# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>CHAPTER</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACKNOWLEDGMENT</td>
<td>ii</td>
</tr>
<tr>
<td>LIST OF TABLES</td>
<td>iv-vi</td>
</tr>
<tr>
<td>1. THE NATURE AND SCOPE OF THE STUDY</td>
<td>1</td>
</tr>
<tr>
<td>The Objectives</td>
<td>1</td>
</tr>
<tr>
<td>The Research Method</td>
<td>1</td>
</tr>
<tr>
<td>Definition and Delimitation of Small Business</td>
<td>3</td>
</tr>
<tr>
<td>Importance of Small Business</td>
<td>6</td>
</tr>
<tr>
<td>Composition of Long-Term Capital</td>
<td>10</td>
</tr>
<tr>
<td>11. SOURCES OF LONG-TERM CAPITAL</td>
<td>19</td>
</tr>
<tr>
<td>Savings and Profits</td>
<td>19</td>
</tr>
<tr>
<td>Commercial Banks</td>
<td>32</td>
</tr>
<tr>
<td>Private Investment</td>
<td>44</td>
</tr>
<tr>
<td>Insurance Companies, Savings Banks, Savings and Loan Associations, Trust Companies, and Investment Companies</td>
<td>50</td>
</tr>
<tr>
<td>Intercompany Financing</td>
<td>55</td>
</tr>
<tr>
<td>Community Industrial Development Groups</td>
<td>60</td>
</tr>
<tr>
<td>Summary of the Financing of Small Business by Private Sources</td>
<td>65</td>
</tr>
<tr>
<td>111. SOURCES OF LONG-TERM CAPITAL (PUBLIC AND QUASI-PUBLIC)</td>
<td>68</td>
</tr>
<tr>
<td>Introduction</td>
<td>68</td>
</tr>
<tr>
<td>Small Business Administration</td>
<td>69</td>
</tr>
<tr>
<td>Federal Reserve Bank Loans</td>
<td>89</td>
</tr>
<tr>
<td>Veterans' Loans</td>
<td>95</td>
</tr>
<tr>
<td>Summary</td>
<td>98</td>
</tr>
<tr>
<td>IV. A CASE STUDY—SURVEY IN COLUMBUS, OHIO, OF SMALL BUSINESSES INCORPORATED IN 1953</td>
<td>101</td>
</tr>
<tr>
<td>Introduction</td>
<td>101</td>
</tr>
<tr>
<td>Social and Economic Characteristics of Promoters</td>
<td>105</td>
</tr>
<tr>
<td>The Origin of the Idea</td>
<td>115</td>
</tr>
<tr>
<td>The Selection of the Location</td>
<td>122</td>
</tr>
<tr>
<td>The Preliminary Customer Analysis</td>
<td>126</td>
</tr>
<tr>
<td>Summary</td>
<td>130</td>
</tr>
<tr>
<td>CHAPTER</td>
<td>PAGE</td>
</tr>
<tr>
<td>---------</td>
<td>------</td>
</tr>
<tr>
<td>V.</td>
<td>A CASE STUDY—SURVEY IN COLUMBUS, OHIO OF SMALL BUSINESSES INCORPORATED IN 1953</td>
</tr>
<tr>
<td></td>
<td>Introduction</td>
</tr>
<tr>
<td></td>
<td>Sources of Long-term Funds</td>
</tr>
<tr>
<td></td>
<td>Criticisms of the Adopted Financial Plan</td>
</tr>
<tr>
<td></td>
<td>Cost of Obtaining Long-term Funds</td>
</tr>
<tr>
<td></td>
<td>Degree of Expected Profitability</td>
</tr>
<tr>
<td></td>
<td>General Pricing Policies</td>
</tr>
<tr>
<td></td>
<td>Summary of the Financial Characteristics of the New Firm</td>
</tr>
<tr>
<td>VI.</td>
<td>NEW APPROACHES TO THE PROBLEM—PROPOSED REMEDIES FOR SHORTCOMINGS IN THE SUPPLY OF LONG-TERM CAPITAL</td>
</tr>
<tr>
<td></td>
<td>Small Business Act of 1950</td>
</tr>
<tr>
<td></td>
<td>Insurance for Small Loans</td>
</tr>
<tr>
<td></td>
<td>Investment Companies for Small Business</td>
</tr>
<tr>
<td></td>
<td>Managerial and Technical Aids</td>
</tr>
<tr>
<td></td>
<td>Tax Revisions to Aid Small Business</td>
</tr>
<tr>
<td></td>
<td>Summary of the Proposed Remedies</td>
</tr>
<tr>
<td>VII.</td>
<td>CONCLUSIONS AND RECOMMENDATIONS</td>
</tr>
<tr>
<td></td>
<td>Existing Weaknesses in the Sources of Supply of Long-term Capital</td>
</tr>
<tr>
<td></td>
<td>An Analysis of the Sources of Long-term Capital Utilized by the Small Businesses</td>
</tr>
<tr>
<td></td>
<td>Proposals to Increase the Availability of Long-term Capital to Small Businesses</td>
</tr>
<tr>
<td></td>
<td>APPENDIX</td>
</tr>
<tr>
<td></td>
<td>BIBLIOGRAPHY</td>
</tr>
<tr>
<td></td>
<td>AUTOBIOGRAPHY</td>
</tr>
</tbody>
</table>
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Finally, a deep obligation is felt toward my wife for her stenographic assistance, and interest throughout the entire undertaking.
# LIST OF TABLES

<p>| I. | Causes of Failure of 500 Bankruptcies, Owners' Opinions | 13 |
| II. | Causes of Failure of 500 Bankruptcies, Creditors' Opinions | 14 |
| III. | Trade Firms Starting Operations in the 1945-47 Period: Percentage Distribution of Sources of Initial Investment Funds by 1947 Sales-Size Groups | 22 |
| IV. | Manufacturing Firms Starting Operations in the 1946-48 Period: Percentage Distribution of Sources and Uses of Initial Investment, by Legal Status and 1948 Sales-Size Groups | 24 |
| V. | Average Interest Rates on Member Bank Business Loans, By Type of Security and Size of Borrower, November 20, 1946 | 39 |
| VI. | Cost of Flotation as a Percentage of Gross Proceeds By Type of Security and Size of Flotation for 1945 through 1947, Inclusive | 48 |
| VII. | RFC Business Loan Authorizations 1948 and 1949, By Size | 79 |
| VIII. | Reasons Why Banks Declined 300 Small Business Loans Authorized by RFC--1948-1949 (Loans of $100,000 or less) | 82 |
| IX. | Percentage Distribution of V-Loans Authorized Through June 30, 1952, By Assets of Borrower | 94 |
| X. | Ages of the Primary Officers of Small Business Corporations Established in Columbus, Ohio, During 1953 | 108 |
| XI. | Highest Education Attained By The Primary Officers of Small Business Corporations Established in Columbus, Ohio, During 1953 | 109 |
| XII. | Marital Status of the Primary Officers of Small Business Corporations Established in Columbus, Ohio, During 1953 | 110 |</p>
<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>XIII.</td>
<td>Previous Experience of the Primary Officers of Small Business Corporations Established in Columbus, Ohio, During 1955</td>
<td>113</td>
</tr>
<tr>
<td>XIV.</td>
<td>Previous Business Ventures of the Primary Officers of Small Business Corporations Established in Columbus, Ohio, During 1955</td>
<td>114</td>
</tr>
<tr>
<td>XV.</td>
<td>The Immediate Factor Causing Primary Officers of Small Business Corporations Established in Columbus, Ohio, During 1953, to Incorporate</td>
<td>118</td>
</tr>
<tr>
<td>XVI.</td>
<td>Extent of Time the Primary Officers of Small Business Corporations Established in Columbus, Ohio, during 1953, Considered the Idea Before Incorporating Business</td>
<td>121</td>
</tr>
<tr>
<td>XVII.</td>
<td>Factors Determining Selection of Columbus by Non-resident Primary Officers of Small Business Corporations Established in Columbus, Ohio, During 1953</td>
<td>123</td>
</tr>
<tr>
<td>XVIII.</td>
<td>Extent of Preliminary Customer Survey Conducted by Primary Officers of Small Business Corporations Established in Columbus, Ohio, During 1953</td>
<td>129</td>
</tr>
<tr>
<td>XIX.</td>
<td>Sources of Capital Utilized by Primary Officers of Small Business Corporations Established in Columbus, Ohio, during 1953</td>
<td>134</td>
</tr>
<tr>
<td>XX.</td>
<td>Bank Loans Negotiated by Primary Officers of Small Business Corporations Established in Columbus, Ohio, During 1953</td>
<td>138</td>
</tr>
<tr>
<td>XXI.</td>
<td>Distribution Between Capital Stock and Promissory Notes Utilized by Primary Officers of Small Business Corporations Established in Columbus, Ohio, During 1953</td>
<td>139</td>
</tr>
<tr>
<td>XXII.</td>
<td>Long-term Rate of Return Expected by Primary Officers on Capital Utilized by Small Business Corporations Established in Columbus, Ohio, During 1953</td>
<td>151</td>
</tr>
<tr>
<td>XXIII.</td>
<td>Remuneration of the Primary Officers of Small Business Corporations Established in Columbus, Ohio, During 1953 in Comparison With Income Received Immediately Prior to Incorporation</td>
<td>153</td>
</tr>
</tbody>
</table>
CHAPTER 1

THE NATURE AND SCOPE OF THE STUDY

THE OBJECTIVES

The objectives of this study are twofold: to make available to the prospective small business promoter (1) a digest of the available sources of long-term capital, and (2) data regarding the personal characteristics of a typical promoter, several non-monetary decisions required of all promoters, and the sources of long-term capital that were actually utilized.

THE RESEARCH METHOD

In order to accomplish the first objective, the literature on the sources of long-term capital will be presented in digest form in the following two chapters as much of the material originally was developed for specific purposes. Hence, few attempts have been made to review all the possible sources of equity capital for the small businessman.

To fulfill the second objective the results of a primary survey conducted in Columbus, Ohio, will be presented in Chapters IV and V. This survey consists of personal
interviews with thirty-three officers of selected small businesses in Columbus, Ohio, that were incorporated during 1953. The data obtained from this survey will be analyzed to determine the immediate problems and difficulties involved in raising long-term capital with a view of determining possible trends.

Possible solutions to the problem of long-term financing will be reviewed in Chapter VI. Finally, in Chapter VII, the effectiveness of the present methods of raising long-term capital will be examined and several recommendations, selected from the larger number of proposals discussed in the previous chapter, will be made with regard to alleviating deficiencies in the supply of long-term capital.

The Limitations of the Approach

The data contained in the aforementioned primary research is subject to three limitations inherent in a study of this kind. They are:

1. The small business corporations surveyed in any given industry are presumed to be typical of any small organization in that particular industry.

2. The survey is confined to corporations because data are not generally available for unincorporated businesses.

3. Of necessity, the survey is confined to incorporated businesses which were at least partially successful in carrying out their financing plans.
DEFINITION AND DELIMITATION OF SMALL BUSINESS

The Seven General Tests of Size

Unfortunately, there is no agreement as to a definition of "small business." The term is used loosely and with widely differing connotations. Generally speaking, seven bases or tests of size have been utilized from time to time. These tests of size vary for different purposes, but the most frequently used are: (1) number of employees, (2) total assets, (3) volume of sales, (4) net worth, (5) net profits, (6) non-dominance in industry, and (7) independent ownership.

In an effort to give direction to thinking about small business, the Office of Small Business, Office of Domestic Commerce, Department of Commerce, has made an analysis of the sales of manufacturing establishments as reported in Census of Manufacturers, 1947. They point out that, "It should be emphasized that 'the number of employees' has not been used as a factor to determine small size but as the most convenient index for measurement of size. Number of employees has been chosen because it is believed that any other single means of estimating size, such as total assets, net income, or other measures indicated, have greater disadvantages."1

---

1 Selective Service Act of 1940, Section 10.
Congress on many occasions has defined an enterprise to be "small business" if:

1. Its position in the trade or industry of which it is a part is not dominant;

2. The number of its employees does not exceed five hundred; and

3. It is independently owned and operated.2

The employee limitation, or the tests of independence or dominance in an industry can be only guideposts. Other factors which should be considered are sales volume, total assets, and the nature of the industry. For example, the Smaller War Plants Corporation's definition of a small business was elastic enough to allow the inclusion of $5,000,000 firms if they were competing with larger companies.3

Investment bankers are inclined to regard new corporations that are unable to float an issue of security as small business. The Securities and Exchange Commission includes within the definition of small business a business with total assets of under $250,000. This seems to describe small business more properly than any other definition which

---


uses a capital assets limitation. 4

"Small business" should probably include some concerns having more than five hundred employees and should include some with total assets of more than $250,000. It is not possible to draw a hard and fast line in defining small business, but it is desirable to be satisfied with a rough general concept of what it includes. The qualities implicit in small business are those of the self-determined or independent owner-manager. A typical small business unit is both owned and operated directly by its active proprietor or proprietors, with no overhead affiliations or control. Growth in size involves successful stages of self-management and hired management, increasing remoteness of ownership and management, division of ownership among many persons, absentee ownership and the impersonal qualities commonly associated with very large enterprise. 5

Definition Formulated for This Study

From the above definitions of a "small business" the following definition has been formulated as being appropriate for this discussion: A "small business" is one that has fewer than fifty employees if it is a manufacturing


firm; or total assets of not over $100,000 if it is a non-manufacturing firm. Furthermore, the enterprise must operate on a local basis and be dependent, more or less, upon local sources for its funds. When references are made to small business, this definition is presumed unless a statement to the contrary is made specifically.

