of uncertainty as to whether their income will be sufficient to absorb the heavy depreciation charges in the early years of the life of newly-acquired assets. This problem can be largely overcome by a long carry-forward of losses. It would be clearly unwise to adopt accelerated depreciation without a long carry-forward of at least 7 years and possibly as much as 10 years.

Accelerated depreciation would involve a temporary loss or, more correctly, a postponement in revenue to the Government. During the period when the plan was being introduced, total depreciation charges would increase. Years later, when the plan was in full operation, total depreciation charges would again reach normal. But the gap during the transition would never be closed, and a net loss or postponement of revenue would be the result. This loss might amount to as much as a billion dollars in a peak year. However, the advantages of the plan would easily justify the postponement of revenues. Unlike a straight tax cut, this reduction in revenue would be selective. The benefit would go to those who are serving society by assuming risks and expanding production, rather than to all businesses regardless of their productive activity.

5. The Dividend Credit

One of the most controversial issues in current tax policy relates to the so-called double taxation of dividends. Income represented by dividends is taxed once under the corporation income tax and again under the individual income tax. It is frequently asserted that this double taxation is unsound from the point of view of its economic effects, and discriminatory. A dividend credit — either at the corporate or individual level — is therefore often proposed. However, in view of the urgent need for revenue from corporate income, as previously pointed out, the dividend credit is not here recommended.

If, nevertheless, a dividend credit should be adopted, it is recommended that it be granted at the corporate level rather than at the individual level.

Such a plan would provide that the portion of corporate net income which was paid out as dividends would be subject to a lower rate than income retained by the corporation. To protect smaller corporations which rely on reinvested earnings for their expansion, the first \$100,000 of income would be presumed to be distributed, whether or not it were actually distributed.

The advantage of this plan of permitting a dividend credit at the corporate level is that it provides a positive incentive to the distribution of corporate earnings to stockholders, thus promoting consumption. If the credit were granted at the individual level, the effect on corporate dividend policy would be slight. Thus, the credit would be granted without obtaining any direct economic advantage from it.

It must be reiterated that if the credit were granted at the corporate level, it would be absolutely essential to the preservation of small business that at least \$100,000 of income should be treated as though it were distributed — regardless of its actual disposition.

X. INDIVIDUAL INCOME TAX

The problem of individual income taxation is to encourage consumption by granting relatively high exemptions and moderate rates in the lower brackets, and at the same time to encourage risky investment by granting moderate rates in the middle and upper brackets -- all the while preserving the principle of graduated rates and obtaining the large revenue which must come from this source. This is a large order.

An individual income tax designed to raise \$14 billion and to provide investment incentives for persons in the middle and upper brackets allows few alternatives in rates, exemptions, etc. Indeed, in order to attain the required revenue and incentive objectives at reasonable rates, it becomes urgent to explore the possibility of closing important loopholes and of remedying certain lax provisions in the present individual income tax.

The effect of the individual income tax as a deterrent to investment can be materially reduced, not only by rate reductions but by other measures as well. Most individuals in the higher income brackets, who are in a position to make risky investments, have diverse sources of income. Thus, it is often possible for them to offset the loss from a particular investment against the income from other investments or from their personal services. As the tax law now stands, capital losses can be offset only against capital gains. The treatment of capital losses should be modified so that capital losses may be offset against income other than capital gains. Moreover, to increase the possibility of loss-offsetting, a carry-forward of capital losses should be permitted. With these provisions, the effect of the income tax in increasing the risk from new investments would be materially reduced.

Even with more liberal treatment of losses, the rates of the individual income tax must be moderate so that the amount of prospective return from new investments will encourage the flow of money into risky investments.

With present inadequate knowledge of investment incentives, there is no demonstrable formula for deciding upon a level of income tax rates which would leave sufficient return to induce investors to commit their funds. Prima facie, it would seem desirable to have a system of rates which would permit a high-bracket investor to retain perhaps one-fifth and a middle-income investor to retain one-third to one-half of any marginal income derived from investment. If the

corporation income tax were 40 percent, this would mean that the individual rate for the top bracket should not exceed 65 percent, and for a middle bracket, say \$10,000-\$12,000, should not exceed perhaps 35 percent.

It should be stated, parenthetically, that a top bracket rate as low as 65 percent would be fully as effective, revenue-wise, as present rates if certain obvious and important means of avoidance were removed; e.g., differential treatment of capital gains, privilege of filing separate returns, exemption of income from governmental securities, etc.

The provision of a 7-year carry-forward of losses and of accelerated depreciation for unincorporated companies, as previously suggested, would also reduce the impact of the individual income tax on small businesses.

Personal exemptions and the credit for dependents should remain at approximately the present level. However, the exemption for the normal tax, which is now \$500 for the taxpayer with no allowance for the spouse or dependents, should be changed to conform to the surtax exemption. The present surtax exemptions of \$500 per capita are probably inadequate for single persons and married persons without dependents. It is recommended that the exemptions be changed to \$700 for a single person or head of a family, \$500 for the spouse, and \$400 for each additional dependent.

The following is a suggested schedule of individual income tax rates designed to raise \$14 billion at full employment. For purposes of comparison present rates are also shown.

PROPOSED INDIVIDUAL INCOME TAX SCHEDULE

Surtax net income (i.e., after personal exemptions (000)	Present law bracket rate (inc. normal tax)	Pro- posed bracket rate	Reduc- tion in bracket rate from present law	Effective rate on entire income, under proposed schedule, for a married indi- vidual who has two dependents and whose income is at the top of the bracket
0 - 2	23%	18%	5%	9
2 - 4	25	20	5	13
4 - 6	29	23	6	15
6 - 8	33	26	7	17
8 - 10	37	29	8	19
10 - 12	41	32	9	21
12 - 14	46	36	10	23
14 - 16	50	40	10	25
16 - 18	53	44	9	27
18 - 20	56	47	9	29
20 - 22	59	50	9	30
22 - 26	62	53	9	34
26 - 32	65	55	10	37
32 - 38	68	57	11	40
38 - 44	72	58	14	43
44 - 50	75	59	16	44
50 - 60	78	60	18	47
60 - 70	81	61	20	49
70 - 80	84	62	22	51
80 - 90	87	63	24	52
90 - 100	90	64	26	53
100 - 150	92	65	27	57
150 - 200	93	65	28	59
Over 200	94	65	29	--

This schedule appears to be harsh in the lower brackets, and it will be disappointing to many who are hoping for drastic reductions in individual income tax rates. However, in view of the fact that a very large portion of the income of individuals is in the lower brackets, it is impossible to raise large revenue from this source without heavy rates at the bottom. For example, a reduction of 2 percentage points in the first bracket rate would cost more than a half-billion in revenue. The harshness of these rates is, of course, mitigated by the personal exemptions. For example, a family

of four with an income of \$2,000 would pay no tax, or a similar family with an income of \$3,000 would pay something less than \$180.

The averaging of income should be introduced in order to prevent undue discrimination against individuals with irregular (risky) incomes. Such averaging would be administratively difficult, but well worth the difficulty. A possible method is that suggested by Professor Groves; namely, to permit the taxpayer "to sum his taxes over a period of years, calculate what his tax bill would have been if his income had been distributed evenly among these years, determine the difference between the two and claim the difference as a refund or tax credit."^{14/}

^{14/} Production, Jobs, and Taxes, p. 85

XI. CONCLUSIONS

The tax proposals presented in the foregoing pages have been designed to encourage employment and to stimulate competition, and, at the same time, to produce sufficient revenue to balance the budget under conditions of full employment.

To encourage employment and to stimulate competition, the following three objectives have been aimed at:

- (1) To enlarge the stream of income available for consumption.
- (2) To provide incentives for greater investment, especially within the strategic small business section of the economy, which must be depended upon for great expansion if full employment is to be achieved.
- (3) To reduce the discriminatory impact of present taxes upon small business.

To broaden consumption, it has been suggested that excise taxes be drastically reduced, that payroll taxes be held to their present levels, that the estate and gift taxes be strengthened, and that individual income tax exemptions be increased and rates reduced in the lower brackets.

To encourage investment generally, it has been recommended that the excess-profits tax be eliminated or drastically modified, that the capital stock and declared value excess-profits taxes be repealed, that a long carry-over of losses be permitted, that depreciation be accelerated, that the individual income tax rates in the middle and upper brackets be reduced, and that capital losses be made more freely deductible.

Since the present tax system tends to increase the risks of small business much more than that of large, each of these proposals would tend to improve the prospects and strengthen the relative position of small business. In addition, to overcome some of the financial handicaps of small business and to stimulate competition, it has been suggested that the corporation income tax rates be more graduated in the lower brackets than at present.

S E C T I O N I I

FINANCIAL CONDITION OF SMALL BUSINESS

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EXHIBIT 11111111111111111111

I. INTRODUCTION

One of the objectives of the tax plan presented in this document is to alleviate the problems of small business in obtaining adequate capital and credit.

The financial difficulties of small business arise from the fact that sufficient long-term credit is not available, interest rates are high, the opportunities for selling securities are limited, the cost of flotation of securities is high, and local private venture capital is difficult to find. The unsatisfied credit needs of small business have been large even in periods of high levels of business activity.

Bank credit has been more readily obtainable than funds from other sources, but even, here, small companies have been at a distinct disadvantage. Generally, they are unable to obtain intermediate and long-term credit, and they pay interest rates which average 3 times as high as those paid by large borrowers.

Small businesses which have been unable to obtain funds from commercial banks, capital markets, individual lenders, or the company's earnings have resorted frequently to the use of trade credit, to factors, to credit agencies, or to personal loan companies. Such sources have usually been extremely costly and have often impaired the independence of small business.