IMPORTANCE OF SMALL BUSINESS

Number of Small Business Units

Despite the Goliaths of industry, America is still numerically a nation of small businesses. Of the four million firms in this country, fewer than 75,000 employ more than fifty persons. Three million have fewer than four employees. Small businesses account for about thirty-five percent of our national income. Small businesses predominate in some sectors of the economy, but occupy a decidedly subordinate role in others. For example, small businesses occupy a predominant role among service establishments, are more important than larger businesses in both retailing and the amusement industry, and are nearly as important as larger businesses in construction and wholesaling. However, in the hotel business and in manufacturing, small businesses occupy a decidedly subordinate role. 6

Economic Role of Small Business

Freedom to organize and operate small, independent businesses is a principal connotation of "free" in a free enterprise system. New businesses are important to the health of the economy. In their efforts to grow by serving consumers better, they provide the vigorous competition which is the heart of our private enterprise system. Not only do they create new payrolls, but in doing so, they enlarge markets generally for other businessmen and farmers. For example, the large manufacturer relies on a host of lesser enterprises for both buying and selling. One large manufacturer advertised recently: "We are the customer of more than 10,000 different businesses and we market our product through more than 10,000 other businesses." The major customers for both buying and selling of the 15,000 major manufacturers are the 169,000 small manufacturers. Thus, small business serves as the link between the products of giant factories and their ultimate markets. Small industries often make up a large share of the market for power companies. One case is cited where a large utility company sells power to 4,700 small firms out of

Large producers of oil, tires, and automobile accessories solicit individuals to operate distributing units as their own businesses. On a cost basis alone it would not pay big business to establish distributing units as conveniently located as those which small business provides. Small business is necessary to furnish the wide variety of goods and services desired by the ultimate consumer. In many fields the market is either not large enough or is too unstandardized to attract big business.

Small business is the seed bed from which the industry and commerce of the United States have grown and must continue to grow. It is a principal avenue through which many ideas and fresh infusions of competition reach the vitals of the American enterprise system. For the very reason that it represents a multitude of individual sources of initiative, it contributes both vitality and flexibility to the economy and thus constitutes a basic element of our national strength in a world where the institutions of freedom are challenged by monolithic states. The concern here, therefore, is not only with a large segment of our national economy and the cornerstone of its vitality, but

---

with a fundamental aspect of our national life. Small business enterprise is a symbol of a society in which the hired man can become his own boss. To untold numbers of people it means a sense of independence that otherwise would be lost.

**Political Role of Small Business**

Of all the economic elements in our society, small business enterprise is the least amenable to the centralized control that accompanies monopoly. History shows that the elimination of the independent businessman has been the first step in the development of totalitarianism. It would be hard to envisage a vigorous middle class or even a strong nucleus of independent voters without the small business element. In serving its own interest, small business also serves as a social and political stabilizer; its very numbers act as a safeguard against concentration of power. The wide distribution of economic power among many independent proprietors is the foundation of the American economy. Both Franklin and Jefferson feared that industrialization would lead to a labor proletariat without property and without hope.11

Big business, per se, should not be condemned because the outstanding contributions of the assembly-line techniques

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10 Patman, loc. cit., p. 7497.

11 Ibid.
have been an important factor in America's greatness. America is fortunate in the great productive power it possesses by virtue of our large enterprises, but in the admiration of these towering giants we must not neglect the smaller trees of our great industrial forest.

COMPOSITION OF LONG-TERM CAPITAL

Definition

For the purposes of this study, long-term capital consists of two components, namely, (1) equity capital, and (2) borrowed capital with maturities of five years or more.12

Characteristics of Equity Capital

Equity capital includes the original investment in the firm and the permanent additions to that investment for expansion of the business.13 In the strict sense, equity

12 There is, indeed, little unanimity on the length of maturity of a credit instrument in order to qualify as "long-term." Nevertheless, Congress has on numerous occasions, as have several governmental agencies and many economists, defined credit maturities as follows: "short-term" credit consists of maturities of less than one year; "intermediate" credit extends from one to five years; "long-term" credit refers to maturities of over five years' duration. It should be noted, however, the Federal Reserve System designates any loan in excess of a one-year term as a long-term loan. By no means could this be construed as a substitution for equity capital. At the other extreme, Dewing considers 15 to 40 years as a "medium" term bond, with "long-term" reserved for maturities of over forty years.

13 Kaplan, op. cit., p. 162.
capital means residual ownership. Thus, equity capital of a business is that part of its capital which is permanently invested in it by its proprietors, whether they be single entrepreneurs, partners, stockholders, with no obligation on the part of the firm to return it, except pro rata in case of dissolution. It is the permanent part of the capital.

Implications of Long-term Borrowed Capital

Frequently the inability of a firm to secure equity capital has created a demand for long-term borrowed funds. Thus, it seems desirable to investigate sources of long-term debt capital as well as equity capital. Essentially these long-term loans are used in lieu of ownership capital, however, this study is not to be construed as an apology for leverage. It is well known that external leverage is an inherently speculative factor and one that intensifies the possibilities of both gain and loss. When good business practices dictate the profitable use of long-term debt, then, and only then, should it be substituted for equity capital. For those specific cases, it would seem incumbent that it be included in any discussion of long-term capital.

THE DIFFICULTY OF OBTAINING LONG-TERM CAPITAL

Statement of the Problem

The most serious problem facing the industrious and
competent small businessman or potential small businessman is the shortage of long-term capital.

Leaders in all walks of American life—economists, businessmen, bankers and legislators—have expressed concern over this problem and have been seeking a solution to it. Although historically there has been a lack of attention to small businessmen from Congress and from Government agencies and departments, within the last few years a sincere effort has been started to give small business the attention it deserves.14

Tables I and II are of considerable interest with regard to the lack of capital as a major small business problem. They include a summary of five hundred cases of business bankruptcies. Opinions were solicited not only from the owners concerned, but also from the creditors involved. Over two-thirds of the owners blamed the business depression, and nearly one-half of them thought that insufficient capital was a factor while twenty-eight percent were willing to blame inefficient management. On the other hand, most creditors thought from their observations that inefficient management was a primary factor in nearly sixty percent of the cases, while insufficient capital was a contributing cause in about thirty-three percent of the cases.

Thus, it appears that lack of capital is a major small business problem which frequently may contribute to the insolvency of the firm.

TABLE 1

CAUSES OF FAILURE OF 500 BANKRUPTCIES,
OWNERS' OPINIONS

<table>
<thead>
<tr>
<th>Cause of Failure</th>
<th>Percentage of enterprises affected</th>
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<tbody>
<tr>
<td>Business depression</td>
<td>67.7</td>
</tr>
<tr>
<td>Insufficient capital</td>
<td>48.2</td>
</tr>
<tr>
<td>Competition</td>
<td>37.9</td>
</tr>
<tr>
<td>Adverse domestic and personal factors</td>
<td>35.1</td>
</tr>
<tr>
<td>Decline in value of assets</td>
<td>51.6</td>
</tr>
<tr>
<td>Bad-debt losses</td>
<td>29.8</td>
</tr>
<tr>
<td>Inefficient management</td>
<td>28.2</td>
</tr>
<tr>
<td>Excessive overhead expenses</td>
<td>24.0</td>
</tr>
<tr>
<td>Poor business location</td>
<td>14.6</td>
</tr>
<tr>
<td>Losses from speculation</td>
<td>11.6</td>
</tr>
<tr>
<td>Unfavorable changes in trading area</td>
<td>11.2</td>
</tr>
<tr>
<td>Excessive interest charges on borrowed capital</td>
<td>11.1</td>
</tr>
<tr>
<td>Too rapid expansion</td>
<td>10.5</td>
</tr>
<tr>
<td>Losses from signing notes with recourse</td>
<td>9.6</td>
</tr>
<tr>
<td>Buying too much on credit</td>
<td>9.5</td>
</tr>
<tr>
<td>Real estate losses</td>
<td>6.1</td>
</tr>
<tr>
<td>Lack of adequate books</td>
<td>5.6</td>
</tr>
<tr>
<td>Automobile accident losses</td>
<td>2.5</td>
</tr>
<tr>
<td>Failure to carry sufficient insurance</td>
<td>2.3</td>
</tr>
<tr>
<td>Unusual expenses</td>
<td>1.8</td>
</tr>
<tr>
<td>Inefficient and dishonest employees</td>
<td>.9</td>
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</tbody>
</table>

a. Totals add up to more than 100 percent since more than one cause was given in most cases.

<table>
<thead>
<tr>
<th>Cause of Failure</th>
<th>Percentage of enterprises affected</th>
</tr>
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<tbody>
<tr>
<td>Inefficient management</td>
<td>58.7</td>
</tr>
<tr>
<td>Dishonesty and fraud</td>
<td>33.7</td>
</tr>
<tr>
<td>Insufficient capital</td>
<td>32.9</td>
</tr>
<tr>
<td>Business depression</td>
<td>29.1</td>
</tr>
<tr>
<td>Adverse domestic and personal factors</td>
<td>28.1</td>
</tr>
<tr>
<td>Bad-debt losses</td>
<td>17.6</td>
</tr>
<tr>
<td>Competition</td>
<td>9.1</td>
</tr>
<tr>
<td>Excessive overhead</td>
<td>8.9</td>
</tr>
<tr>
<td>Too rapid expansion</td>
<td>7.2</td>
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<tr>
<td>Decline in value of assets</td>
<td>5.8</td>
</tr>
<tr>
<td>Losses from speculation</td>
<td>5.8</td>
</tr>
<tr>
<td>Buying too much on credit</td>
<td>5.9</td>
</tr>
<tr>
<td>Poor business location</td>
<td>2.7</td>
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<tr>
<td>Decline in rental income</td>
<td>2.3</td>
</tr>
<tr>
<td>Lack of adequate books</td>
<td>2.1</td>
</tr>
<tr>
<td>Excessive interest charges on borrowed capital</td>
<td>2.1</td>
</tr>
<tr>
<td>Unfavorable changes in trading area</td>
<td>1.9</td>
</tr>
<tr>
<td>Signing notes with recourse</td>
<td>1.4</td>
</tr>
<tr>
<td>Real estate losses</td>
<td>1.4</td>
</tr>
<tr>
<td>Unusual expenses</td>
<td>1.4</td>
</tr>
<tr>
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<td>.7</td>
</tr>
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<td>.6</td>
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</table>

a. Totals add up to more than 100 percent since more than one cause was given in most cases.

Factors Responsible for the Lack of Supply of Long-term Capital

The problem of supplying long-term capital for small business is basic and has not been met adequately. Mr. Abraham D. H. Kaplan, who made a study of the problems of small business for the Committee on Economic Development, concluded that flotation of securities by firms in the small and even in the intermediate class has proved prohibitively expensive and that to date the record of the willingness of the market to absorb small issues has been disappointing. He found that the percentage of individual savings invested in small business ventures has been declining. In part the drying up of the sources of individual investment is attributable to high levels of taxation, resulting in smaller percentages of earnings available for business ventures or for plowing back into established enterprises. In part the trend is a natural result of the progressive concentration of the population in large urban communities; local acquaintance and kinship have become less of a factor in providing backing for new enterprise. As Mr. Kaplan said, "The present-day equivalent of Uncle Bill and Aunt Susie must be found in a more impersonal source of capital funds--the more so since the tax levels on business and individual incomes have slowed the rates at which earnings can be plowed back for business growth."15

15 Kaplan, op. cit., p. 45.
Furthermore, the middle class investor from whom the main supply of capital must come cannot afford to buy anything but listed securities; in fact, it is doubtful whether he ever should buy anything but the shares of the big and well-established companies.

The above opinion of Mr. Kaplan should not be construed to mean that long-term capital is unavailable per se. Specific cases can be found where small businessmen have acquired new capital; however, the validity of the demand for additional means of supplying long-term capital should not be discounted by these specific instances.

Factors Responsible for Increased Demand of Long-term Capital

A few decades ago the so-called small business of today would have been considered a big business, at least in many lines of endeavor. Costs have mounted, thus increasing the capital needs of going businesses and the capital required to start businesses. Of course, the rise in the price level has about doubled the amount of capital required since 1939, but that is responsible for only a part of the new needs for equity capital.

In 1945-47, the Office of Business Economics of the Department of Commerce made a study of one thousand recently-organized retail and wholesale establishments to ascertain the average initial investment. For wholesalers, the average initial investment was found to be $22,000, which
was approximately double the prewar average. For retailers the average was $9,500, but with wide variations among the different lines of activity. For retailers handling building materials, hardware and farm implements, for example, the average initial investment was $25,000; for retail distributors of motor vehicles, $14,000; for apparel stores, $9,700; for retailers of furniture and house furnishings; $9,700; for retailers of household appliances, $7,000; and for gasoline filling stations, $5,600. 16

In addition to the higher price level, technical progress has brought new labor-saving machines which reduce labor costs but necessarily require more equity capital for businesses. Small businessmen must use the newest and best industrial and merchandising methods or they may expect to be crowded out of business by efficient competitors who do utilize them. Technology has produced a wider variety of merchandise which must be stocked, and this requires added capital to finance larger inventories. Furthermore, with war-accelerated advances in technology, many of the smaller producing units require improved equipment and research facilities as well as larger capital to maintain a healthier position in their respective industries.

Rising standards of living are reflected in the pattern

of competitive enterprise, and the capital requirements thereof. The prewar retail establishment is rapidly becoming drab in comparison to more recently organized competitors who have installed new lighting facilities, and new display equipment, as well as new store fronts. Such innovations have great value in obtaining business, but they cost money. The number of innovations is still increasing; i.e., air conditioning. Furthermore, dealing with the Government requires a longer credit period in many instances than the period common to the particular industry. The Federal Government is spending more than fifty billion dollars a year for goods and services. If small business is to receive a fair share of this business it must expect its capital needs to increase.