II. SOUND BUSINESSES UNABLE TO OBTAIN FUNDS

The financial problems of small business are so great that, as several surveys have demonstrated, from one-third to one-half of the small businesses which are in sound financial condition still experience difficulty in getting funds from private sources.

1. Commerce Department 1934 Study

In 1934, under the direction of Dr. Theodore Beckman, the Commerce Department made a nation-wide study of the financial conditions of 6,158 manufacturers employing between 21 and 250 wage earners each. 15/

The findings of the survey concerning the sources of funds for long-term requirements are shown on Chart 3. The most striking fact is that long-term funds could not be obtained from any source by 47.2 percent, or nearly half of all the manufacturers which reported sources of capital funds. Banks provided funds to 18.9 percent, stocks to 9.6 percent and bonds to 8.2 percent. Personal and private loans -- a high cost source -- provided funds to 7.3 percent of the small manufacturers.

Difficulties to obtaining needed financial aid were reported from all sections of the country. The situation appeared to be fairly uniform for each Federal Reserve district.

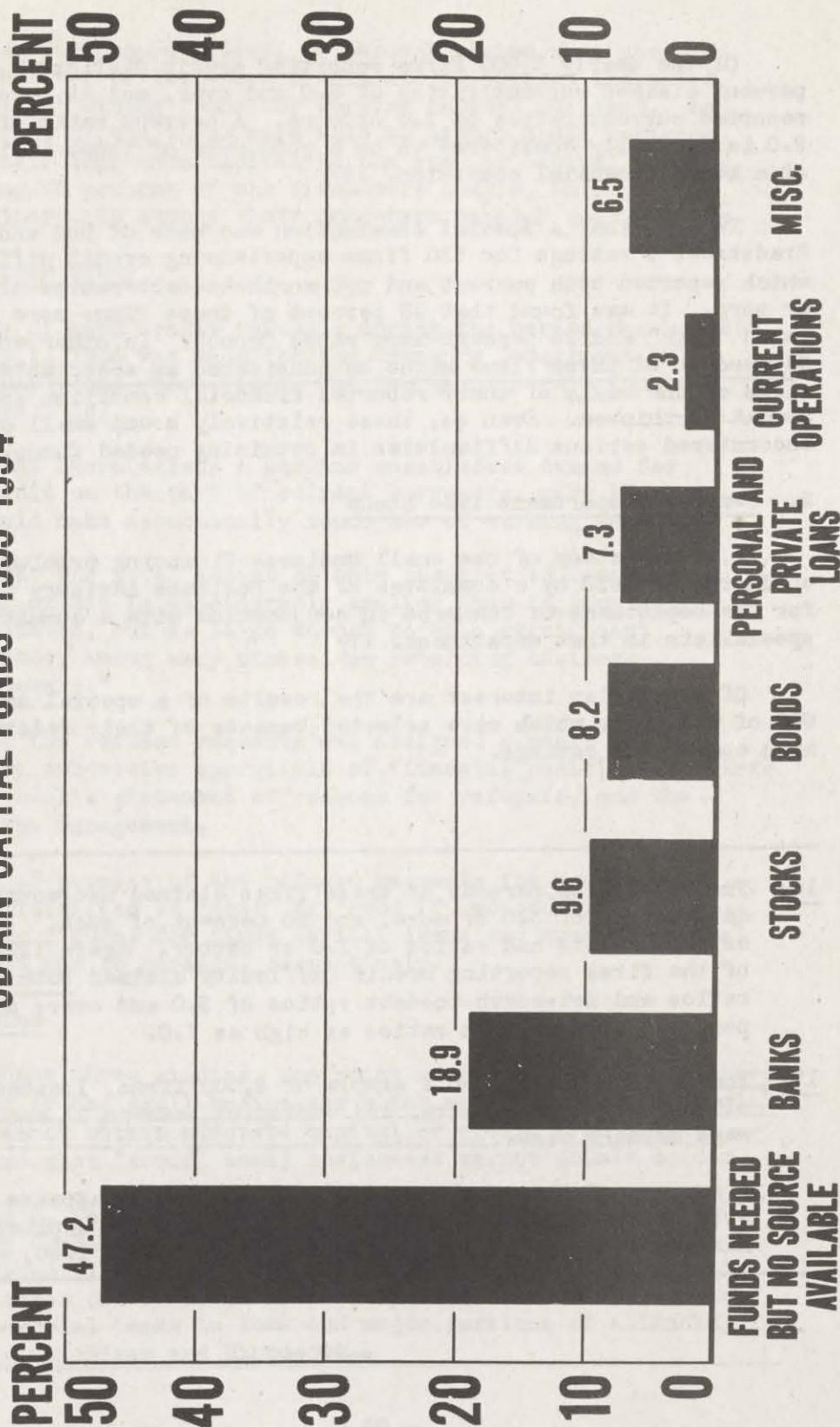
Moreover, the reported difficulties were not confined to a few industries. Manufacturers representing practically every phase of American industrial activity reported that adequate credit could not be obtained from customary sources. Manufacturers of food products and of textiles complained as often as producers of heavy goods.

A surprisingly high proportion of the firms reporting credit difficulty were found to be in a good, if not excellent, financial condition.

15/ This sample of firms used in this study consisted of small plants: 73.5 percent of the manufacturers employed less than 100 wage earners each, and the remaining 26.5 percent of the firms employed on the average 154 workers each.

U.S. Department of Commerce, "Survey of Reports of Credit and Capital Difficulties Submitted by Small Manufacturers", 1935.

LONG-TERM CREDIT REQUIREMENTS **SOURCES FROM WHICH SMALL MANUFACTURERS NORMALLY** **OBTAIN CAPITAL FUNDS 1933-1934**



SOURCE: U.S. Dept. of Commerce, Survey of Reports of Credit and Capital Difficulties Submitted by Small Manufacturers, 1935, p. 66.

Of the nearly 2,000 firms reporting credit difficulty, 23 percent claimed current ratios of 3.0 and over, and 42 percent reported current ratios of 2.0 or more. A current ratio of 2.0 is generally considered to be a good rule of thumb indication of a sound financial condition. 16/

In addition, a special examination was made of Dun and Bradstreet's ratings for 620 firms experiencing credit difficulty which reported both current and net-worth-to-debt ratios of 2.0 or more. It was found that 38 percent of these firms were rated "high" and 26 percent were rated "good". In other words, 64 percent of these firms might be considered as acceptable credit risks on the basis of their reported financial condition and credit worthiness. Even so, these relatively sound small companies encountered serious difficulties in obtaining needed funds.

2. Commerce Department 1938 Study

A second study of the small business financing problem was conducted in 1938 by a committee of the Business Advisory Council for the Department of Commerce in conjunction with a committee of specialists in that department. 17/

Of particular interest are the results of a special study of 600 of the firms which were selected because of their relatively high commercial ratings.

16/ Furthermore 33 percent of these firms claimed net-worth-to-debt ratios of 3.0 or more, and 50 percent of such establishments had ratios of 2.0 or better. Again 18 percent of the firms reporting credit difficulty claimed both current ratios and net-worth-to-debt ratios of 3.0 and over; and 33 percent reported both ratios as high as 2.0.

17/ The study was based on a sample of 6,000 firms, located in all parts of the country, and employing between 21 and 150 wage earners each.

A summary of the results of this investigation appears in William Leavitt Stoddard, "Small Business Wants Capital," Harvard Business Review, Vol. 18, No. 3, Spring 1940, p. 272.

Of these 600 "sound" firms, 40 percent stated that they had no source whatever of long-term credit and 45 percent indicated difficulty in obtaining funds for working capital purposes. As only 25 percent of the firms were able to secure their mortgage loans and their long-term capital in the regular capital markets, the remaining 75 percent of the firms were unable, through the normal machinery, to supply their long-term capital requirements.

3. Hardy-Viner Study

A study of bank credit refusals during the period March, 1933, to September 1, 1934 was made for the Treasury Department by Charles O. Hardy and Jacob Viner. The two major conclusions of the study are: 18/

- a. "That there exists a genuine unsatisfied demand for credit on the part of solvent borrowers, many of whom could make economically sound use of working capital."
- b. "That the total amount of this unsatisfied demand for credit is considerably smaller than is popularly believed, but is large enough to be a significant factor, among many others, in retarding business recovery."

Each of the refused requests was assigned a merit rating determined by subjective appraisals of financial position, earnings record, the bank's statement of reasons for refusals, and the quality of the management.

Nearly 40 percent of the refused requests for commercial loans were classified as "good" or "good if reduced." The corresponding figures for fixed capital loans and working capital loans were 15 and 25 percent, respectively.

4. Conclusion

From these three studies, one point emerges: between one-third and one-half of the small businesses which are in a sound financial condition cannot obtain adequate capital or credit from private sources. And when "sound" small businesses cannot obtain needed

18/ Charles O. Hardy and Jacob Viner, "Report on the Availability of Bank Credit in the Seventh Federal Reserve District." Washington, 1935, p. VI. The survey covered an analysis of 1,788 cases of credit refusal to 1,497 different applicants by commercial banks in Iowa and major portions of Illinois, Indiana, Michigan and Minnesota.

funds, the financial problems of the less well situated are, of course, even more serious.

This is clear from the evidence presented in the following pages on the difficulties of small business in obtaining funds from the various existent sources.

III EXTERNAL SOURCES OF FUNDS

The three major sources from which small business obtains outside financial assistance are (1) private banks, (2) issuances of securities, and (3) investments by individuals. For some time these sources have either been restricted or closed to small business. They are not now adequate to meet credit and capital needs in the reconversion and post-war periods.