It can be seen that an increased demand for long-term capital has occurred simultaneously with factors that have tended to retard the supply of this type of funds for small firms.
CHAPTER II

SOURCES OF LONG-TERM CAPITAL

SAVINGS AND PROFITS

An adequate supply of funds is of primary importance to the creation of an economic environment within which small business may prosper. Failure to meet the legitimate financial demands of small business leads to waste of manpower, materials, and capital, and may contribute to increased concentration of control within our industries. It is desired at this point to undertake a critical review of the various potential sources of funds for starting or expanding small business. Each source will be considered as it now exists, with a view toward determining any trend. First of all, consideration will be given to the primary source of equity capital for small business, i.e., the savings and reinvested earnings of the proprietors or owners. The difficulty experienced by small enterprisers in securing capital from outside sources stresses the importance of savings and profits.

The Importance of Personal Savings of the Entrepreneurs

The Department of Commerce recently undertook two independent studies on the financing of firms established
since World War II. The first survey was concerned with wholesale and retail firms, and the second dealt with manufacturing concerns.

The former study was based on about one thousand reports received from a carefully selected sample of six hundred thousand retail and seventy thousand wholesale firms which, according to the records of the Bureau of Old Age and Survivors insurance, started in business between the beginning of 1945 and the end of the third quarter of 1947. Firms with no employees do not report to the Bureau of Old Age and Survivors insurance and thus could not be included in the survey. Reports from firms already discontinued at the time of the survey also proved difficult to obtain, and as a result, the coverage of such firms was insufficient.\(^1\)

The most significant findings of the survey for present purposes relate to the sources of the capital with which the new firms were established. It was estimated that of the seven billion dollars for total initial investment required by all new trade firms during the survey period, sixty-three percent was provided from the personal savings of the entrepreneurs. Another fourteen percent was obtained through bank loans, while eight percent came from suppliers and eleven percent from other loans, mainly from friends and

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relatives. The capital markets supplied but a very small proportion of the initial capital. The importance of the personal savings of entrepreneurs as a source of capital for new trade firms is again indicated by the fact that more than forty-five percent of the reporting firms obtained their initial capital entirely through personal savings. As noted previously, since firms with no employees were excluded from the survey, it is probable that the true percentage financed entirely through personal savings of entrepreneurs was considerably higher than the above figure indicates.

From Table III it is evident that the predominant position of equity capital as a source of initial capital is characteristic of all new firms regardless of size. However, this source appears to be relatively more important in the case of the smallest firms and become less important as the size of the firm increases. Conversely, supplier credit assumes somewhat greater importance as the size of the firm increases. It is significant that total equity capital varies inversely with the size of the firm. This is due, apparently, to the comparative unimportance of capital stock subscriptions as a source of capital for new small firms due to their inherent inability to tap the organized capital markets.

2 ibid.
3 ibid.
<table>
<thead>
<tr>
<th>Line of Trade and 1947 Sales-Size(a)</th>
<th>Total</th>
<th>Equity Capital</th>
<th>Supplier Credit</th>
<th>Bank Loans</th>
<th>Mortgage Loans</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wholesale</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Under $100,000</td>
<td>100</td>
<td>60</td>
<td>18</td>
<td>10</td>
<td>1</td>
<td>12</td>
</tr>
<tr>
<td>$100,000 to $499,999</td>
<td>100</td>
<td>75</td>
<td>6</td>
<td>10</td>
<td>---</td>
<td>9</td>
</tr>
<tr>
<td>$500,000 and over</td>
<td>100</td>
<td>44</td>
<td>23</td>
<td>19</td>
<td>1</td>
<td>13</td>
</tr>
<tr>
<td>Retail</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Under $10,000</td>
<td>100</td>
<td>63</td>
<td>10</td>
<td>14</td>
<td>2</td>
<td>11</td>
</tr>
<tr>
<td>$10,000 to $49,999</td>
<td>100</td>
<td>66</td>
<td>8</td>
<td>13</td>
<td>2</td>
<td>11</td>
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<tr>
<td>$50,000 to $99,999</td>
<td>100</td>
<td>64</td>
<td>9</td>
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<td>1</td>
<td>16</td>
</tr>
<tr>
<td>$100,000 and over</td>
<td>100</td>
<td>62</td>
<td>12</td>
<td>15</td>
<td>2</td>
<td>9</td>
</tr>
</tbody>
</table>

(a) Firms with no employees excluded.

It was found in the survey of initial investment funds for new manufacturing concerns in the 1946-1948 period that the distribution of capital among the several sources was very similar to that experienced by new trade firms. About fifty-nine percent came from the savings of the entrepreneur, thirteen percent from banks, nine percent from trade suppliers, seven percent from parent companies (as equity funds), and the remainder consisted of loans from parent companies, individuals, and government agencies. In all, some thirty-four percent was debt financing. Forty-seven percent of new manufacturing concerns were financed entirely through personal savings or capital stock subscriptions of officers and directors. The importance of personal savings was again understated in the results as firms with no employees were not considered.


The results were based upon the reports of about 1,100 new manufacturing firms which furnished information for the years 1946 through 1948. During this period, 166,000 manufacturing firms raised an estimated two billion dollars. Of this amount about $1.2 billion was financed out of the entrepreneurs' accumulated personal savings. An additional $300 million was supplied by parent companies' loans and equity investment, and directors. Advances by banks, merchandise and equipment suppliers, and governmental agencies accounted for over $450 million of the initial funds. The remaining funds came from the sales of stocks ($50 million), and $10 million of bond issues.

Ibid.
TABLE IV

MANUFACTURING FIRMS STARTING OPERATIONS IN THE 1946-1948 PERIOD: PERCENTAGE DISTRIBUTION OF SOURCES AND USES OF INITIAL INVESTMENT, BY LEGAL STATUS AND 1948 SALES-SIZE GROUP

<table>
<thead>
<tr>
<th>Item</th>
<th>Corporate</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Under $100,000</td>
<td>$100,000-$249,999</td>
<td>$250,000-$499,999</td>
<td>$500,000 and over</td>
</tr>
<tr>
<td>Sources, total</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Personal savings</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>Capital Stock:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Officers &amp; Directors</td>
<td>62</td>
<td>57</td>
<td>54</td>
<td>33</td>
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<tr>
<td>Parent Company</td>
<td>4</td>
<td>7</td>
<td>11</td>
<td>19</td>
</tr>
<tr>
<td>General Public</td>
<td>2</td>
<td>5</td>
<td>1</td>
<td>11</td>
</tr>
<tr>
<td>Supplier Credit:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Merchandise</td>
<td>3</td>
<td>1</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Equipment</td>
<td>5</td>
<td>2</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>Bank Loans:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-mortgages</td>
<td>3</td>
<td>4</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Mortgages:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>On business properties</td>
<td>7</td>
<td>6</td>
<td>8</td>
<td>10</td>
</tr>
<tr>
<td>On other properties</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>--</td>
</tr>
<tr>
<td>Other sources</td>
<td>13</td>
<td>16</td>
<td>15</td>
<td>12</td>
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</table>

<table>
<thead>
<tr>
<th>Item</th>
<th>Noncorporate</th>
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<tr>
<td></td>
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<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Personal savings</td>
<td>65</td>
<td>61</td>
<td>62</td>
<td>58</td>
</tr>
<tr>
<td>Capital Stock:</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Officers &amp; Directors</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Parent Company</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>General Public</td>
<td>--</td>
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<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Supplier Credit:</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Merchandise</td>
<td>2</td>
<td>2</td>
<td>3</td>
<td>8</td>
</tr>
<tr>
<td>Equipment</td>
<td>3</td>
<td>14</td>
<td>10</td>
<td>3</td>
</tr>
<tr>
<td>Bank Loans:</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Non-mortgages</td>
<td>6</td>
<td>4</td>
<td>6</td>
<td>16</td>
</tr>
<tr>
<td>Mortgages:</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>On business properties</td>
<td>6</td>
<td>6</td>
<td>6</td>
<td>3</td>
</tr>
<tr>
<td>On other properties</td>
<td>3</td>
<td>--</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td>Other sources</td>
<td>16</td>
<td>13</td>
<td>9</td>
<td>10</td>
</tr>
</tbody>
</table>

*Firms with no employees excluded.

In Table IV the same variations in the relative importance of initial capital sources for trade firms were noted in the second survey on manufacturing concerns. Equity financing in general was of greater importance to the smallest firms. As firms increased in size, equity funds declined in relative importance while debt financing increased. Furthermore, in regard to debt financing, bank loans were more readily available to the larger sized firms.

Still another survey revealed that the most important sources of equity capital for firms in the Minneapolis Federal Reserve Bank district were the entrepreneur, relatives and close friends, business concerns, local and nearby capitalists and the securities market in that order.6

Depreciation Reserves as a Source of Funds for Expansion

The importance of the savings of entrepreneurs in the financing of new small businesses has been shown. Of great

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6 Litterer, Oscar F. Where Does Small Business Obtain Its Capital? Minneapolis, Minnesota, Federal Reserve Bank, December, 1946. This research was based on personal interviews during 1945 with top executives of 122 small firms located in the Ninth Federal Reserve district. Well-established as well as new firms were selected. Ten concerns had been in business less than one year. Forms of organization included 29 individual proprietorships, 40 partnerships, 49 corporations, and 4 cooperatives. The survey included 65 manufacturing concerns, 30 retail, 13 wholesale and 6 service establishments. In the aggregate, initial capital of $5,400,000 was made up as follows: 93 percent equity financing, 5.3 percent long-term borrowing, and 1.7 short-term borrowing.
importance to the growth of these businesses are depreciation reserves and the reinvestment of earnings. Regarding depreciation, Hoagland states the following on page 520 in his book entitled, Corporation Finance:

It is the function of the accountant to make proper charges to the depreciation accounts in order that the integrity of the investment may be maintained. Depreciation accounting is never an end in itself. It is only a means to the end of defining accurately what the profits of a given accounting period are. Before there can be any profit, there must first be a maintenance of the investment on the books at the beginning of the accounting period. Small tools that are presumed to be consumed within the accounting period create no depreciation complications. They are completely charged off as an item of expense. It is only those items of capital whose utility units are consumed over a period covering more than one accounting period that are included in any depreciation accounting.

On page 521 he emphasizes that the depreciation reserve is not a fund.

However accurate the depreciation schedule may be and however carefully it is observed, a depreciation reserve never makes available the funds needed to replace assets. At best, the depreciation reserve is a valuation reserve and is not a "pile of cash in the back room." Only a depreciation fund would ensure the accumulation of cash necessary to replace the worn-out asset. However, it is the expectation that the maintenance of the integrity of the investment will keep the credit of the corporation at levels high enough to justify hope of obtaining the funds needed for replacements as and when needed.

Therefore, when credits are made to the depreciation reserve from time to time, the funds that are released can be used for other purposes, thereby promoting the growth of the enterprise. It is immediately apparent that this source would be of greatest value to manufacturing firms which
ordinarily have a larger percentage of fixed assets to
total assets than do the typical wholesale or retail firms.
Merchandising enterprises have most of their invested
capital in the form of a stock of goods whose turnover is
expected to be relatively rapid. Since wholesaling and
retailing firms use relatively little fixed capital the
depreciation reserves probably are not as good a source
for expansion purposes as they are for manufacturing
companies.

Retained Earnings as a Source of Funds for Expansion

Business in general and small firms in particular have
depended in the past upon retained earnings for a large
part of their funds required for expansion. While the large
business may have alternative means of financing such as
the issuance of securities or borrowing from commercial
banks and insurance companies, profits supply a large per­
cent of the financial requirements of small firms and in
many cases are their only source of funds. It is necessary,
then, to examine the profit experience of small business.

Large corporations, in general, may have a higher rate
of return than small corporations. For example, in the
third quarter of 1951, corporations with assets under
$250,000 had a ratio of profits to stockholders equity be­
fore Federal taxes of 17.4 percent; for corporations with
assets of $250,000 to $999,999, the ratio was 21.3 percent;
for corporations with assets of $1,000,000 to $4,999,999 the ratio was 22.6 percent; for corporations with assets of $5,000,000 to $99,999,999 the ratio was 25.4 percent, and finally, for corporations with more than $100,000,000 in assets, the ratio was 26.8 percent. This relatively larger return earned by the largest concerns also holds true after Federal taxes have been deducted.

The variation in profits of small businesses is perhaps of greater significance than the level of profits. The small firms gain more ground relatively than do the larger firms on the upswing of the business cycle, but on the downside of the cycle the smaller firms suffer much more than do larger firms. This fact may be established by reference to a study of corporate earnings, by size of

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8 Ibid. Caution must be used in analyzing the figures given above. The data does not include compensation to officers of the firms. Frequently the owner may take his profits in the form of salary, thus leaving the firm with a low rate of profit. If compensation to officers is considered, the earnings of small business compare much more favorably. Nevertheless, how much of this salary may be justifiably considered as profit is virtually unanswerable. Furthermore, the above relationship may not continue to prevail in the future. In the Survey of Current Business, January 1, 1946, pp. 12 and 15, it can be seen that for the years 1941 and 1942, medium sized units, with assets of $500,000 to $10,000,000 tended to earn larger percentages on stockholders' equity, before taxes, than either their smaller or larger counterparts.
firm, for the years 1932 to 1941. These were years in which the business cycle moved from an extremely low point to a condition of prosperity engendered by a defense boom which later developed into the war boom of 1942-45. It was observed that the largest concerns, as a group, managed to break even in 1932, while their smallest counterparts were experiencing reported deficits averaging as high as 35 percent of invested capital. Each of the succeeding years was, as a whole, more profitable. Then, by 1941, each group collectively showed a net profit, but by 1941, the largest firms had gone from an approximate break-even point to an average return of 10 percent; while the smallest firms had moved from an average loss of 35 percent to a net profit of approximately 3 percent. Thus, it would appear that profits or deficits of small business are subject to wider variations; in other words, the larger the business unit the greater the stability of income.