1. Private Banks

Throughout the history of this country small firms have turned most frequently to commercial banks to meet their capital and credit needs.

a. Long-term Loans

One of the greatest needs of small business is long-term credit. Small business needs long-term loans to increase working capital, to replace and improve existing plant and equipment and to refund debts on easier terms. The need is particularly acute at the present time for the purpose of reconverting machinery and equipment from war to peacetime production.

Nevertheless, small business experiences the greatest difficulty in getting long-term bank credit. Bank loans to small business, are generally on a short-term basis. This, of course, increases the cost of the loans and deprives small businessmen of the safety and security needed for long-term credit purposes. There has been some increase in term lending (loans of one year and over) by commercial banks during recent years but small business still receives inadequate long-term credit.

This is shown in a special survey issued by the Board of Governors of the Federal Reserve System of commercial and industrial loans made by 5,362 member banks during the month of April 16 to May 15, 1942. It was found that out of a total volume of loans of \$2,200,000,000 long-term loans amounted to only \$45,000,000, or 2 percent.

Nearly all of the \$45,000,000 long-term credit went either to large businesses or to a few small firms which were in a very superior financial condition.

In the words of the Federal Reserve report "...small firms obtain term loans (maturity of one year and over) only when they have a very high credit standing, and then the loans are fairly substantial in amount. For this reason, term loan rates to small borrowers are below rates on shorter paper, contrary to the usual time differential, reflecting the highly selected quality of small firms that obtain term loans as compared to the bulk of small firm borrowers." ^{19/} (Italics not in original).

As a result of this inability to obtain long-term loans, small business must, of necessity, operate to a much larger extent than big business on the basis of short-term credit. That this actually is the case is apparent from Chart 4. It shows current liabilities as a percentage of total borrowed capital for manufacturing corporations, classified by size. ^{20/}

The chart shows that, particularly in peacetime years, the percentage was much higher for small than for large business. For corporations with total assets under \$50,000, current liabilities comprised 86 percent of borrowed capital in 1932 and 81 percent in 1937. ^{21/} As corporations increased in size up to \$50,000,000, the percentage steadily declined, reaching 44 percent for 1932 and 53 percent for 1937. ^{22/}

^{19/} Board of Governors of Federal Reserve System, "Commerical and Industrial Loans at Member Banks." Reprint from Federal Reserve Bulletins for August, September, and November, 1942, p. 26.

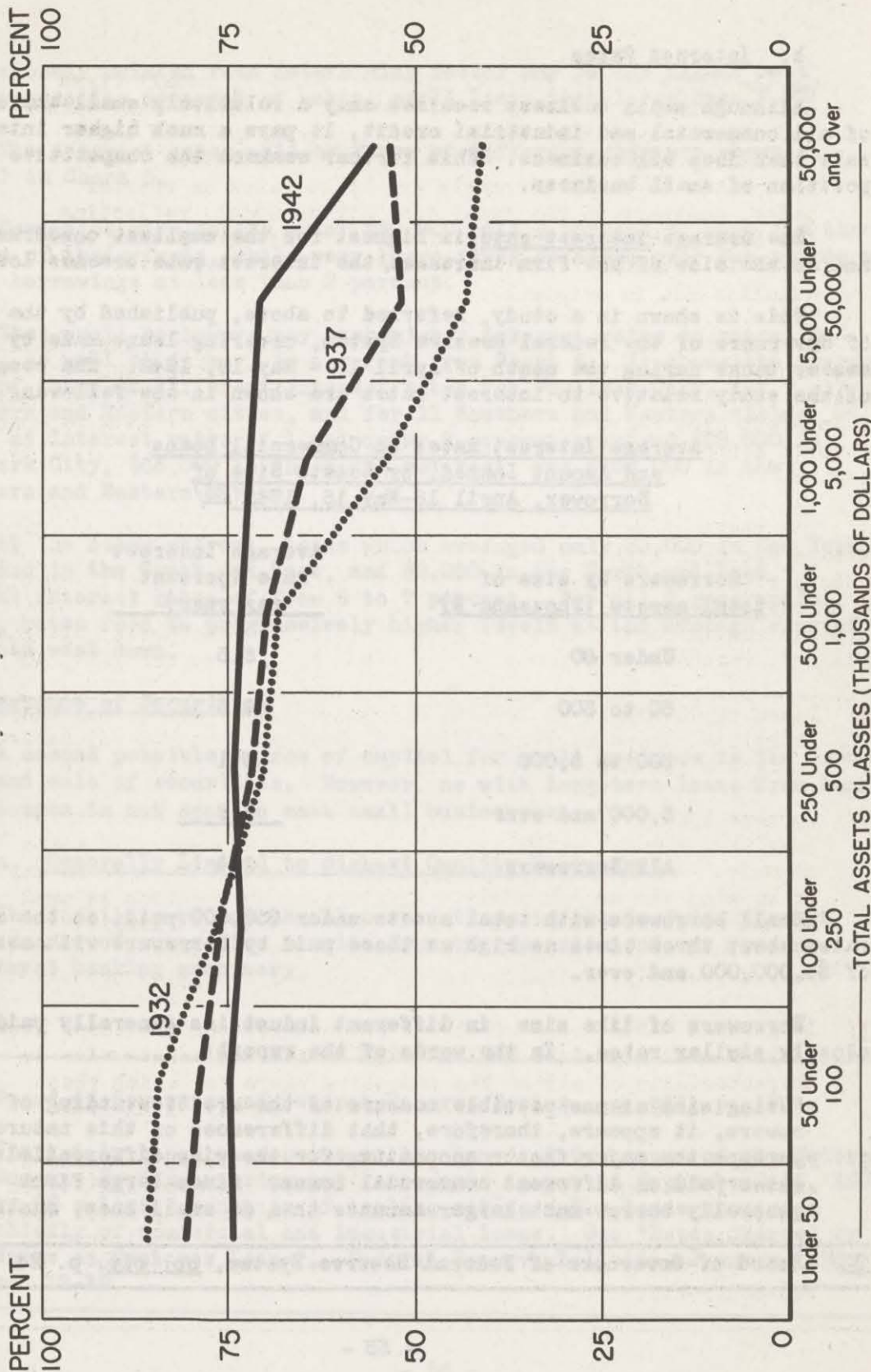
^{20/} Current liabilities are liabilities with original maturity of less than 1 year, which consist chiefly of accounts and notes payable. In the material presented in Chart 2 there is no way of knowing the amount of this short-term credit which is owed to banks. Borrowed capital comprises (1) current liabilities, as defined above, plus (2) debts with original maturity of 1 year or more (principally bonds, notes and mortgages payable).

^{21/} In general, this trend of higher percentages for the lower assets classes with a gradual decline with increasing assets size is characteristic of all of the peacetime years for which these Statistics of Income data are available, namely, 1931-1941.

^{22/} During the war year of 1942 percentage relationship remained unusually steady. This probably reflected the desirability on the part of large and small companies of having a greater amount of short-term credit in order to meet financial requirements, while operating on the basis of short-term contracts or sub-contracts.

MANUFACTURING CORPORATIONS CURRENT LIABILITIES AS PERCENT OF BORROWED CAPITAL

1932, 1937, 1942



Source: "Statistics of Income", Part 2 (Including Source Book and Worksheets), prepared by Bureau of Internal Revenue.

b. Interest Rates

Although small business receives only a relatively small share of all commercial and industrial credit, it pays a much higher interest rate than does big business. This further weakens the competitive position of small business.

The average interest rate is highest for the smallest concerns, and as the size of the firm increases, the interest rate becomes lower.

This is shown in a study, referred to above, published by the Board of Governors of the Federal Reserve System, covering loans made by 5,362 member banks during the month of April 16 - May 15, 1942. The results of the study relative to interest rates are shown in the following table:

Average Interest Rates on Commercial Loans
and Amount Loaned, by Assets Size of
Borrower, April 16-May 15, 1942 23/

<u>Borrowers by size of</u> <u>total assets (Thousand \$)</u>	<u>Average interest</u> <u>rate (percent</u> <u>per year)</u>
Under 50	5.5
50 to 500	4.5
500 to 5,000	3.1
5,000 and over	<u>1.8</u>
All Borrowers	3.4

Small borrowers with total assets under \$50,000 paid, on the average, rates about three times as high as those paid by borrowers with assets of \$5,000,000 and over.

Borrowers of like size in different industries generally paid closely similar rates. In the words of the report:

"Using size as one possible measure of the credit standing of borrowers, it appears, therefore, that differences of this nature were perhaps the major factor accounting for the wide differentials in rates paid on different commercial loans. Since large firms generally borrow much larger amounts than do small ones, another

23/ Board of Governors of Federal Reserve System, op. cit. p. 24

closely related rate determining factor may be the higher cost per dollar advanced of making small loans than large ones." 24/

The interest rates paid by firms of different sizes are shown in detail in Chart 5.

Companies with assets under \$50,000 paid 6 percent or more for three-fifths of their funds, while very large firms obtained over two-thirds of their borrowings at less than 2 percent.

That small borrowers pay much higher interest rates in peacetime years, as well as in war, is apparent from Chart 6. It shows the average size of loans at different interest rates for New York City, for 7 other Northern and Eastern cities, and for 11 Southern and Western cities. 25/ Loans at interest rates of 1 and under 2 percent averaged \$88,000 in New York City, \$65,000 in the South and West, and \$180,000 in the Northern and Eastern cities.