The wider dispersion of the small firms than of larger firms with respect to net profits is due in part to variations in managerial abilities. Also it is due to the fact that the activities of smaller firms tend to be less diversified than those of larger firms and thus to be

10 Ibid., p. 136.
more sharply affected by the ups and downs of the economy. It seems reasonable to conclude that, compared with a small firm having equally competent management, the larger, more diversified firms ordinarily stand a better chance at any given time of having some prospering activities to counterbalance activities that are depressed. The net profits of the larger corporations can be expected to be less erratic, and have a narrower range of variation from year to year than those of smaller corporations.

The different profit characteristics of corporations of various sizes create several important problems in the financing of small business. First, the variability in net profits of small firms means that net earnings are a less satisfactory source for the financing of expansion than is the case with the larger firms, where there are more stable earnings. These fluctuations may cause many small firms to seek outside financing for expansion. Second, the marginal concern with the high break-even point is unable to accumulate sufficient savings in prosperous times to carry itself during periods of business recession. Third, borrowing is often necessary to supply working capital. In such cases a small firm may be perennially in debt. Fourth, the greater instability of earning power among small firms tends to deter the acquisition of outside equity capital. Investors generally prefer to place their available funds with an enterprise which has a better earnings record and greater
prospects for stable earnings in the future.

The inability to encourage outside equity capital due to the limitations imposed by the earning behavior means that retained earnings and depreciation reserves must remain the principal sources of expansion. It follows from this observation that high income taxation is likely to be more burdensome for small firms than for large. It is true that small corporations pay lower taxes than do large ones because net income under $25,000 is taxed at a lower rate, however, their ability to grow through the reinvestment of earnings is substantially curtailed. The fact that the larger corporations pay a higher rate is not very important when the small ones have greater fluctuations in net earnings. It is apparent that high income taxation tends to weigh more heavily on small firms than on large ones.11

Therefore, government tax policy has an important affect on the ability of a small business to retain its earnings for expansion. From this study it can be concluded that savings and reinvested earnings must remain an important source of equity capital for small business, and that their reliability will tend to vary inversely with tax rates.

11 Proposals for tax relief for small business are discussed in Chapter VI.
COMMERICAL BANKS

Fixed assets of a business are those having a life greater than one year and usually have a life of several years. Such assets should be financed under ordinary circumstances by the equity capital contributed to the business by the owners, or by long-term loans having a duration related to the life of the assets financed by such loans.

The current assets of the business should usually be thought of in terms of normal or minimum requirements and peak or seasonal requirements. The minimum working capital requirements of a business should ideally be financed by capital from relatively permanent sources such as the owner's capital or long-term borrowing. However, every business finds that its working capital requirements vary materially during the course of the year reflecting the seasonal pattern of the particular business, or the length of the production period. Since such financial needs are temporary, they should be financed on a relatively short-term basis that coincides with the need.

Many small firms are forced to rely on internal financing of both short-term and long-term capital needs. Others will supplement their requirements with loans from private individuals. A large number of firms rely on funds borrowed from commercial banks for working capital needs. While trade suppliers may contribute a large amount of non-cash credit
to small firms through open accounts, commercial banks have supplied the largest proportion of cash credit. This has been shown by the Department of Commerce Survey for the period June, 1949 to June, 1950, when 66 percent of the number of small business loans and 79 percent of the total came from commercial banks. This is as it should be, because the banker is best prepared to handle short-term credit. However, if the banker were beyond doubt prepared and willing to do the job of handling loans of longer maturities in order to finance worthy, essential small businesses, our discussion could probably end here.

The amount of commercial bank loans to business concerns of all types and sizes increased some $19 billion in the last decade, reaching an all-time high of $26 billion in 1952. Since no loan survey has been made in recent years, the latest information on bank loans to small

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12 McHugh, Loughlin F. "Financing Small Business in the Postwar Period." Survey of Current Business, November 1951, p. 17. This survey by the Office of Business Economics of the Department of Commerce consisted of mailing questionnaires to a small random sample of 200 firms with information received in return from approximately 150 of the firms.

Loans of one year or more accounted for about 25 percent of the borrowing by small manufacturing and retailing firms in the year covered by the survey. This is the case both in terms of the number and amounts of loans. Thus, about 75 percent of the borrowing was short-term.

business is the Federal Reserve survey of member bank loans outstanding on November 20, 1946. On this date, approximately 77 percent of the number and 22 percent of the amount of member bank loans went to small business. The typical loan was between $1,000 and $5,000 in size.

Loans with an original maturity of more than one year accounted for one-fifth of the number and one-third of the dollar amount of all member bank loans outstanding to business concerns. Total term loans at the end of 1946

14 Schmidt, Charles H. "Member Bank Loans to Small Business," Federal Reserve Bulletin, August, 1947, p. 963. Almost 2,000 member banks, including banks in all regions and size classes, participated in the survey and submitted detailed information on about 100,000 individual loans to businesses of all sizes. The sample of loans included about one-sixth of the total number of loans outstanding on the survey date.

Small business was considered in this survey to be small manufacturing and mining concerns with total assets of less than $750,000; wholesale trade concerns with total assets of less than $250,000; retail trade, service, construction, public utility, and all other concerns with total assets of less than $50,000.

15 Ibid. Credit to small business included 514,000 loans totaling $2.9 billion. A significant part of the total amount of bank credit to small business is extended by non-member banks which were not covered by the survey. Most of these banks are small. Like the smaller member banks, they are generally located in rural communities, thus their business loans would be made to small businesses. Although the volume of credit extended to small businesses on the survey date is unknown, it must have been less than $950 million, since this was the amount outstanding at the end of 1946.

16 Ibid., p. 969.
were 144,000 and amounted to 4.6 billions.\textsuperscript{17} Of the 144,000 loans, 80 percent had a maturity within 5 years, while no more than 2 percent had a maturity of more than 10 years.\textsuperscript{18} At least 90 percent of the term loans made during 1946 were small in size, averaging $3,700. The small term loan is typically secured by real estate or a chattel mortgage on equipment. It is repayable on an equal installment basis and matures within five years.\textsuperscript{19}

The majority of loans made by a commercial bank are secured in order to limit the lender's risk. The Federal Reserve survey mentioned above indicated that nearly two-thirds of the number and some 44 percent of the total amount of all member bank loans were secured by some form of collateral or were endorsed.\textsuperscript{20}

\begin{itemize}
\item \textsuperscript{17} Holthausen, Duncan McC. "Term Lending to Business by Commercial Banks in 1946," \textit{Federal Reserve Bulletin}, May, 1947, p. 490.
\item \textsuperscript{18} Ibid., p. 500. The total term loans are probably understated by these data since short-term loans may, in reality, be a provision of intermediate term capital. It is not uncommon for banks to advance credit for a short period of time, say ninety days, but with the understanding that the loan will be renewed upon maturity. In this manner the banks maintain an appearance of complete liquidity and have a legal right to require repayment relatively early. In fact, though, since renewals are common, many short-term loans are in reality term loans.
\item \textsuperscript{19} Ibid.
\end{itemize}
Concern increases, the proportion of total loans which are secured decreases.\textsuperscript{21} This means that large companies with extensive markets are able to borrow on an unsecured basis, and that small concerns must pledge security in order to obtain credit.

**Controversy Over the Role of Banks in Financing Small Business**

There has been considerable controversy over the exact role played by the banks in financing small business in the past. Bankers claim they have provided adequate funds although some well-known bankers have expressed disagreement with this position. In this regard, a study was made to determine the reasons why banks declined three hundred small business loans which were subsequently made by the Reconstruction Finance Corporation in 1948 and 1949. The reason given in 46.5 percent of the cases was that bankers would not extend "long-term" credit.\textsuperscript{22} Many bankers stated that they were limiting their loans to those with maturities at ninety days or less. Others said that they avoided long-term loans because of criticism of bank examiners, while still others stated that the short-term needs of their customers exhausted all of their loanable funds.\textsuperscript{23}

\textsuperscript{21} ibid.


\textsuperscript{23} ibid.
The maturities requested on these loans ranged from two to ten years, with a good many at or near five years. The "appraisal value" of collateral was 244 percent of the amount loaned.\textsuperscript{24}

The controversy as to whether or not banks adequately provided needed capital for small business would probably find both bankers and businessmen agreeing if they had the same concept of capital needs for a small business. Most banking authorities state that banks furnish most of the short-term needs of small business, but do not provide adequately for the long-term needs.\textsuperscript{25} When bankers say that they provide for the capital requirements of a small business, they are for the most part referring to loans

\textsuperscript{24} Ibid.

\textsuperscript{25} While it is probable that the short-term credit needs are provided for rather well by commercial banks, available data could be used to support a contrary conclusion. No data are available on the number of loan applications declined, or the reasons for refusing credit. Thus, while 671,000 loans were outstanding on the day of the Federal Reserve loan survey on November 20, 1946, this number is not represented by an equivalent number of firms, and, even if it were, it would represent less than 20 percent of the small firms in existence at that time. It is possible, one could argue, that only one firm out of five needed bank credit. However, could not one conclude the converse? For example, of the 92 companies interviewed recently in Pioneer Valley, Mass., 35 percent were financing themselves completely while only 41 firms were using bank loans. Thus there were 51 companies without bank loans. Of these, more than half did not need them. Eighteen of the fifty-one businesses without loans expressed dissatisfaction with banks in the area. It is entirely possible that some of this discontent might be directed at variations in banks' short-term lending policies as well as longer-term practices.
which average much less than a year in term; whereas the small businessman is thinking of equity capital or loans that will serve in lieu of equity and has in mind terms of about ten years. Although there are also disagreements between these factions in the matter of collateral requirements, interest charges and government participation in loans, the crux of the argument centers about the length of term-loans available to small business.

As to the complaint by small businessmen that banks charge them excessive interest rates, attention is directed to Table V which shows the average interest rates paid on commercial bank loans classified by type of security and size of borrower. The average interest rate declines progressively from the smallest to the largest size group. This is to be expected since interest rates are based primarily upon risk and cost of handling the loan. Experience indicates that the risk is larger on loans made to small borrowers than to large ones and the cost of setting up a loan on the bank's books is fairly constant. At least, it does not vary in proportion to the size of the

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### Table V

**Average Interest Rates on Member Bank Business Loans, by Type of Security and Size of Borrower, November 20, 1946**

<table>
<thead>
<tr>
<th>Type of Security</th>
<th>All Borrowers</th>
<th>Under 50</th>
<th>50-250</th>
<th>250-275</th>
<th>750-5,000</th>
<th>5,000 and over</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unsecured</td>
<td>2.5</td>
<td>5.4</td>
<td>4.3</td>
<td>3.3</td>
<td>2.5</td>
<td>1.8</td>
</tr>
<tr>
<td>Secured:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Endorsed or co-maker</td>
<td>3.7</td>
<td>5.5</td>
<td>4.2</td>
<td>3.4</td>
<td>2.8</td>
<td>1.6</td>
</tr>
<tr>
<td>Inventory</td>
<td>3.1</td>
<td>4.8</td>
<td>4.2</td>
<td>3.6</td>
<td>3.2</td>
<td>2.8</td>
</tr>
<tr>
<td>Equipment</td>
<td>4.4</td>
<td>6.3</td>
<td>5.0</td>
<td>4.6</td>
<td>3.6</td>
<td>2.0</td>
</tr>
<tr>
<td>Plant &amp; other real estate</td>
<td>4.3</td>
<td>4.8</td>
<td>4.3</td>
<td>4.1</td>
<td>3.7</td>
<td>3.2</td>
</tr>
<tr>
<td>Stocks and bonds</td>
<td>2.7</td>
<td>3.8</td>
<td>3.2</td>
<td>2.6</td>
<td>2.5</td>
<td>2.1</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>4.5</td>
<td>5.5</td>
<td>4.9</td>
<td>4.5</td>
<td>3.8</td>
<td>3.6</td>
</tr>
<tr>
<td>Life Insurance</td>
<td>3.4</td>
<td>3.9</td>
<td>3.5</td>
<td>3.1</td>
<td>2.6</td>
<td>2.3</td>
</tr>
<tr>
<td>Assignment of claims</td>
<td>3.5</td>
<td>5.0</td>
<td>4.5</td>
<td>4.0</td>
<td>3.5</td>
<td>2.6</td>
</tr>
<tr>
<td>Government participation or guaranty</td>
<td>4.0</td>
<td>4.6</td>
<td>4.3</td>
<td>4.1</td>
<td>6.0</td>
<td>3.3</td>
</tr>
<tr>
<td>Other Security</td>
<td>2.6</td>
<td>4.7</td>
<td>3.7</td>
<td>3.5</td>
<td>2.4</td>
<td>1.8</td>
</tr>
<tr>
<td><strong>All types</strong></td>
<td><strong>2.9</strong></td>
<td><strong>5.2</strong></td>
<td><strong>4.2</strong></td>
<td><strong>3.5</strong></td>
<td><strong>2.8</strong></td>
<td><strong>1.9</strong></td>
</tr>
</tbody>
</table>

loan, and as a consequence, the cost per dollar is higher on small loans. It will be observed that the interest rates on unsecured loans tend to be lower than on secured loans. This may be explained by the fact that security is required only on longer term and more risky loans. However, in no case was the average rate at what might be regarded as an unreasonably high, or at an unduly divergent level from other size groups.