At the other extreme, loans which averaged only \$3,000 in New York City and in the South and West, and \$2,000 in the North and East, brought interest rates of from 6 to 7 percent. For all 3 geographic areas, rates rose to progressively higher levels as the average size of the loan went down.

2. Issuance of Securities

A second possible source of capital for small business is the issuance and sale of securities. However, as with long-term loans from banks, this source is not open to most small businesses.

a. Generally Limited to Highest Quality Businesses

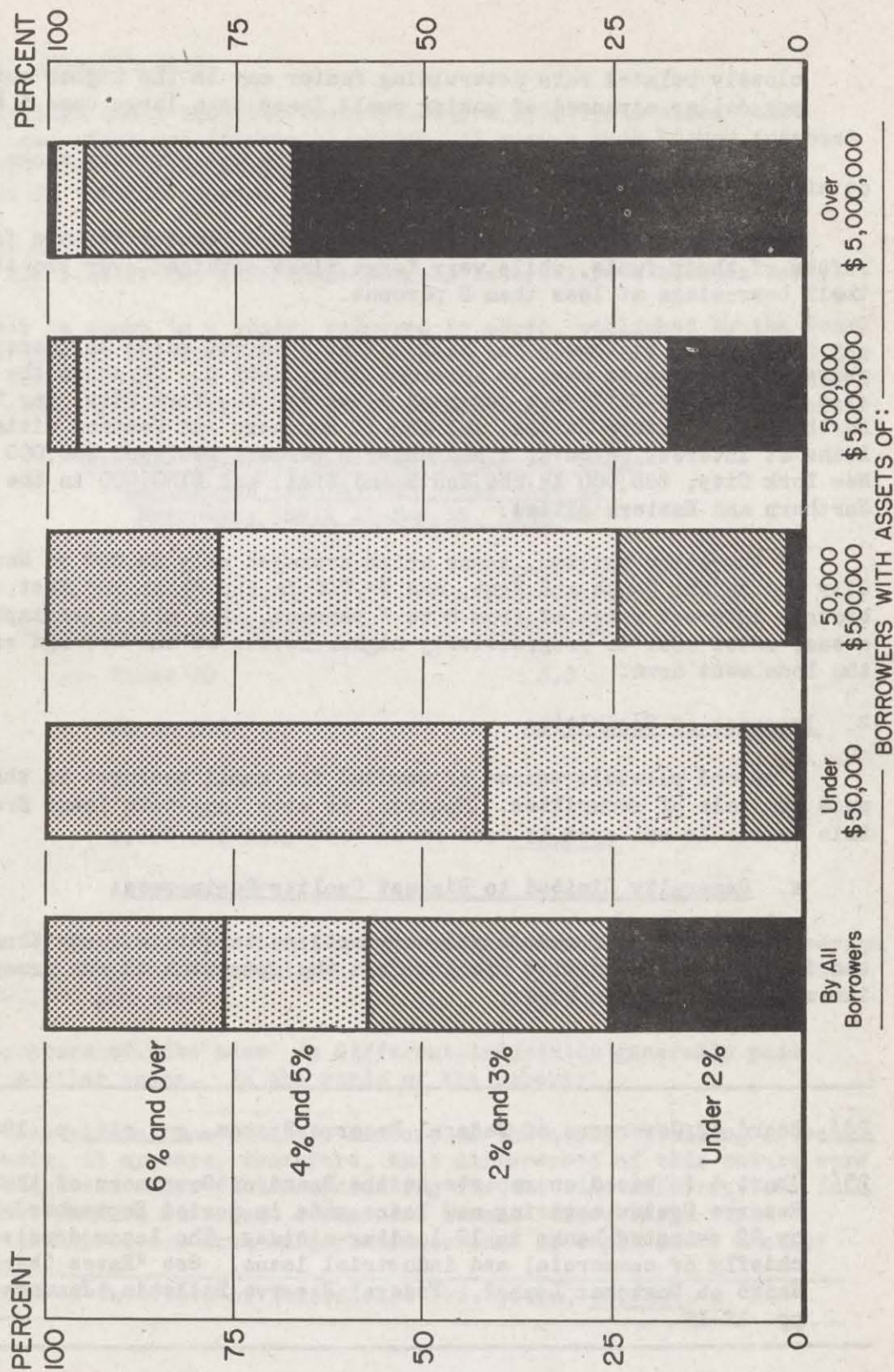
The inability of most small corporations to obtain funds through the issuance of securities results from the operation of our present investment banking machinery.

24/ Board of Governors of Federal Reserve System, op. cit., p. 19

25/ Chart 6 is based on reports to the Board of Governors of the Federal Reserve System covering new loans made in period September 1-15, 1938 by 92 selected banks in 19 leading cities. The loans consisted chiefly of commercial and industrial loans. See "Rates Charged by Banks on Customer Loans", Federal Reserve Bulletin, January 1939 pp. 17-19.

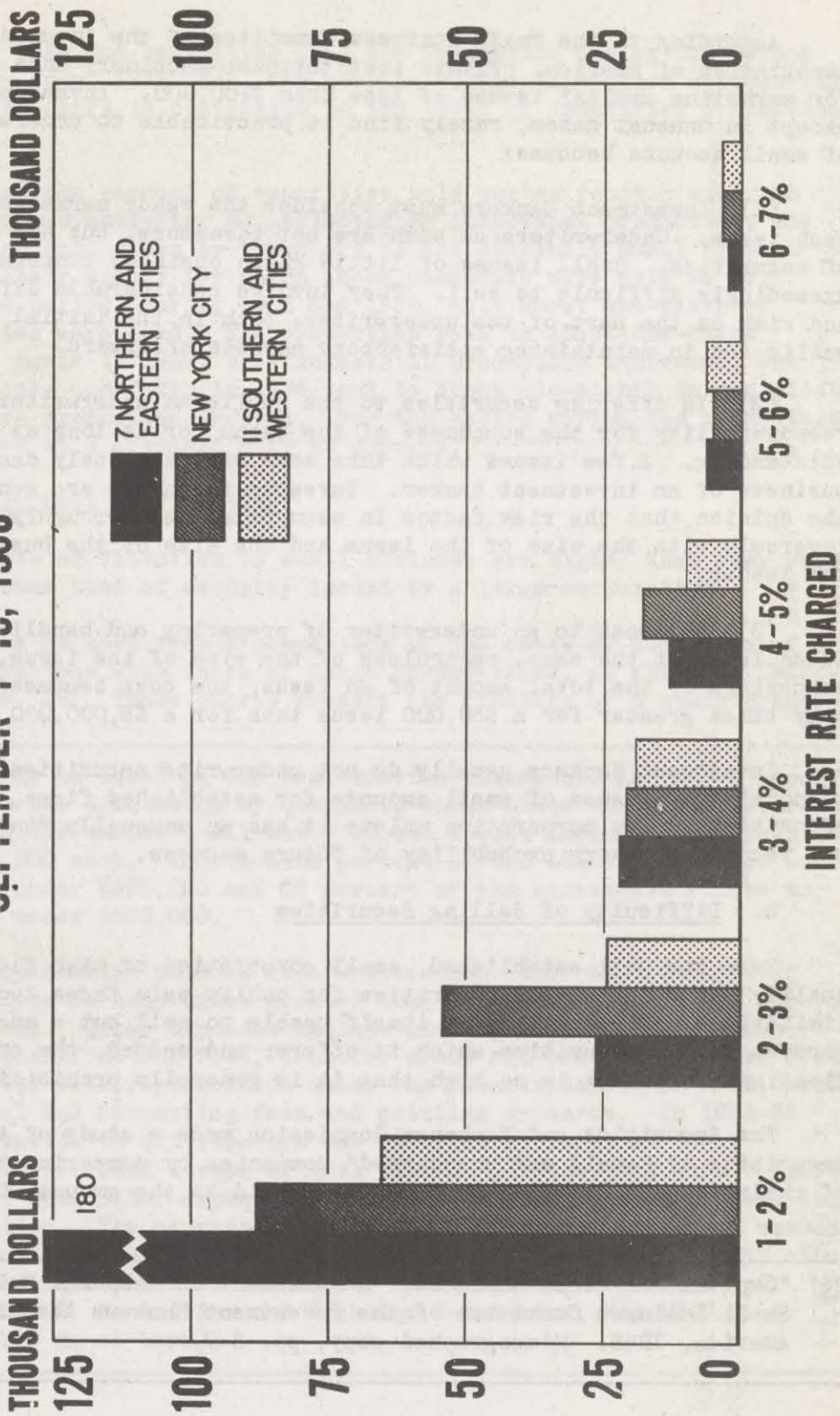
INTEREST RATES OF LOANS

PERCENT OF FUNDS BORROWED AT MEMBER BANKS OF FEDERAL RESERVE BOARD
AT DIFFERENT RATES, APRIL-MAY 1942



MADE AT DIFFERENT INTEREST RATES

SEPTEMBER 1-15, 1938



Source: Federal Reserve Bulletin, January 1939, page 18.

According to the Small Business Committee of the Investment Bankers Association of America, private institutional machinery does not exist for marketing capital issues of less than \$100,000. Investment bankers, except in unusual cases, rarely find it practicable to underwrite issues of small amounts because:

(1) Investment bankers must consider the ready marketability of each issue. Underwriters as such are not investors, but are merchants of securities. Small issues of little known business concerns are exceedingly difficult to sell. They involve considerable difficulty and risk on the part of the underwriter, both in the initial sale of the public and in maintaining satisfactory markets afterward.

(2) In offering securities to the public an underwriter accepts a responsibility for the soundness of the issue for as long as it remains outstanding. A few issues which turn sour will seriously damage the business of an investment banker. Investment bankers are generally of the opinion that the risk factor in securities tends roughly to vary inversely with the size of the issue and the size of the business of the issuer.

(3) The cost to an underwriter of preparing and handling a new issue is about the same, regardless of the size of the issue. As a percentage of the total amount of an issue, the cost becomes, therefore, many times greater for a \$50,000 issue than for a \$5,000,000 issue.^{26/}

Investment bankers usually do not underwrite securities of new corporations, issues of small amounts for established firms, nor securities of any corporation unless it has an unusually fine historical record and every probability of future success.

b. Difficulty of Selling Securities

Even the well established, small corporation of high financial quality which does issue securities for public sale faces two serious limitations. First, it finds itself unable to sell but a small proportion of the securities which it offers; and second, the cost of floating the issues is so high that it is generally prohibitive.

The Securities and Exchange Commission made a study of the securities of "small and unseasoned" companies by comparing the value of their securities which were actually sold to the amount which they

^{26/} "Capital for Small Business," A Statement on National Policy by the Small Business Committee of the Investment Bankers Association of America, 1945. Mimeographed copy, pp. 6-7.

offered for sale and registered with the Commission during the period July, 1933 - June, 1938. ^{27/} The percent of the securities sold during each of these years is contrasted to the level of industrial production in Chart 7.

Although the percent of securities sold varies roughly with the rate of economic activity, as reflected by industrial production, the most striking fact shown by the chart is the extremely small proportion of their securities which these companies were able to sell. Early in the period, during 1933 and 1934, only about one-sixth of the securities were sold. The proportion rose to about one-third in 1935 and again in 1937, when industrial production increased, but dropped to only one-fifth in 1936, and to about one-eighth in the first of 1938, when production dropped. For the entire period the percentage of securities sold averaged only 22 percent.

c. High Cost of Flotation

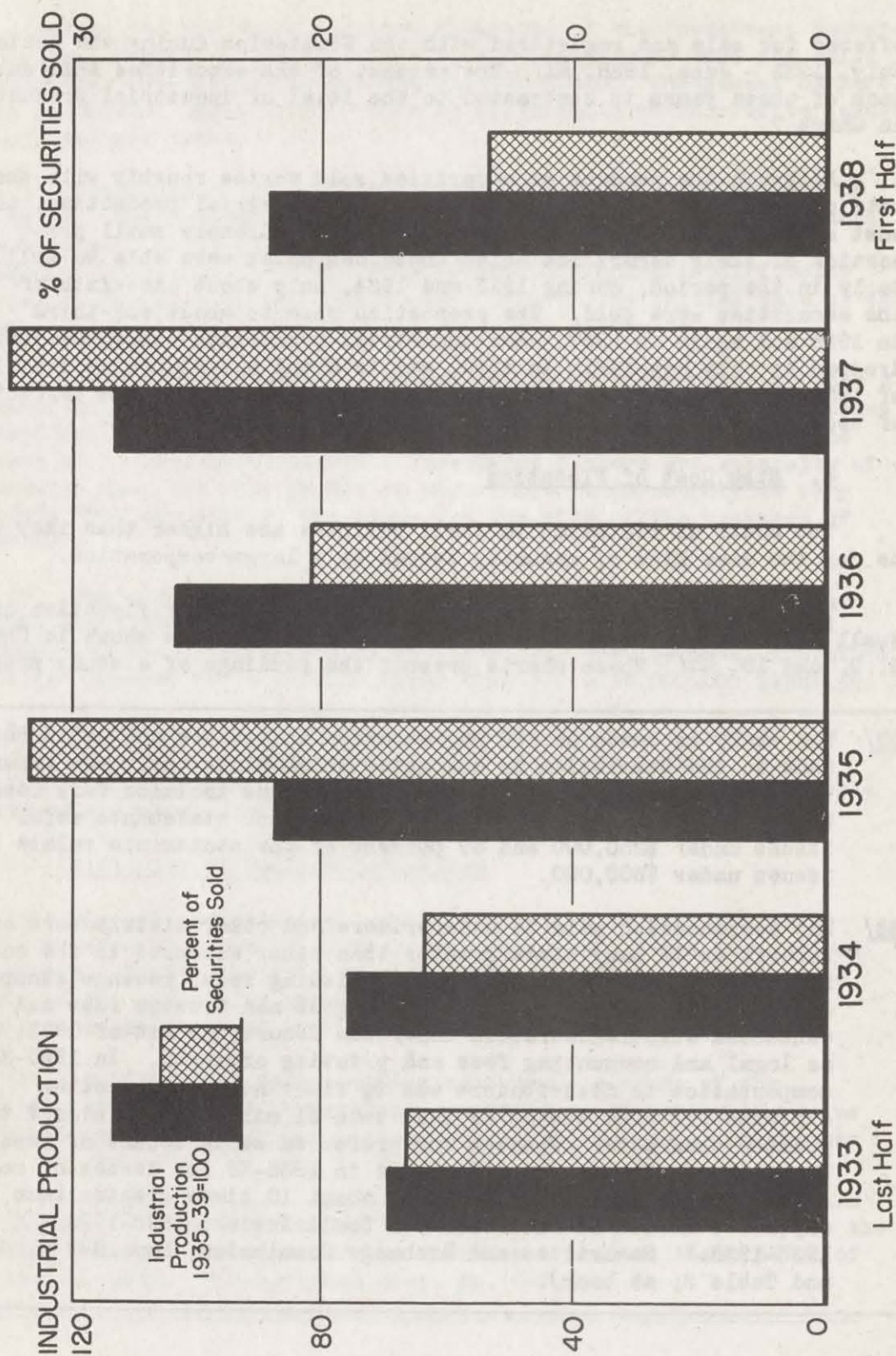
The costs of flotation to small business are higher than they would be for the same kind of security issued by a larger corporation.

This can be seen from a comparison of the costs of flotation of small corporations with those of large corporations, as shown in Charts 8, 9, and 10. ^{28/} These charts present the findings of a study prepared

^{27/} The study is based on 662 registration statements and sales reports made to the Commission by companies which place their own securities on the market. All but 9 of the issues included were less than \$5,000,000 each. Thirty-nine percent of the statements refer to issues under \$250,000 and 69 percent of the statements relate to issues under \$500,000.

^{28/} The compensation paid to underwriters and other distributors of securities is many times greater than other expenses in the cost of flotation. Other expenses include listing fees, revenue stamps, State qualification fees, transfer agent and trustee fees and fees connected with registration under the Securities Act of 1933, such as legal and accounting fees and printing expenses. In 1935-38 compensation to distributors was $2\frac{1}{2}$ times as large as other expenses for bond issues of less than \$1 million, and over 7 times greater than other expenses for preferred stock issues of less than \$1 million. The compensation cost in 1936-38 for issues of common stock of less than \$1 million was about 10 times greater than other expenses. ("Cost of Flotation for Small Issues, 1925-1929 and 1935-1938." Securities and Exchange Commission, May 1940 p. 4 and Table 3, at back).

SMALL AND UNSEASONED COMPANIES SECURITIES SOLD AS PERCENT OF AMOUNT REGISTERED*



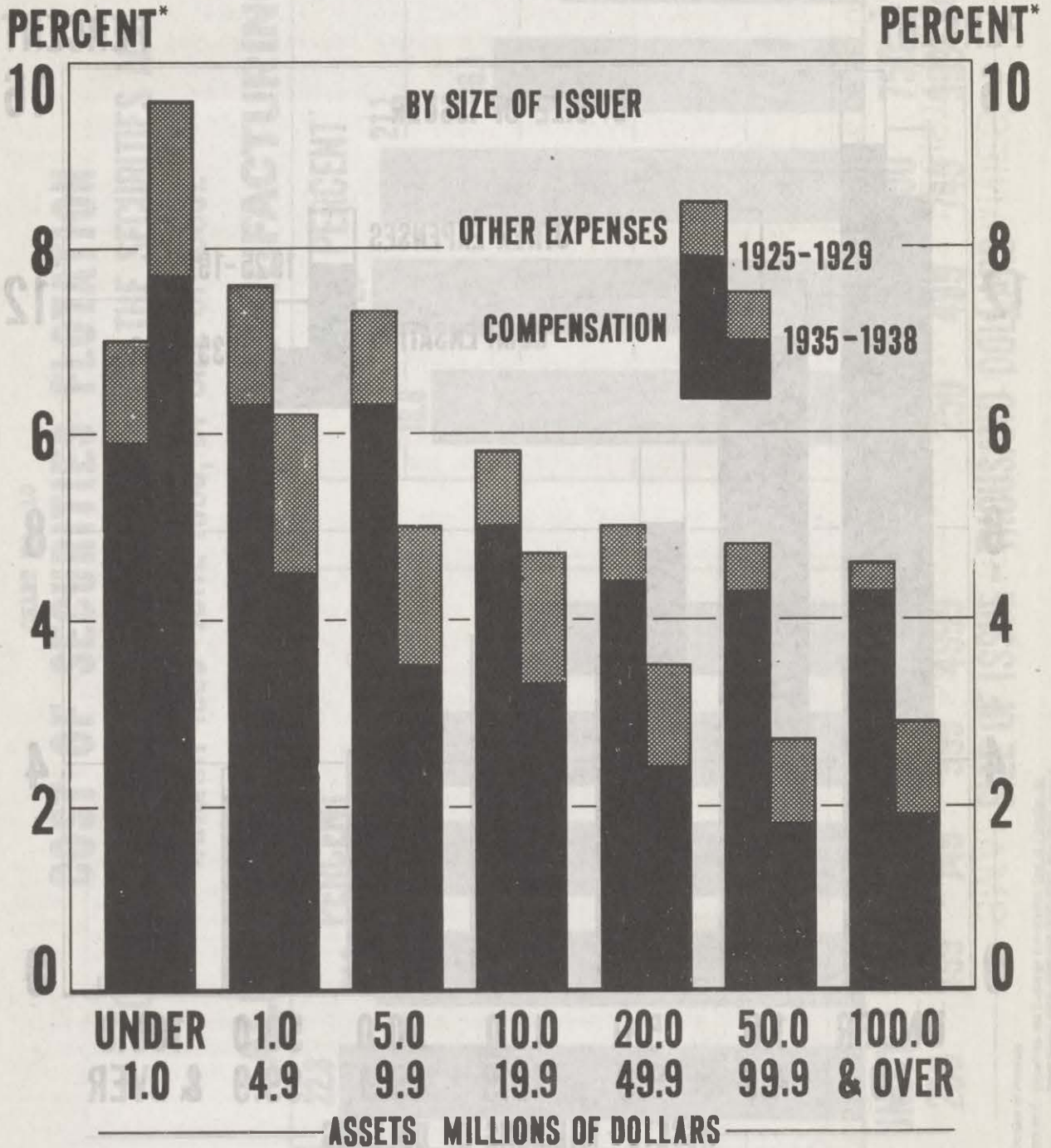
*Sale record of securities registered in 662 statements under the Securities Act of 1933 on forms A-1 and AO-1.
Sources: T.N.E.C. Monograph No. 17 page 293, and Federal Reserve Board.