It should be mentioned that some of the larger banks in some sections of the country have been increasing their proportion of term loans to small business. This is true of the Bank of America of California where small business loans for terms up to three years are relatively well-supplied. The National City Bank of New York has recently announced that it will grant medium and long-term credit to small firms in New York City. These loans will be between $1,000 and $10,000, repayable on a monthly basis, and will have a maturity of three to five years. Another example is the First National Bank of Chicago which has ten million dollars allocated for small business loans.

27 Koch, Albert R. "Business Loans by Member Banks." Federal Reserve Bulletin, March, 1947, p. 255. This is understandable since Koch found that the average loan to large business was over ninety times that of the average loan to the smaller concern.

28 Other large banks having well-known formal programs for extending term loans to small business are the Pennsylvania Company for Banking and Trusts, in
There is also some hope for increased term lending to small business in a plan advanced by the Metropolitan Life Insurance Company, whereby private life insurance company funds would be loaned through banks. As proposed, the banks would make the loans on a participation basis, with the insurance company providing as much as 90 percent and the bank at least 10 percent of each loan. Single loans could amount to as much as $250,000 for a maximum term of ten years.29 Some banks have participated with insurance companies in the past, but bankers have not seemed very enthusiastic about this plan because they do not like to tie up money, even as little as 10 percent of a loan for a period extending perhaps for 10 years.30

The commercial banking system is composed mainly of small banks which are said to depend heavily for their livelihood upon loans to and deposits of small business concerns. As a matter of fact, most banks are in themselves small business. Of the approximately 15,000 banks in this country as of June, 1940, 12,000, or about 80 percent, had deposits of less than $2,000,000, and they employed an

26 (cont'd.) Philadelphia, and the Chase National Bank of New York. In the latter case, these loans are made through one of Chase's 3,700 correspondent banks, and Chase may participate up to 90 percent of the dollar amount at a minimum of 4½ percent interest.


30 ibid.
average of three officers and eleven employees. The average
officer's salary was less than $3,500 for all bank officers
in the United States. Of the national banks of the United
States, 75 percent are said to pay annual dividends of
$5,000 or less, and over half pay annual dividends of $3,000
or less.31 Today, in spite of the rapid monetization of
public debt during 1942--1945 and a postwar expansion of
private debt monetization, the average bank still has
deposits considerably less than $5 million. In an exhaustive
study of 1949 member bank salaries, Roland I. Robinson found
that the average salary for member bank officers and employ-
ees combined was $3,070. For officers separately, the
average salary was $6,700 and the employees' average annual
salary or wage was $2,430. In country banks the figures
were $5,230 and $2,100. In member banks with deposits from
$2 to $5 million the average salary for officers was $4,160
and for employees $1,840.32

The commercial banker owes it to his depositors to
invest their money in only the safest possible manner which
in addition will allow withdrawals on demand. He owes it
to his stockholders to make money on investments, and not

31 Daughters, Charles G. Small Business Loans and Risk
Capital, 77th Congress, 2nd Session, S Print 6,

32 Robinson, Roland I. "A Study of Banking Salaries." Burroughs
Clearing House. August, 1950, p. 34.
to take unnecessary risks. However, it is also frequently argued that the banker has an obligation to society, to control credit in the overall interest of the economy and to assist in the creation of new business with long-term risk investments. Thus, these two responsibilities appear to be in conflict with each other—the interest of the depositors and stockholders and the interest of the economy in general. Therefore, attention must be called to the difference between the need for short- or intermediate-term borrowed funds and the need for equity capital. Commercial banks clearly lack the qualities that are necessary to provide the latter. They raise funds on a promise-to-pay basis; this creates an element of fixity unsuited to the risks adhering to the residual equity position.\(^3^3\)

From a review of the evidence at hand, one could conclude that banks can, within limits, help in supplying working capital that may ultimately create additional equity. They may even stretch loans to five years where there is collateral in real estate, equipment, or inventory covered by warehouse receipts. But they cannot be expected, with the funds of depositors, to assume the risks that go with ownership of enterprises. Bank credit is no adequate substitute for direct investment of individual savings in

\(^{33}\) In fact, banks are very extreme cases of external leverage, or trading on the equity.
specific small business ventures. Therefore, it must be concluded that our commercial banking system as presently constituted cannot be expected to provide equity requirements of small business.34

PRIVATE INVESTMENT

The Declining Role of the Local Capitalist

Local capital upon which small business used to depend for much of its needs has largely disappeared or sought other channels of investment. As has been suggested, some students of the subject feel that present tax laws encourage individuals with money to invest in government bonds, or other seasoned securities, because investment of their funds in risky ventures does not yield a return after taxes commensurate with the risks. At one time well-to-do individuals familiar with the locality, its businesses and their managements were important sources of capital for small firms.35

The urbanization and industrialization of our society have seemed to break down many of the personal ties which at one time made possible local ventures by local capitalists. People do not know each other as well or as

34 The proposals for a government sponsored small-loan insurance program will be discussed in Chapter VI.

35 For manufacturing firms starting operations in 1946--1948 the percentage was negligible. See Table IV above.
intimately as they once did and the sources of information which were the basis for earlier investments no longer suffice.

Developing along with this change, or caused by it, as has been mentioned, has been an increasing tendency on the part of savers to seek comparatively safe investments in contrast to equity securities which represent venturing. This is evidenced by the growth of savings banks, life insurance companies, commercial bank savings accounts, and savings and loan associations. Such organizations are devices for pooling of funds for investment in securities such as mortgage bonds, mortgages on residential real estate, and the issues of Federal, state, and local governments. In 1929 commercial banks held 42 percent of total long-term savings of individuals; in 1946 they held only 21 percent. In 1950 life insurance companies and government bonds shared $95 billion of our savings (52 percent of the total).

The Unimportance of Security Sales on the Open Market

Another external source from which businesses may obtain long-term capital, as suggested at an earlier point,

36 These institutions, as possible sources of long-term capital, will be discussed in the following section.

is through sale of stocks or bonds on the open market. For large enterprises, this is an exceptionally low-cost, effective, and absolutely essential method of raising capital. However, it is a method which is geared to large enterprises and is both expensive and unsatisfactory for the smaller concerns.

Virtually every study of the financing of small business has demonstrated the difficulties encountered by both new and established small firms in acquiring capital on the open market. Although many concerns have sold stock to secure permanent capital, the securities were purchased in most cases by the owners or their friends and relatives.

The principal obstacle to the use of securities by small firms for raising outside capital is the cost of issuance arising out of the lack of a broad market. The Securities and Exchange Commission has studied the cost of flotation by listed corporations during the period of 1945-1947. The results are shown in Table VI. For all flotations, it can be seen that the costs declined uniformly as the size of the issue increased. Furthermore, the cost was approximately 22 percent of proceeds for flotations smaller than $500,000 but only slightly over one percent for flotations over $50 million. In view of the costs as indicated by Table VI, a new firm capitalized at $100,000 would have little use for this particular source. This was further sustained by Tables III and IV on pages 4 and 6.
respectively, which show the very small contribution made by securities toward the initial investment of new small firms. An established small business would be in an identical position. The flotation expense of 28 percent of gross proceeds for common stock flotations of less than $500,000 is almost prohibitive and is certainly highly disadvantageous from a competitive viewpoint. Such data reveal the desirability of developing mechanisms for selling the issues of small firms on a more favorable basis. Noting that Americans bet more than twice as much on horse races in 1949 as they invested in common stock issues, a New York broker commented: "Business obviously needs a $2 window."38

In the survey of consumer finances made by the Federal Reserve System in 1950 only about 8 percent of all spending units reported owning an interest in the unincorporated business or in a privately-held corporation. The amount invested in business tended to be larger for the corporate than the unincorporated form of ownership. About one-third of those having shares in privately-owned corporations valued their interests at $25,000 or more, as compared with only about one-tenth of the owners of interests in unincorporated businesses who valued their interests so highly. Nearly one-half of the unincorporated business interests

TABLE VI

COST OF FLOTA TION AS A PERCENTAGE OF GROSS PROCEEDS BY TYPE OF SECURITY AND SIZE OF FLOTA TION FOR 1945 THROUGH 1947 INCLUSIVE

<table>
<thead>
<tr>
<th>Size of Flotation (Millions of dollars)</th>
<th>All Flotations</th>
<th>Common Stock</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of Flotations</td>
<td>Cost of Flotation</td>
</tr>
<tr>
<td>All sizes</td>
<td>715</td>
<td>2.48</td>
</tr>
<tr>
<td>Under 0.5</td>
<td>19</td>
<td>21.91</td>
</tr>
<tr>
<td>0.5 to 1.0</td>
<td>95</td>
<td>15.26</td>
</tr>
<tr>
<td>1.0 to 2.0</td>
<td>136</td>
<td>11.55</td>
</tr>
<tr>
<td>2.0 to 5.0</td>
<td>176</td>
<td>6.55</td>
</tr>
<tr>
<td>5.0 to 10.0</td>
<td>103</td>
<td>4.54</td>
</tr>
<tr>
<td>10.0 to 20.0</td>
<td>71</td>
<td>3.19</td>
</tr>
<tr>
<td>20.0 to 50.0</td>
<td>68</td>
<td>2.14</td>
</tr>
<tr>
<td>50.0 and over</td>
<td>47</td>
<td>1.15</td>
</tr>
</tbody>
</table>

were worth less than $5,000 compared with about one-fourth
of those in the corporate form. Furthermore, in the 1949
survey of consumer finances by the Federal Reserve System,
it was revealed that only 8 percent of the spending units
with incomes in excess of $3,000 owned stock in a corpo-
ration which was open to investment by the general public.
Sixty-nine percent of these spending units stated they were
adverse to holding common stock, some because they regarded
common stock as unsafe and others because they were un-
familiar with this form of investment. This hostility
toward equity investments is all the more detrimental to
small business because of its well-recognized degree of
risk. Thus, if investment is made in equity securities,
it will be in the securities of a large, well-known
corporation with a relatively long history of earnings and
dividends, not in a small unknown business where greater
risk is involved.

According to the above studies it is clearly indicated
that few small business entrepreneurs can expect to secure
outside long-term capital through the securities market.
This is due to the localized nature of the business, and the
high cost of raising small amounts of long-term funds. Also,

39 Survey of Consumer Finances, Federal Reserve System,

40 "1949 Survey of Consumer Finances." Federal Reserve
the trend toward increasing investments in life insurance and government bonds, in conjunction with savings accounts, largely motivated by a desire for security, has reduced to a more modest amount the formerly large sources of long-term capital which were obtained from friends or relatives. Thus, from all the evidence at hand, it seems logical to conclude that private investment has passed within the past few decades from a leading source of small business capital to a minor role in the financing of new small enterprises.

INSURANCE COMPANIES, SAVINGS BANKS, SAVINGS AND LOAN ASSOCIATIONS, TRUST COMPANIES, AND INVESTMENT COMPANIES

The Role of Life Insurance Companies

Life insurance companies operate under state charter, and are subject to regulation by the insurance commissioners of the various states in which they do business. Moreover, the amount and type of their permissible investments are regulated by state statutes. In general, these statutes prohibit, or limit to a small percentage of total assets, the amount invested in equity capital, and restrict purchases of corporate bonds to the higher grade issues. Real estate mortgages are likewise generally approved, subject to certain limitations on the amount loaned in relation to the appraised value. Some forty-one states permit life insurance companies to invest in common stock of business
concerns. For example, New York, in 1951, liberalized its law governing common stock investment so that life insurance companies could invest up to three percent of total assets in such issues. The liberalization created by the 1951 amendments permits investment in common stocks if the institution is solvent, has paid cash dividends on stock for a period of ten years, has earned during the same period at least four percent on the par value of all shares outstanding and when the shares are registered on a national securities exchange.\textsuperscript{41} Obviously this revision in the New York State insurance law will not help small business.

The life insurance companies have been primarily engaged in mortgage lending or bond purchases.\textsuperscript{42} The mortgage type of investment requires extensive investigation and involves considerable administrative cost. Loans can be made only when there is a minimum of risk involved. Unless there is considerable physical value to offer as collateral, a long history of successful earnings is required. As a result of these restrictions most small businesses are unable to participate in the lending programs

\textsuperscript{41} House of Representatives Committee on Small Business, 82nd Congress, \textit{op. cit.}, p. 72.

\textsuperscript{42} Quentin, Alfred N. "Review of the Year." \textit{Journal of the American Association University Teachers of Insurance}, March, 1953, p. 72.
of life insurance companies.\(^43\)

**The Role of Mutual Savings Banks**

Mutual savings banks, of which there are approximately 530 with combined assets in excess of \(\geq 20\) billion dollars, are located chiefly in the New England and Middle Atlantic states.\(^44\) They operate under state charter and function exclusively as depositories for savings. Because of statutory limitations on investments, business holdings are a relatively small proportion of total assets, and are confined entirely to the highest-grade corporate bonds.\(^45\)

**The Role of Savings and Loan Associations**

Savings and loan associations number about 6000 with combined assets at the end of 1953 of more than 26 billion dollars.\(^46\) They are mutual societies operating under state or federal charter and are subject to the supervision of the governing body granting the charter. At the present time, these associations are primarily savings institutions with

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43 One possible method of lending to small business was discussed on page 22, namely, Metropolitan Life Insurance Company's participation of loans with commercial banks.


45 Ibid.

the financing of residential property their major investment activity. As a consequence, savings and loan associations have virtually no direct role in business financing.