CHART NO. 8

COST OF SECURITIES FLOTATION

BOND ISSUES OF LESS THAN \$5,000,000

1925-29 AND 1935-38



*Percent of Proceeds

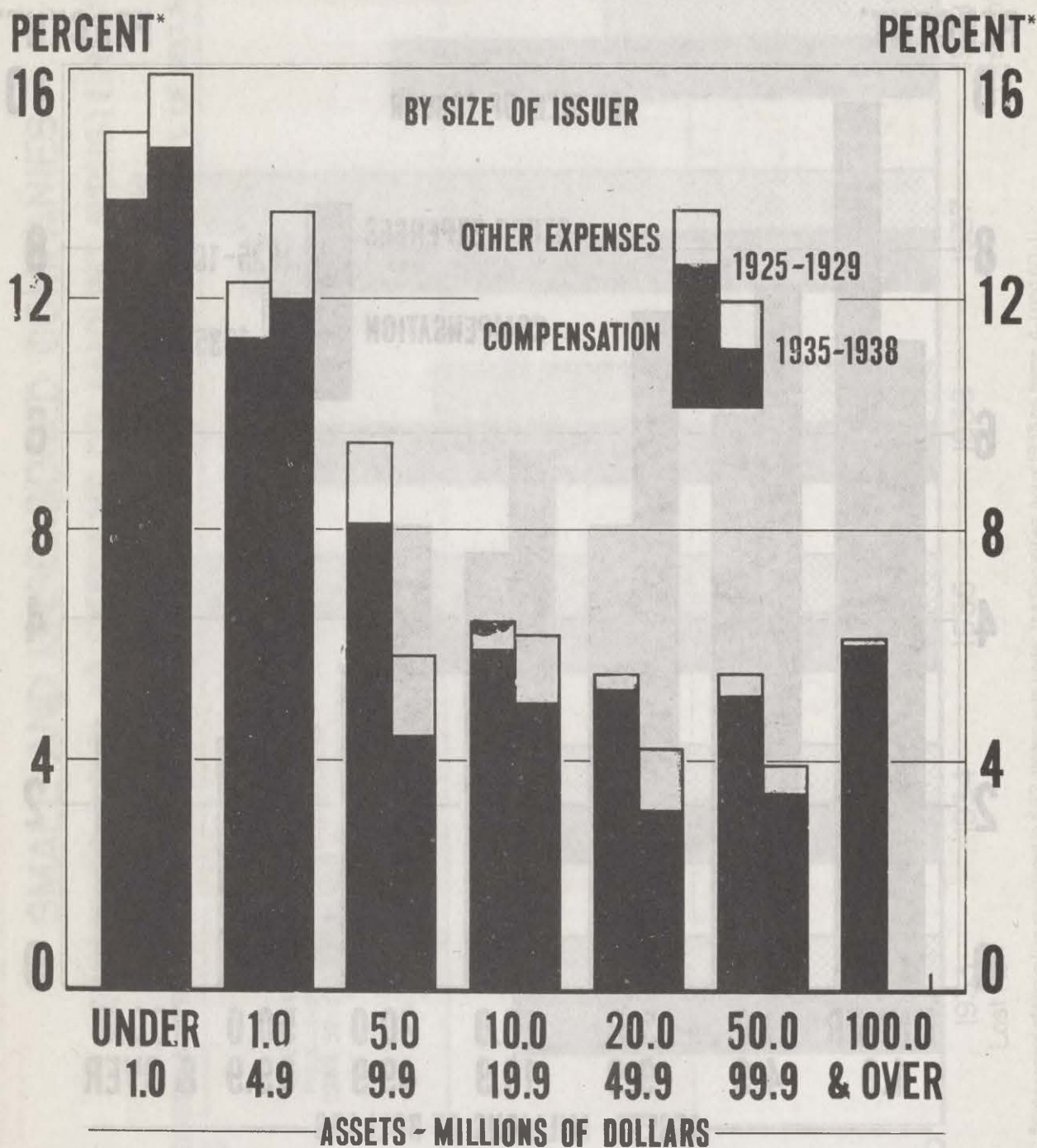
Source: Securities and Exchange Commission, *Cost of Flotation for Small Issues, 1925-1929 and 1935-1938*, May 1940, Table V

CHART NO. 9

COST OF SECURITIES FLOTATION

PREFERRED STOCK ISSUES OF LESS THAN \$5,000,000

1925-29 AND 1935-38



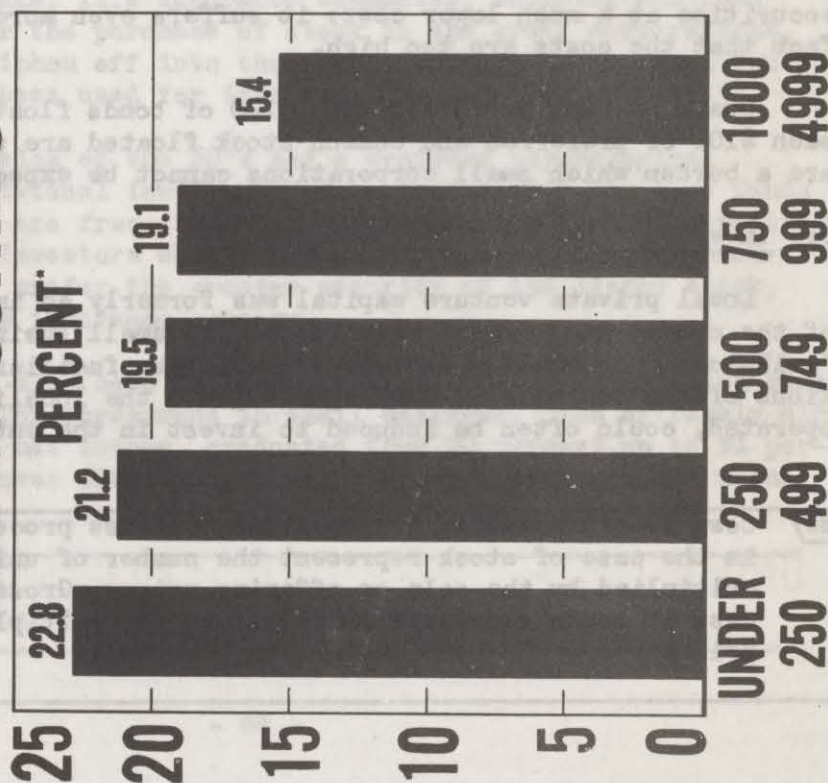
*Percent of Proceeds

Source: Securities and Exchange Commission, Cost of Flotation for Small Issues, 1925-1929 and 1935-1938, May 1940, Table V.