The Role of Trust Companies

A trust is a contract whereby the maker of the trust, called the trustor, places his property under the control of a trustee for the benefit of a certain party, or parties, called the beneficiaries. The trustee may be an individual or an institution such as a trust company. However, the great majority of trusts created to administer personal resources are operated by the trust departments of banks or trust companies. The amount of funds being administered in trust is indeterminable. The Comptroller of the Currency reports that on December 31, 1948, there were 1,505 national banks handling over 20.4 billion dollars in 172,719 separate trusts.

Trust investments are generally handled conservatively. The Comptroller reported that on the above date the national banks had 65.5 percent of their trust investments in bonds, 24.1 percent in stocks, 4.3 percent in mortgages, 3.4 percent


48 Comptroller of the Currency. Annual Report, 1948, p. 185. A survey conducted by the American Bankers Association and reported in the April, 1948 issue of The Trust Bulletin, estimated that in 1947 there were 2,976 banks and trust companies administering 36.2 billion in trust property.
in real estate, and 2.7 percent in other investments. A trustee's powers to discharge his duties are determined either by the trust instrument, or by state statutes. There are two general types of state laws: the "legal list" rule and the "prudent-man" rule. Using either interpretation of the statutes, few, if any, investments in new small business enterprises would be permitted.

The Role of Investment Companies

Regarding investment trusts or companies, a few were organized to finance equities of intermediate-size business. The smallest investment made by any of these in a single enterprise in 1936 to 1939 was one hundred thousand dollars. In recognition of the difficulties of small business enterprises in raising long-term capital on reasonable terms during the 1930's, Section 12e of the Investment Company Act expressly permits registered investment companies of any kind, either alone or jointly, to make investments in securities of a company engaged primarily in the business of underwriting, furnishing capital to industry, financing promotional enterprises, purchasing securities of issuers for which there is no ready market in existence, and

49 Ibid.

50 Daughters, op. cit., p. 99.
reorganizing companies, or similar activities.\textsuperscript{51} An investment company may purchase stock of such a company up to 5 percent of the value of the total assets of the investment company, but there is no limit on the proportion of the stock of the venture capital company which an investment company may own.\textsuperscript{52} In the thirteen years that have elapsed since the Investment Company Act was passed, other than for the formation of the American Research and Development Company, nothing has happened in the promotion of small ventures by investment companies. That regulated companies have not used the above authority granted them is fairly conclusive evidence that small business problems are only rather remotely related to this form of investment. Thus small enterprises are out of the scope of these regulated companies.

In conclusion, it would appear, then, that insurance companies, savings banks, savings and loan associations, trust companies, and investment trusts are not investment media readily adaptable to the financing of long-term needs of small business firms.

\textbf{INTERCOMPANY FINANCING}

The tenor of the discussion thus far is that large


\textsuperscript{52} \textit{Ibid.}
businesses have easier access to the various sources of funds than do the smaller firms. The big problem of small companies is to obtain adequate financing. By contrast the major problem of large companies is to obtain reliable trade outlets for their great productive capacities. When large companies sell goods on favorable terms or make outright loans to small companies, it has the effect of solving both problems simultaneously, i.e., the small company is financed and the trade of the larger company is expanded. The frequency with which one encounters reference to intercompany credit in textbooks, articles and pamphlets suggests that it is a commonplace and widespread practice. For example, the study conducted by the Federal Reserve Bank of Minneapolis mentioned earlier lists loans and advances from suppliers as the third most important source of credit used by the 122 firms studied. The Department of Commerce study for trade firms starting operations in the 1945-47 period showed that supplier credit accounted for 18 percent of the initial investment funds of wholesale firms and 10 percent of the retail firms' initial funds. Supplier credit amounted to 11 percent of the manufacturing firms initial investment funds during 1946-1948.

53 Litterer, op. cit., p. 4.
54 See Table III, p. 22.
55 See Table IV, p. 24.
There are three main types of intercompany aid.

(1) The most common form of intercompany financial aid grows from the practice of selling merchandise on credit. When the seller himself cannot afford to finance the sale, he often discounts the buyer's note. In this way the seller's credit standing permits bank credit to be made available to buyers who normally would have trouble negotiating a similar loan on their own accord. The chief disadvantage of ordinary trade credit is that it is short-term and must be renewed periodically.

(2) Of much greater value to the small company, in regard to permanent capital, is a long-term loan by one of its suppliers for purposes other than to finance a sale by the latter. In small corporations long-term bonds are frequently the evidence of such an advance. Also, it is not uncommon for suppliers to actually purchase preferred or common stock. The interest of the larger company in such cases is almost always to conserve or strengthen an outlet for its own products. The pages of Moody's investment manuals contain numerous examples of companies that have purchased the stocks and bonds of smaller companies to whom they sell.

(3) It is even more common practice for large corporate buyers to extend financial aid to smaller corporate sellers, the motivating interest of the larger company being to conserve and to strengthen an important source of supply.
The effect is often to develop the weaker company into a strong producer.56

As the above surveys show, intercompany financing is quite widely utilized. This is an important aid to small business and performs an important function in supplying capital to firms unable to obtain it from other sources. Some believe that this financial relationship, because of interest to debtor and creditor alike, is more helpful than obtaining capital directly from other sources. Investors are often more interested in the contractual position of their credit advance than they are in the welfare of their debtors.57 Thus, a small business cannot hope for much consideration from such investors in times of adversity. When one firm extends credit to another, as a rule, such a firm looks forward to a long period of mutually profitable trade transactions between creditor and debtor. More often than not, the profit to be derived from these transactions dwarfs the return promised on the investment and renders safety a matter of secondary importance.58

Mercantile credit has, however, an undesirable quality.

56 Eiteman, Wilford J. "Inter-company Financing." Commercial and Financial Chronicle. November 17, 1949, p. 43. No data on the length of maturities of inter-company credit advances are available at the present time. Hence, it is impossible to determine the amount of credit that could be imputed to types two and three listed above which would represent long-term advances.

57 Ibid.

58 Ibid.
If the business does not pay cash for its purchases it can
buy from only those who will extend it credit.

Another very minor intercompany method of financing
may be found in pooling arrangements. Groups of small
companies, particularly manufacturers, have in some cases
banded together to obtain financing or contracts, or both,
for the group as a whole. This joint action sometimes
extends to technical research, market research and other
activities that the group can carry on more economically
and effectively than can any member acting alone.59

In conclusion, although intercompany financing offers
a worthy contribution to the capital requirements of small
business, as shown above, in the absence of evidence to the
contrary, in the postwar period, the largest part of it
quantitatively probably represents current working capital
requirements.60 Hence, the great majority of small

59 Dockeray, op. cit., p. 22.

60 The principal form of short-term credit appearing on
business balance sheets is "accounts payable." These
"accounts payable," for the most part, represent trade
credit. In pre-World War II, Jacoby and Saulnier report
that more than 80 percent or 2.7 million concerns were
indebted for short-term trade credit as represented by
the presence of "accounts payable" on their financial
statements. While the amount of long-term intercompany
advances is unknown, it logically could not exceed the
above figures for short-term credit. See Jacoby and
Saulnier. *Business Finance and Banking.* New York:
National Bureau of Economic Research, 1947, p. 42 and
pp. 52-54.
businesses cannot logically depend on other businesses to solve their overall long-term capital problems.

COMMUNITY INDUSTRIAL DEVELOPMENT GROUPS

As the problem of securing long-term capital has become more acute, various institutions have been developed to provide such capital. These organizations are generally best known as community industrial development groups. These privately-sponsored civic corporations for the financing of new and expanding local enterprises have emerged in a number of communities. The general purpose is to bring the enterprise that needs capital into contact with the sources of funds seeking investment outlets, to make investments from the community fund, or to aid a business in obtaining additional financing. In a sense, it is an effort to reproduce, through a formal organization, the equivalent of

61 In its undated, mimeographed pamphlet, Community Industrial Financing Plan, the Chamber of Commerce of the United States lists and describes twenty-two such organizations in the following communities: Akron, Ohio; Baltimore, Maryland; Brockton, Massachusetts; Danville, Illinois (2); Easton, Pennsylvania; Elmira, New York; Grand Rapids, Michigan; Greater Muskegon, Michigan; Hopkinsville, Kentucky; Hoquiam, Washington; LaCrosse, Wisconsin; Little Rock, Arkansas; Louisville, Kentucky; New Bedford, Massachusetts; Omaha, Nebraska; Portland, Maine; Rochester, New York; Scranton, Pennsylvania; Tulsa, Oklahoma; Wheeling, West Virginia; and Wilkes-Barre, Pennsylvania.

62 Kaplan, op. cit., p. 156.
the practical, neighborly interest in a local venture that used to develop in former periods spontaneously as a result of the closer relationships of friends and relatives. At the same time, it recognizes the fact that technical expertise and experience are necessary to launch a new venture under present conditions. Industrial development groups may also be concerned with aiding local established businesses out of difficulties, although they are designed primarily to bring new businesses to the community. In all there are about fifty community agencies that might properly be listed as industrial development corporations, although more than twice that number are known to have been started. 63

The Baltimore Corporation

The most frequently cited example of the successful community organization to encourage independent enterprise is the Baltimore Corporation. The fund originally invested in the corporation by a group of leading citizens is utilized primarily to facilitate the making of investigations and appraisals of applicant enterprises and the maintenance of engineering and related facilities for counseling. 64 When a new enterprise is found promising,

63 ibid., p. 157.
the directors of the corporation may invest their own personal resources in the venture or find other members of the community who are interested. The organization has a standing list of such prospective investors. The Baltimore Corporation has, according to its directors, been able to support itself by means of the fees charged for engineering and counseling services to companies seeking its advice.65

The Louisville Industrial Foundation

The Louisville Industrial Foundation represents a second type of community development corporation.66 It is based on a pooled investment fund contributed by civic leaders. From the fund investments are made directly in small enterprises, either those entering the community or local organizations requiring reorganization or expansion, that cannot obtain adequate capital from other sources. Investments are limited in amount to $100,000 for periods up to ten years and only to manufacturing companies in the Louisville area. The Foundation presents a combination of private business characteristics and quasi-public motives. It was incorporated under the laws of Kentucky in 1916 as

65 Kaplan, *op. cit.*, p. 158.

66 It is fifth in standpoint of age, the second in size of capital funds, and perhaps one of the best known.
a technically profit-making enterprise and its structure is the conventional one consisting of a board of fifteen directors, elected by the stockholders; an executive committee of the board; and a salaried administrative personnel.

This fund was formed originally by the resident business firms and the townspeople of Louisville, during a public subscription drive held in 1916, and has been maintained intact since that time. The original amount, $875,759, has since been increased through earnings from investments (above administrative expenses and losses) to $983,659. This fund is treated as an interest-bearing revolving fund, and has turned over four and one-half times in 26 years, while providing capital loans for 44 small firms.67

Development Credit Corporation of Maine

The most recent variation of the above type is the Development Credit Corporation of Maine which has not confined its activities to locating small business, but is actively engaged in supplying term loans to small business. The Corporation has capital of $50,000, subscribed by 77 Maine individuals, business firms, and utilities. Banks did not subscribe because of the high degree of risk involved.

Funds for investment, however, come primarily from loans to the Corporation by commercial banks, trust and insurance companies, savings banks, and building and loan associations in Maine which are voluntary members of the Corporation. These groups agree to lend funds upon call up to a maximum amount of 2½ percent of their own capital and surplus at the interest rate of 2 percent a year. The funds received from the members are in turn loaned in the form of demand notes to business at a minimum of 5 percent. Operating expenses are paid from the difference of the borrowing and lending rates. Profits will be used primarily to cover losses and build up reserves. The Corporation does not attempt to compete with existing financial institutions, but is concerned with providing capital which is otherwise unavailable.

**Evaluation of Community Industrial Development Groups**

These community industrial development groups have been very helpful so far as their activities have extended, and they provide hope that their patterns will be duplicated in many other areas. Nevertheless, the activities of these groups have been very limited. In most instances these organizations have confined their aid only to those small

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firms which show exceptional promise of high earnings or a distinct competitive advantage. Investment generally occurs only when commercial feasibility has been assured virtually beyond doubt. Thus, it must be realized that development corporations have touched only a negligible fraction of small business and its capital requirements. Efforts to provide long-term capital for small business must obviously be made on a much broader front if an improvement is to be made in the total situation.

SUMMARY OF THE FINANCING OF SMALL BUSINESS
BY PRIVATE SOURCES

Much of the initial financing of new business enterprises is derived from the savings of the owners. The usual sources of funds for expansion are depreciation reserves and net profits of the firms. Increases in personal and corporate income taxes accompanied by increases in costs have made it more difficult for small businesses to acquire sufficient capital from these sources. At the same time, dependence on local conditions and lack of product diversification make small enterprises susceptible to extreme variations in profits and losses. Thus, savings of the owners, depreciation reserves, and reinvested earnings, in many cases, are inadequate for the promotion and growth of small businesses.

In many instances it might be desirable to supplement
the owners' investments with external financing. Small firms have also been handicapped in their efforts to procure long-term capital from outside sources. The costs of marketing small security issues are prohibitive. There is no market for such issues. Rather than invest in small unknown firms, the normal investor prefers securities of larger corporations. While community industrial development groups have participated in equity and long-term debt financing, their contributions up to the present have not been very extensive.

The inability to raise equity capital has created a demand for long-term loans. As noted, costs are high and the market thin, thus discouraging debt financing on the open market. While commercial banks have increased term loans to small businesses, the maturities are generally less than five years. Banks, in general, are not in a position to grant long-term capital. This is explained by the fact that banks are themselves small businesses and do not have adequate resources to permit diversification of risks.\(^\text{87}\) In addition, they are high leverage organizations.

\(^\text{87}\) Considerable term lending was done prior to World War II through participation of several banks in order to diversify the loan risk and keep the amount borrowed from each bank within the maximum loan limits. Unfortunately, this type of interbank cooperation generally was confined to the larger loans. Albert R. Koch, in his article appearing in the Federal Reserve Bulletin, March, 1947, p. 255, found that this type of lending was not as prevalent in 1946 as it was in the
Also the cost of servicing long-term small loans would be extremely high. Participation in long-term small business lending by insurance companies is small due to legal limitations on types of permissible investments.

Short-term credit seems to be in general adequately supplied by existing institutions. Trade credit represents the most important source of short-term, non-cash credit; commercial banks are the most important external suppliers of short-term, cash credit.

In recognition of the need for additional financial aid created by the inadequacies of private financing, Congress has established various programs which provide for direct financing with government funds or indirect financing through established financial institutions. These government agencies will be treated in the succeeding chapter with a view of determining to what extent they have participated in small business long-term debt financing.

67 (cont'd.) previous decade.

There is ample evidence today to indicate that similar handling of small business loans is necessary, particularly in order to diversify the risk. Many complaints have been made that small country banks cannot, because of maximum loan limits, or will not, because of bank policy or inadequate correspondent relationships, attempt to finance the long-term requirements of small business. Although not used extensively to date, several large correspondent banks have announced they would participate with country banks in granting small business credit.

Chapter VI contains a proposal for encouragement of term lending through participation of several banks in order to diversify the loan risk and keep the amount borrowed from each bank within the maximum loan limits.
CHAPTER III

SOURCES OF LONG-TERM CAPITAL
(PUBLIC AND QUASI-PUBLIC)

INTRODUCTION

There has arisen from time to time a need for additional financial aid created by inadequacies in private financing or by sudden demands for increased investment for defense production. In recognition of this demand for additional sources of capital, Congress has established various programs which provide for direct financing with agency funds or indirect financing through established financial institutions.

Having considered private agencies, governmental lending agencies designed to assist small business with its long-term capital problem will be reviewed. Included in the Government agencies authorized to make business loans to small firms are the Federal Reserve System, the Veterans Administration, and the Small Business Administration which replaced the Reconstruction Finance Corporation, and the Small War Plants Administration.¹ Each of these

¹ There are more than thirty U. S. Government lending agencies.
organizations will be considered to discern the extent of their contribution in the field of small business financing, with a view toward possible improvements. As will be shown, with the demise of the RFC there is at present no major source of capital for the small businessman. However, with the passage of time, its successor, the Small Business Administration, shows evidences of filling the breach caused by the RFC liquidation. The Federal Reserve program has been largely inactive; the Small War Plants Administration was a defense emergency organization, and the Veterans Administration provides only one-time loans of very small amounts to veterans for business purposes. Although of relatively minor importance the latter three organizations are worth studying as experiments of government lending to small business.

SMALL BUSINESS ADMINISTRATION

With the enactment of Public Law 163 by the 83rd Congress on July 30, 1953, the Small Business Administration was created to carry out lending operations to small business. This law provided that sixty days after enactment the Reconstruction Finance Corporation was to cease all lending activities. On September 29, 1953 the RFC began liquidation proceedings. On that date all branch offices of the RFC closed, leaving only eight regional offices open in order to carry out liquidation of the investments.
The SBA was organized to carry out the RFC's small business activities.

The SBA got off to a restrained start with the emphasis placed on promoting a long-run goal of private investment "pools" similar to the Development Credit Corporation of Maine which was discussed in Chapter II. Since the dismissal of its first administrator, William D. Mitchell, on October 31, 1953, a more liberal short-run lending policy gradually is being formulated. No loans were approved during his tenure of office. From November 1, 1953 to February 2, 1954, a total of 53 loans have been made with 19 approvals given in the latter part of January. These loans have totaled $2.2 million.

Now that the Small Business Administration has clarified its loan policy somewhat, more definite statements covering lending policies can be made. A point which should be emphasized is that the SBA does not plan to compete with private lending institutions. As evidence of this assertion the law creating the Small Business Administration provides

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2 See page 63.


4 Ibid.
very specifically that SBA shall not make a direct loan to any owner of a small business unless he shows that the financial assistance applied for is not otherwise available on reasonable terms.\(^5\) The SBA loan policy statement further implements this by providing that only when a bank refuses to make the loan, either in its entirety or in participation with SBA, can the applicant then apply for a direct loan.\(^6\)

Every effort is made both by the law and the SBA loan policy statement to give the banks first chance at a loan. The SBA prefers the bank or other lending institution to make the loan itself. If it decides not to do so on its own, then the SBA offers to participate in the loan. If the bank refuses even a participation, the SBA may make the loan directly if it meets their requirements.

There are two kinds of participations—deferred and immediate. In a deferred participation loan, the bank provides the entire amount but has an agreement with SBA for SBA to purchase part of the loan on demand at any time. In an immediate participation loan, SBA agrees to take a part of the loan from the start. In both cases, the limit


of SBA participation is 90 percent or less. Another provision for all loans is that no one borrower can receive more than $150,000 from SBA. The law says that the SBA shall purchase an immediate participation only where it is shown that a deferred participation is not available. Thus, the order of preference for loans to small business is as follows:

(1) Loans made by private lending institutions.
(2) Deferred participations by lending institutions with SBA.
(3) Immediate participations.
(4) Direct loans by SBA.

The law further states that any loan must be of such sound value or so secured as reasonably to assure repayment. Therefore, the "Three C's" of credit must be present in all SBA loans in some degree. The term of a loan may range up to ten years.

In return for SBA participation in an installment loan the bank pays the SBA a fee which is on a sliding scale according to the percentage of SBA participation. The

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8 ibid.
9 SBA fees charged the banks for holding a reserve fund ready on demand are as follows:

1 percent per annum on the declining balance of SBA participation up to and including 50 percent of such balance.
yield to the bank on a 6 percent loan under the present plan ranges from 4 percent to 5 percent, depending on the percentage of SBA participation. This is in contrast to the flat 2 percent previously charged the banks by the RFC.

President Eisenhower, in his recent budget message to Congress, indicated the SBA will lend $15 billion in the first six months of 1954. The SBA, when created, was voted $50 million for a revolving fund, and since no new funds were included in the budget beginning July 1, 1954, the administration must expect these funds to last through the next fiscal year. This means that SBA still can lend some $32.5 million in fiscal 1955, in addition to the $17.5 million of loans anticipated for fiscal year 1954. Also $5 million has been allotted for disaster loans.

Even lending at the volume indicated above, the SBA will still be small as compared to its predecessor, the RFC. In 20 years, the RFC loaned over $10 billion dollars to over 200,000 businesses.10 Even in the 1953 fiscal year when the Republicans were trying to wind up RFC's affairs, the agency

9 (cont'd.) 1½ percent per annum on the declining balance of SBA participation in excess of 50 percent of such balance up to and including 75 percent.

2 percent per annum on the declining balance of SBA participation in excess of 75 percent up to and including 90 percent.

loaned $220 million to businesses of all sizes.\(^1\)

In addition to the lending function, the SBA has objectives of rendering two other types of assistance. The first is the agency's Defense Procurement Program under which SBA and defense officials work together to assure small businesses a share of defense contracts. So far, SBA claims it has procured some $117 million of defense business for about 1,000 small companies.\(^2\) The second objective, in addition to lending, is technical and managerial aids. The latter number 40 and cover a wide range of subjects.\(^3\)

Technical aids for small business number 30 and are constantly being added to.\(^4\) In order to better carry out these objectives the SBA maintains 30 field offices throughout the country staffed with men familiar with the problems of small business.

While there is no immediate likelihood of the SBA's becoming an RFC in disguise, a review of the activities of

\(^{11}\) Ibid.

\(^{12}\) Ibid.

\(^{13}\) Barnes. "The SBA and the Banks," loc. cit., p. 122. These subjects include production, methods engineering, figuring break even points, how small plans can sell to the Federal Government, business insurance, accident prevention, subcontracting, pricing policy in bidding on government contracts, materials control, advertising packaging, budgeting, and others.

\(^{14}\) Ibid. They cover such things as the proper alignment of machine tools, cutting oils and coolants, surface finishing techniques for various metals, lengthening the life of tools, and others.
the latter agency in regard to small business lending is necessary because the SBA is confronted with the same problems and pressures which faced the RFC during its score of years. Since the SBA has been in existence for such a short period of time and has had a limited operation during this interval, a study of the RFC becomes virtually mandatory in order to evaluate recent proposed lending proposals involving public agencies.

Reconstruction Finance Corporation

After the outbreak of hostilities in Korea until the time of its liquidation proceedings, the RFC was engaged in providing credit to firms in defense or essential civilian production when working capital and funds for expansion or improvement were necessary to permit such concerns to carry out their commitments. In another period, such as during periods of business recession, RFC might have extended credit to counteract a contraction of credit by commercial lending organizations or to meet the financial requirements created by a particular situation where Congress has authorized a specific lending program. Generally, the RFC supplemented the lending activities of private institutions. As a result the RFC for 20 years was a standby for the small businessman in need of capital. Although, as will be shown, the amount of help to small businessmen measured in amount of loans was not very large,
the RFC had the effect of making private institutions more considerate of the needs of small businessmen. If the small businessman could not get needed capital elsewhere at "reasonable" rates, he could make application to the RFC, and if his collateral and earning prospects were sufficient to cover the amount, he might get a direct loan from that organization.15 Actually, the RFC was created for the purpose of providing loans, not to small business, but to banks, utility companies and to railroads. It was authorized by Act of Congress in 1932 to aid in overcoming the depression. It was not until 1934 that Congress amended the RFC act to permit it to make loans to ordinary business enterprises and to participate with banks in such loans.

Perhaps the main reason that RFC loans were not made to small business on a larger scale was due to the small businessman's being uninformed on the policies and procedures of the government lending organization. The formalities encountered in an RFC loan were generally similar to those outlined for the Small Business Administration above.16 If unable to obtain the entire loan from a bank, the borrower was then to ascertain whether a bank would make the loan if

15 No loan or participation in a loan may be approved by the RFC if the financial assistance applied for is otherwise available on reasonable terms.

16 See pages 70-73.
the RFC agreed to participate. Where a bank was willing to make the loan with the RFC participating, the bank could advise the applicant to apply to the RFC on such a basis, or it could itself communicate with the RFC regarding a participation agreement. However, if the applicant was unable to obtain the loan from any private source, with or without RFC participation, the RFC then considered the application as a direct loan. As suggested above, the RFC Act, as amended, required that all business loans be so secured so as to reasonably assure repayment. Loans matured at the discretion of the RFC up to a maximum of 10 years, and generally were repayable in monthly installments. Schedules of repayment were arranged with a view to the orderly liquidation of the debt by the borrower, and, insofar as can be estimated, on a basis that would enable the borrower to make plans for the expansion of the business in the future without being unnecessarily restricted by the repayment schedule that would have impaired the borrower's working capital during the life of the loan. Throughout the entire life of the organization the rate of interest charged was four percent. Payment of fees or commissions for the

17 Participations could be either "immediate" or "deferred."

18 RFC loans, although limited to ten years, could be re-renewed at the discretion of the administrator.

19 The law provided that interest should be at such rates as might be fixed from time to time by the directors of the RFC.
Having considered the technique of RFC lending, it is well to review the lending record of the organization. In 20 years, the RFC loaned out $10 billion of taxpayers' money in loans to 200,000 businesses from chiropractors and chicken ranchers to steel mills and railroads. On September 29, 1953, the RFC Administrator had before him a portfolio of something in excess of three-quarters of a billion dollars in loans and investments to liquidate, to which would be added commitments to disburse another $220,000,000 under loans approved before the liquidation date. Nearly $500,000,000, or the greater part of this total consisted of business loans. Ninety-two percent in number of these business loans were in amounts of $100,000 or less each.

The RFC, however, held a sizable number of large loans, including those to Kaiser-Fraizer, Lone Star Steel, Reynolds Metals, and Texas Consolidated Oil.