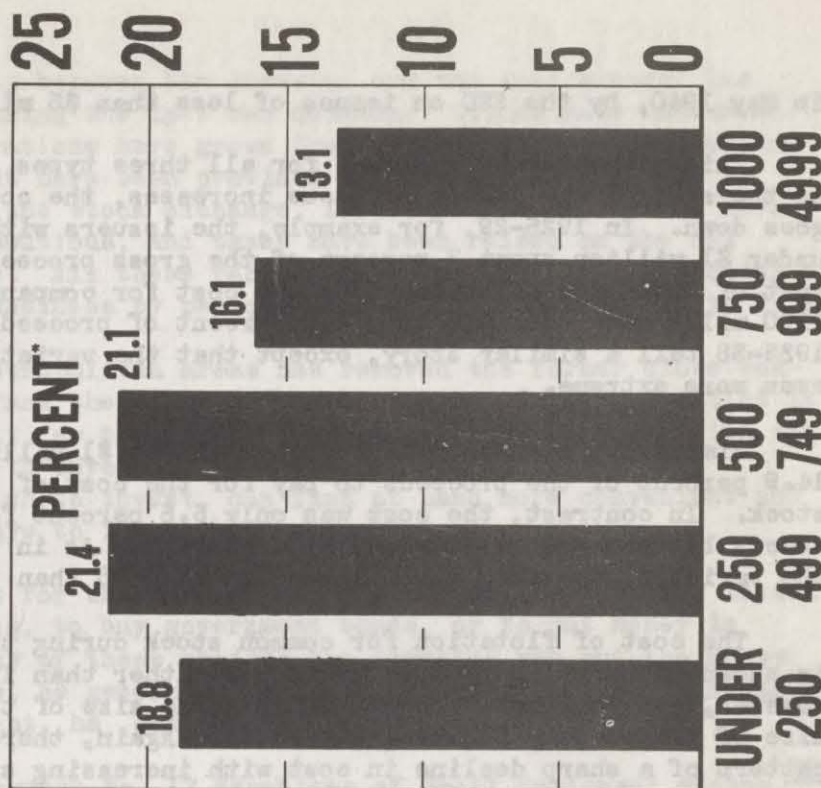
CHART NO. 10

COST OF SECURITIES FLOTATION **COMMON STOCK ISSUES REGISTERED UNDER THE SECURITIES ACT** **JANUARY 1936 - JUNE 1938, BY SIZE OF ISSUE**

ALL INDUSTRIES



MANUFACTURING



SIZE OF ISSUE - THOUSAND DOLLARS

*Percent of Proceeds

SOURCE: Securities and Exchange Commission, Cost of Flotation for Small Issues, 1925-1929 and 1935-1938, May 1940, page 4.

in May 1940, by the SEC on issues of less than \$5 million. 29/

This situation is the same for all three types of securities: As the size of the issuer or issue increases, the cost of flotation goes down. In 1925-29, for example, the issuers with total assets under \$1 million spent 7 percent of the gross proceeds to pay for the cost of flotation of bonds. But the cost for companies with assets of \$100 million or over was only 4.6 percent of proceeds. The data for 1935-38 tell a similar story, except that the variation had become even more extreme.

Similarly, issuers with assets of under \$1 million spent in 1925-29, 14.9 percent of the proceeds to pay for the cost of floating preferred stock. In contrast, the cost was only 5.5 percent for issuers with assets between \$50 million and \$100 million. As in the case of bonds, the variation was even more extreme in 1935-38 than in 1925-29.

The cost of flotation for common stock during the period 1936-38 is shown in Chart 10 by size of issue, rather than issuer. There is however, a direct relationship between the size of the issue and the size of the company floating the stock. Again, there is the same pattern of a sharp decline in cost with increasing size.

Small business is placed at a serious disadvantage not merely because it has to compete against big business which is able to issue securities at a much lower cost; it suffers even more because of the fact that the costs are too high.

Costs of nearly \$10 for each \$100 of bonds floated, \$15 to \$20 for each \$100 of preferred and common stock floated are prohibitive. They are a burden which small corporations cannot be expected to assume.

3. Investment by Individuals Declined

Local private venture capital was formerly an important source of the credit and capital requirements of small business. Comfortably "well-to-do" or wealthy individuals who were familiar with the operations of the business, its management, and the locality in which it operated, could often be induced to invest in the enterprise.

29/ Cost is expressed as a percentage of gross proceeds. Gross proceeds in the case of stock represent the number of units sold or offered multiplied by the sale or offering price. Gross proceeds in the case of bonds represent principal amount multiplied by offering price.

This relationship between the investor and the entrepreneur has changed materially during the last two decades. Cities have increased in population, corporations have grown tremendously in size, convenient outlets for investment have been provided by government bonds and by securities listed on the stock exchange, losses in the depression have made investors more cautious, and taxes have been raised on the net income of individuals. All these factors have resulted in a dwindling of investment in small business by persons with the financial means to do so.

The growth of metropolitan areas has removed the former close contact of the investor and the owner of the business. In larger cities it is extremely difficult for the owners to make personal contacts with the person who has funds to invest. The investor, not knowing of any deserving firm in which to invest, can find at hand more convenient and usually less risky ways to invest his money.

It is convenient for the investor to buy and sell securities listed on the stock exchanges, to buy government bonds, or to put money in savings banks. In any of these choices the investor can put the money in any time he wishes, he generally has a stated steady flow of income, and even more important, he can readily get his money out again.

As the TREC Monograph No. 17 "Problems of Small Business" states, ^{30/}

"The growing practice by individuals of placing their savings with savings banks, life insurance companies, building and loan associations, or the purchase of stock in the great corporations, has tended to siphon off into these institutions money which would otherwise have been used for investment in local enterprise."

The long depression of the 30's had a profound psychological influence on the individual investors. Even though they may have funds for investment, they are frequently afraid to take the risk of investing in small business. Investors who lost money in small business which collapsed, naturally prefer the greater security of the listed stock, savings bank, or life insurance company.

High taxes have also been influential in drying up funds which might have been available for investment in small business. The extremely high surtax on individual net income, graduated from 20 percent up to 91 percent on net incomes over \$200,000, makes a serious cut in income which

might be available for investment. The individual may decide not to invest his remaining income in small business because he can realize a greater net gain with more safety by a conservative investment than by investing in a small business which pays higher dividends. 31/

Mr. Lincoln Filene, the noted Boston merchant, describes the dilemma of the small businessman in the following way: 32/

"It is, of course, clear that not so many years ago the infant industries of the country were often able to secure their initial or venture capital from individuals who had vision, courage, and faith in the building of this Nation. Many of these industries became the great industrial corporations of today. Each started small. The stories of their struggles to meet pay-rolls in the early days, to buy machinery and equipment, are among the great and inspiring stories of America. Today, with the growth of big business, with its shares listed and for sale daily to the public, investors have shut their eyes to the opportunities that are offered everywhere to aid -- and to profit by aiding -- the small industries which are in existence or are springing up."

31/ The lack of marketability of investments in small concerns also lessens the present attractions of long-term capital gains (on property held more than 6 months) taxed at only 25 percent.

32/ Lincoln Filene, "A Proposal to Stimulate the Investment of Private Capital in Small Industry." See Small Business: Access to Capital, a report of Special Committee to Study Problems of American Small Business, U. S. Senate. p. 3.

IV. CONSEQUENCES OF THE SMALL BUSINESS CAPITAL PROBLEM

1. Comparative Financial Strength of Small and Large Business

As a result of difficulties encountered in obtaining capital, smaller firms are generally forced to operate with low current ratios, to depend largely on debt capital instead of equity capital, and to rely unduly on short-term debt. Small businesses are thus placed in a vulnerable financial position. Their ability to withstand adversity is greatly impaired and their instability mortality increased.

The financial vulnerability of small business is indicated by data drawn from the Statistics of Income of the Bureau of Internal Revenue as presented in the following sections. These data are based on corporation income tax returns and do not include businesses operating as partnerships and proprietorships. This limitation does not invalidate the conclusions, however, because small unincorporated firms are known to be, on the whole, in a less strong financial position than the smaller corporations.^{33/}

2. Current Position

The ratio of current assets to current liabilities is extremely low for small manufacturing corporations, as is shown on Chart 11.

This "current ratio" is the standard "rule-of-thumb" test of credit worthiness. If current assets exceed current liabilities by at least 2 times, it is generally considered that the concern is a good credit risk.^{34/}

In 1932 and 1937 the current ratio was under 2.0 for manufacturing corporations with total assets under \$100,000. As in the case of the profit rate, the working capital position rose

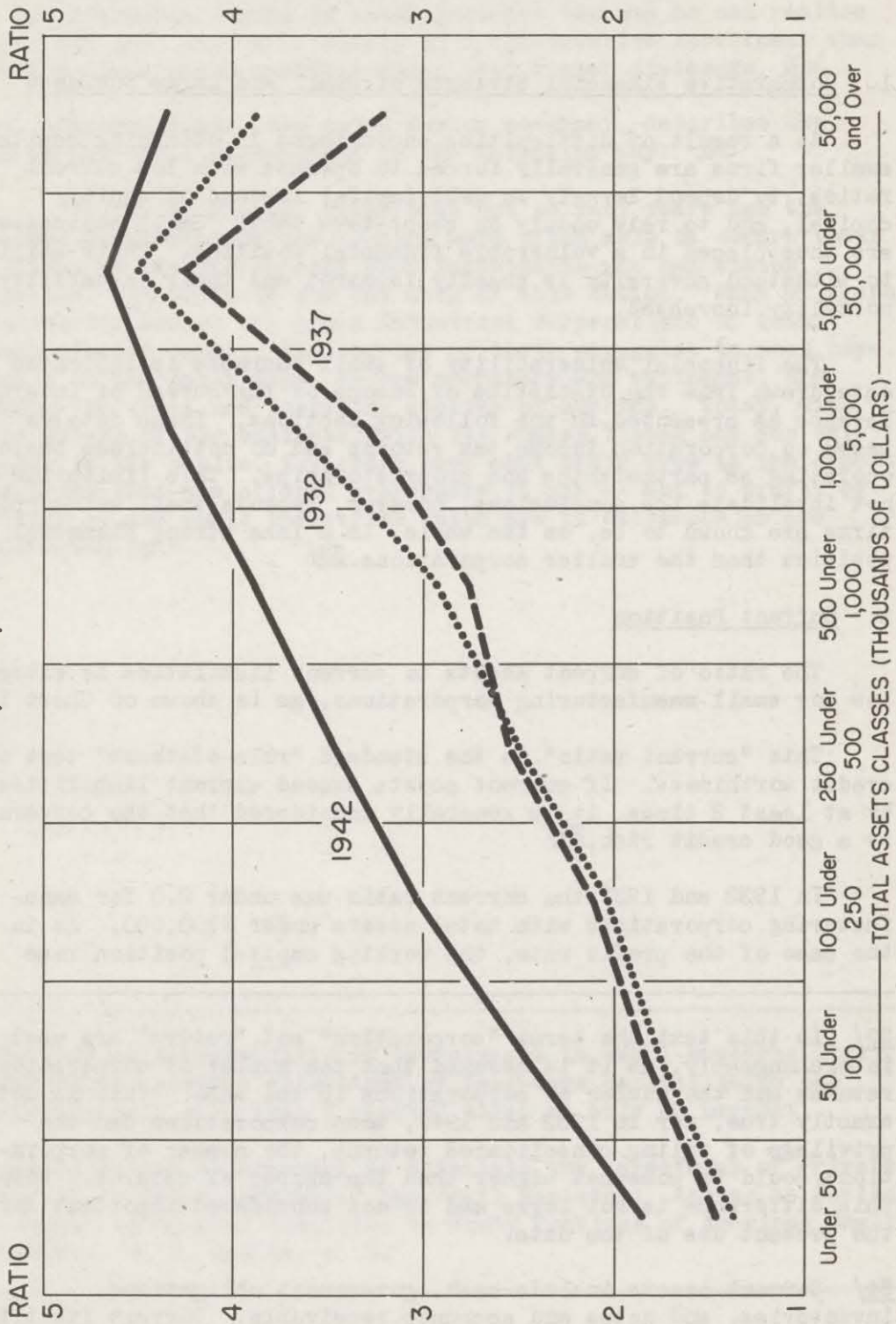
^{33/} In this text the terms "corporation" and "return" are used interchangeably, as it is assumed that the number of corporation returns and the number of corporations is the same. This is not exactly true, for in 1932 and 1942, when corporations had the privilege of filing consolidated returns, the number of corporations could be somewhat higher than the number of returns. However, this difference is not large and is not considered important for the present use of the data.

^{34/} Current assets include cash, government obligations, inventories, and notes and accounts receivable. Current liabilities are liabilities with original maturity of less than 1 year, which consist chiefly of notes and accounts payable. Current assets divided by current liabilities gives the current ratio.

MANUFACTURING CORPORATIONS

RATIO OF CURRENT ASSETS TO CURRENT LIABILITIES

1932, 1937, 1942



Source: "Statistics of Income", Part 2 (Including Source Book and Worksheets), prepared by Bureau of Internal Revenue.

with increased size, reaching its highest levels — 4.50 in 1932 and 4.23 in 1937 — in the next-to-largest size group.

Not only is the working capital ratio lower for small than for large business; it is too low to permit much reinvestment of earnings. Corporations with current assets which are only 1.37 or 1.45 times the current liabilities are in no position to plow back earnings into the company. In fact, they must delicately balance their cash income with their cash outgo in order to remain in business. A slight miscalculation in estimating the magnitude or in the timing of cash receipts would involve these companies in serious difficulties.^{35/}

Although the current ratios are at a higher level in 1942 than in previous years, it must be realized that during the reconversion period the outflow of cash and government obligations of small companies will probably exceed their inflow. Raw materials will have to be built up, the plant will have to be reconverted, payments will have to be made for wages and income tax accruals, and expenses will have to be incurred in reestablishing distribution channels and rebuilding markets. Until these steps are taken and production can be resumed on a large scale, cash receipts from sales to civilian markets will frequently not be adequate to balance against cash outgo.

3. Proportion of Financing by Debt

Compared with larger companies, small manufacturing corporations have been obliged to obtain more of their financing from debt than from equity sources. By expressing net worth as a percentage of total assets, as is done in Chart 12, the amount of investment in the corporation represented by owners' equity is indicated.^{36/}

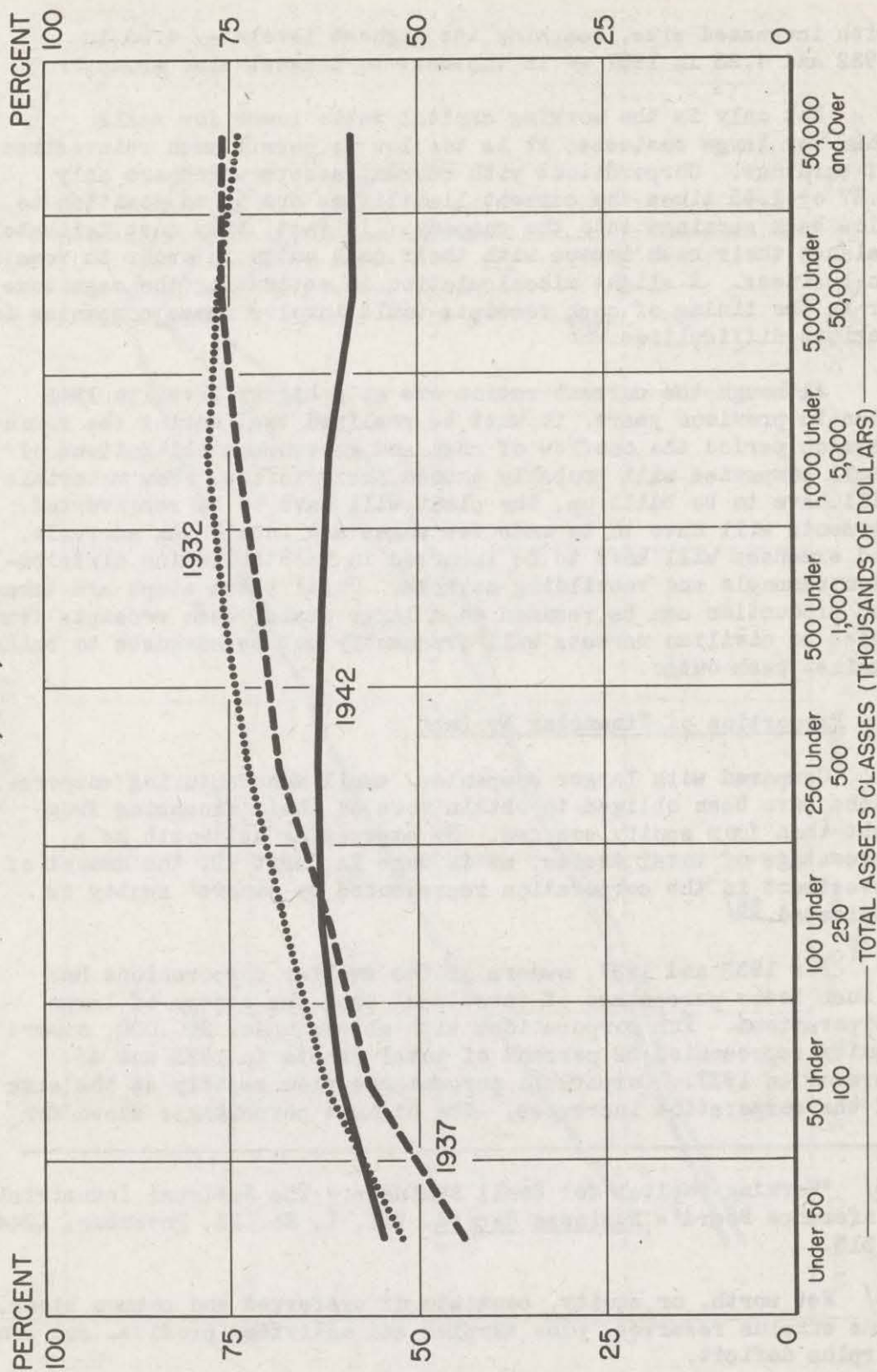
For 1932 and 1937, owners of the smaller corporations had a much lower percentage of investment than the owners of large corporations. For corporations with assets under \$50,000, owners' equity represented 52 percent of total assets in 1932 and 43 percent in 1937. Comparable percentages rise rapidly as the size of the corporation increases. The highest percentages shown for

^{35/} "Working Capital for Small Business," The National Industrial Conference Board's Business Record, Vol. I, No. 11, November, 1944, p.315.

^{36/} Net worth, or equity, consists of preferred and common stock, plus surplus reserves, plus surplus and undivided profits, and minus surplus deficit.

MANUFACTURING CORPORATIONS NET WORTH AS PERCENT OF TOTAL ASSETS

1932, 1937, 1942



Source: "Statistics of Income", Part 2 (including Source Book and Worksheets), prepared by Bureau of Internal Revenue.

1932 are for corporations with assets of \$1 million and under \$5 million (77.8 percent), and for 1937 the highest percent is for corporations with assets of \$5 million and under \$50 million (76.6 percent).

4. Ratio of Short-term Debt to Total Debt

The ratio of current debt to total debt is highest for the smallest corporations, and decreases as the corporations become large in size. In other words, short-term credit is used more to finance the smaller companies, while the more desirable long-term credit is used to a wider extent to finance the large companies.^{37/}

^{37/} Information on this subject has been presented in Chart 4, "Current Liabilities as a Percentage of Borrowed Capital."

CONCLUSIONS

It has been shown that small businesses have more difficulty in obtaining capital from outside sources than large businesses, and that when they do obtain capital it is on less advantageous terms. Small businesses must rely largely on debt capital, an undue portion of which is short-term, and the interest rates charged to small businesses are on the average much higher than those paid by large businesses.

For these reasons, small business is made largely dependent on the reinvestment source of capital not only for expansion but also for putting its financial house in order. Therefore, if the small business section of the economy is to become a vigorous competitive force, it is essential that smaller firms be in a position to reinvest a large part of their savings. The tax system as applied to smaller firms should be constructed with this end in view. Moreover, through a judicious modification of the tax system, it would also be possible to increase the flow of outside funds into small business by reducing the risks and increasing the potential net return after taxes.