20 It was the breach of this provision that caused the RFC to fall into general disrepute.


23 Ibid.
### TABLE VII

RFC BUSINESS LOAN AUTHORIZATIONS, 1948 AND 1949, BY SIZE

<table>
<thead>
<tr>
<th>Size of Loan</th>
<th>Number</th>
<th>Percent</th>
<th>Gross Amount</th>
<th>Percent</th>
<th>RFC Share</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>$5,000 and under</td>
<td>1,309</td>
<td>16.2</td>
<td>$3,827,439</td>
<td>0.4</td>
<td>$3,687,271</td>
<td>0.5</td>
</tr>
<tr>
<td>$5,001 - $10,000</td>
<td>1,090</td>
<td>13.5</td>
<td>$8,488,939</td>
<td>1.0</td>
<td>$7,592,435</td>
<td>1.0</td>
</tr>
<tr>
<td>$10,000 - $25,000</td>
<td>1,894</td>
<td>23.3</td>
<td>$33,847,186</td>
<td>3.9</td>
<td>$29,032,663</td>
<td>3.8</td>
</tr>
<tr>
<td><strong>Total $25,000 and under</strong></td>
<td>4,293</td>
<td>53.0</td>
<td>$46,163,564</td>
<td>5.3</td>
<td><strong>40,312,969</strong></td>
<td><strong>5.3</strong></td>
</tr>
<tr>
<td>$25,001 - $50,000</td>
<td>1,597</td>
<td>19.7</td>
<td>$62,010,992</td>
<td>7.2</td>
<td>$52,635,996</td>
<td>6.9</td>
</tr>
<tr>
<td>$50,001 - $100,000</td>
<td>1,303</td>
<td>16.1</td>
<td>$102,304,275</td>
<td>11.9</td>
<td>$86,843,373</td>
<td>11.5</td>
</tr>
<tr>
<td><strong>Total $100,000 and under</strong></td>
<td>7,193</td>
<td>98.8</td>
<td>$210,478,851</td>
<td>24.4</td>
<td><strong>179,791,738</strong></td>
<td><strong>23.7</strong></td>
</tr>
<tr>
<td>$100,001 - $200,000</td>
<td>391</td>
<td>4.7</td>
<td>$58,512,468</td>
<td>6.8</td>
<td>$51,058,428</td>
<td>6.8</td>
</tr>
<tr>
<td>$200,001 - $500,000</td>
<td>326</td>
<td>4.0</td>
<td>$102,742,739</td>
<td>11.9</td>
<td>$89,456,978</td>
<td>11.8</td>
</tr>
<tr>
<td><strong>Total $500,000 and under</strong></td>
<td>7,900</td>
<td>97.5</td>
<td>$371,734,038</td>
<td>43.1</td>
<td><strong>320,307,144</strong></td>
<td><strong>42.3</strong></td>
</tr>
<tr>
<td>$500,001 - $1,000,000</td>
<td>98</td>
<td>1.2</td>
<td>$71,184,016</td>
<td>8.3</td>
<td>$63,752,124</td>
<td>8.4</td>
</tr>
<tr>
<td>Over $1,000,000</td>
<td>102</td>
<td>1.3</td>
<td>$418,453,702</td>
<td>48.6</td>
<td>$372,980,658</td>
<td>49.3</td>
</tr>
<tr>
<td><strong>Grand Total</strong></td>
<td>8,100</td>
<td>100.0</td>
<td>$861,371,756</td>
<td>100.0</td>
<td><strong>757,039,906</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

Table VII shows business loan authorizations by size for 1948 and 1949. It may be noted that only 5.3 percent of the total amount loaned was in loans of less than $25,000 although this did constitute 53 percent of the 8,100 loans approved. The table further reveals that loans of $100,000 or less were made in 1948 and 1949 for a total amount of about two hundred million dollars which represented 7,193 or about 89 percent of the total number of loans. This amount was very small when compared with the number of small businesses in our population, and averaged about $52 dollars per small business. More revealing is the fact that during 1948 and 1949 less than one-fifth of one percent of our small businesses were accommodated by the RFC.24

Since a borrower of RFC funds had to be unable to procure credit from other sources on reasonable terms, it is pertinent to note the type of unsatisfied credit demands filled by the Corporation. The lending activities of the RFC were probably quite indicative of the need of small business for additional credit facilities.

A sample survey covering 300 business loans authorized by RFC in 1948 and 1949, none of which exceeded $100,000 is presented in Table VIII. Approximately 41 percent of the

24 In Chapter I it was noted that at present there were approximately 4,000,000 business concerns in the country.
445 banks approached by the business concerns declined loans because the maturities requested were too long. Even when short-term credit was already extended, some banks refused to take a term loan. In over 10 percent of the cases the bank declined the application because the collateral was considered unacceptable in view of bank policy or a specific type of collateral was not deemed desirable. Thus, Table VIII emphasizes the "credit gap" that exists when small business attempts to secure anything more than a short-term loan.

Although RFC small business loans were not too impressive in amount, as has been shown above, it must be concluded that they served a useful purpose, improving by their example the term-lending to small business by commercial banks. It should be stated that no evidence was found to indicate that the RFC discriminated against small borrowers. Rather, the poor showing of small business was believed to be due to a lack of information on the part of small businessmen as to the formalities involved in applying for RFC loans.

25 These loans totaled over $9 million and were secured by collateral conservatively appraised by the RFC at 135 percent of the amount loaned. Nevertheless, insufficient collateral is the major reason for refusal of a loan by the RFC. In a study of 3225 loans which were rejected, 58 percent of the cases declined were because of insufficient collateral. In 15 percent of the cases insufficient earning power was not demonstrated, hence, rejection followed. See Small Business and Credit RFC, pp. 54 and 55.
### TABLE VIII

**REASONS WHY BANKS DECLINED 300 SMALL BUSINESS LOANS AUTHORIZED BY RFC—1948-1949**

(Loans of $100,000 or less)

<table>
<thead>
<tr>
<th>Reason</th>
<th>Number of Banks</th>
<th>Percent of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Maturity too long</td>
<td>181</td>
<td>40.7</td>
</tr>
<tr>
<td>2. Declined in general terms</td>
<td>73</td>
<td>16.4</td>
</tr>
<tr>
<td>3. Unacceptable collateral</td>
<td>47</td>
<td>10.6</td>
</tr>
<tr>
<td>4. Bank was extending short-term, but would not make long-term loan</td>
<td>26</td>
<td>5.8</td>
</tr>
<tr>
<td>5. Bank felt applicant's financial condition did not warrant loan</td>
<td>24</td>
<td>5.4</td>
</tr>
<tr>
<td>6. Applicant's business located outside of area serviced by bank</td>
<td>19</td>
<td>4.3</td>
</tr>
<tr>
<td>7. Loan requested exceeds bank legal limit to one borrower</td>
<td>16</td>
<td>3.6</td>
</tr>
<tr>
<td>8. Bank &quot;loaned up.&quot;</td>
<td>10</td>
<td>2.2</td>
</tr>
<tr>
<td>9. Collateral considered insufficient</td>
<td>9</td>
<td>2.0</td>
</tr>
<tr>
<td>10. Loan requested was a special type not made by bank</td>
<td>9</td>
<td>2.0</td>
</tr>
<tr>
<td>11. Policy not to lend to type of business in which applicant engaged</td>
<td>8</td>
<td>1.8</td>
</tr>
<tr>
<td>12. Applicant's enterprise newly formed; credit not established</td>
<td>7</td>
<td>1.6</td>
</tr>
<tr>
<td>13. Miscellaneous reasons</td>
<td>16</td>
<td>3.6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>445</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

Liquidation of the Reconstruction Finance Corporation

As previously noted, on September 29, 1953, the RFC went into liquidation. The RFC will dispose of its assets in the way that seems most appropriate, and may have to accept discounts in some cases. With respect to business loans, however, the policy is not to sell a loan at less than the government's investment therein. With respect to mortgages and securities, the price will be the market price realized, by bid or negotiation.26

The Administrator ruled against the idea of providing a slow and easy liquidation with money coming into the Treasury in small amounts.27 Thus, participating banks will make a cash payment to the RFC for the purchase of a substantial interest in 4000 of the agency's small and medium business loans totaling $100 million dollars.28 The loans included in this group are all well-seasoned.

"In operation it is contemplated the plan will work in this manner: Banks will be offered an individual interest in the entire group of outstanding loans purchased. It is expected the Federal Reserve Banks


27 On June 30, 1954, the RFC was turned over to the Treasury to complete its liquidation.

28 On January 28, 1954, Wright Patman attacked the liquidation of the RFC in this manner as being against the wishes of Congress. See The Congressional Record, January 28, 1954, pp. 932-934.
will act as fiscal agents and custodians for the RFC and issue a participating certificate to each of the banks cooperating in the program representing its respective interest in the loans. The fiscal agent will report periodically to each participating bank on the current status of loans in the portfolio. The banks will rely on the loans without recourse to the RFC. Costs and expenses of the collecting banks and fiscal agents, and interest computed at the same rate on the banks' and the RFC's participating share, will be paid from interest collected. In the beginning all principal collections will be applied as a reduction of the amount of the participating banks' portion of the loans purchased. When this portion of the loans has been reduced to a point where it more closely approaches the amount of the RFC's participation, the government will share in the principal payments. There will be a reserve provision for loss in collection.29

As a result of this method of liquidation the Treasury after June 30, 1954 has been concerned only with the larger business loans and some non-business loans.30

Small Defense Plants Administration

At the outset of the Korean hostilities it was entirely possible that some small firms would be unable to engage in defense production because of a lack of capital.


30 Aside from the business loans, the RFC also had $68,500,000 of mortgage loans acquired by the old RFC Mortgage Company, $16,400,000 of disaster loans, $1,200,000 for civil defense projects, $51,000,000 loaned to the Philippine Government in connection with war rehabilitation, $76,500,000 of railroad loans (principally consisting of a loan to the Baltimore & Ohio Railroad), $25,000,000 of loans to local public agencies, and $45,000,000 of loans to financial institutions, the latter consisting entirely of preferred stock of banks.
The cost of conversion, the delay in obtaining materials, and many other factors can raise capital problems for financing defense production. In addition, concerns with less than 500 employees had received only 25 percent of dollar value of defense contracts up to March of 1950.\textsuperscript{31} It was recalled that there had been many terminations of small firms in the early years of World War II, and that the Smaller War Plants Corporation had been a successful innovation to help abate the financial difficulties of small business engaged in war production. Thus, an effort was made by Congress to strengthen the financial position of small firms engaged in the production of defense and essential civilian goods and services through the creation of the Small Defense Plants Administration. This agency was established by Section 714 of the Defense Production Act of 1950 which was drastically amended in 1951.\textsuperscript{32} As a result, in August of 1951 the Small Defense Plants Administration was created.

In broad terms, the Small Business Defense Plants Act of 1951 provides that the Small Defense Plants Administration\textsuperscript{33}


\textsuperscript{33} Hereafter abbreviated as SDPA.
assist small business:

1. To assure a fair share of government contracts under the national defense program;

2. To be assured a fair and equitable treatment when acting as subcontractors;

3. To obtain loans for expansion and conversion in the interests of the national defense; and

4. To achieve full economic and industrial mobilization.  

The SDPA was largely patterned after the Smaller War Plants Corporation of World War II. The main difference between the two organizations, as concerns our topic, is that the SWPC made loans directly, whereas the SDPA merely recommended to the RFC that specific loans be made. The SDPA had no power to make loans, and no money to lend. Its function was that of determining needs and of making recommendations. 

The Defense Production Act, as amended, stipulated that the SDPA could recommend loans to small firms and that the

34 Ibid.

35 These loans were known as RFC, Section 714 loans.
eligibility of a prospective borrower would be determined by such considerations as independency of ownership, number of employees, volume of business, and non-dominance in its field. The proposed loan could be used for conversion or expansion of facilities, purchase of equipment or supplies, or the financing of research projects. The credit extended by RFC assumed the same pattern as regular RFC loans. Hence, if a local bank was prepared to supply the capital, there was no necessity for action by either the SDPA or the RFC. If the converse were true, then, the RFC could participate with a local bank, or, finally, grant a direct loan to the prospective borrower.36

In addition to recommending loans for a small business, SDPA was authorized to certify to procurement agencies the competency of a firm with respect to credit and capacity to perform a specific government contract. This certification of SDPA had to be accepted by the procurement office as conclusive. The SDPA was also given a $50 million revolving fund for purchases or lease of land and production equipment for sale or lease to small business.37 This was in addition to the power to recommend loans up to a total of $100 million outstanding at any one time.

36 Ibid.

It may be recalled that the Smaller War Plants Corporation of World War II frequently operated in cooperation with private lending agencies. Its original grant of $150 million was later increased to $350 million to meet financial needs of small business. The SWPC authorized, from 1942 to 1945, 6,000 loans amounting to over a half billion dollars. Nearly two-thirds of the number of these loans were for amounts less than $25,000 and about 95 percent were made to firms employing fewer than 250 workers. Losses amounted to less than 1 percent of the total amount in spite of the fact that borrowers could seldom meet standard credit tests. Also, in numerous instances it happened that upon being supplied with the results of an investigation made by the SWPC, commercial banks would make a loan which had previously been denied.

The number of applications for financial assistance and the number of loans authorized by RFC upon recommendation of SDPA did not reach very large proportions. In approximately the first 10 months of operation, only 120 loans were granted totaling approximately $11 million dollars. At the beginning of the SDPA liquidation on September 29, 1953, there were outstanding 1.5 million in

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small business loans. It may be anticipated, nevertheless, that the SDPA plan of operation will be cited frequently in future years when proposals are submitted for governmental aids for the financing of long-term needs of small business.

**FEDERAL RESERVE BANK LOANS**

The Federal Reserve Banks came into the small business loan picture in 1934 when they were authorized by amendment of the Federal Reserve Act to loan directly to business enterprises. Under Section 13(b) of the above act, Federal Reserve Banks are permitted to make direct loans to industrial and commercial businesses under circumstances where the latter are unable to obtain money from usual sources on reasonable terms. The Reserve Banks may also discount or make purchase commitments with any bank in their respective districts. Loans must be confined to working capital purposes and must not have a maturity in excess of five years. New concerns may not be accommodated as the loans are available only to established businesses.

In view of these restrictions, the use of Section 13(b) loans has not been extensive. Up to November 30, 1953,

there had been $800,420,000 in industrial loans approved since the inception of the program in 1934 represented by 3,764 loans. On the above date there were only $2,546,000 in loans outstanding.

There is no recent information available concerning the extent of participation by small business in this program. Since the only analysis made of this type of lending was between the dates of June 19, 1934 and December 29, 1937, of necessity, these figures must be used. A breakdown of the 2406 loans totaling $150,982,000 during this period showed that only $4,703,000 or 3.1% of the aggregate amount advanced was in loans of $10,000 or less. At the other extreme loans of over $50,000 totaled $118,894,000 or 79 percent of the entire amount. Furthermore, except for 1942, the first full year of our participation in World War II, Federal Reserve direct loans have been declining steadily since 1935 and are now of almost negligible proportions. Only 341 of these loans were granted


41 Seventy-sixth Congress, 1st Session, U. S. Senate Hearings of the Committee on Banking and Currency. S 1482, A Bill to Provide for the Insurance by the RFC of Loans Made by Banks to Business Enterprises, Washington, D. C., 1939, p. 115. This represented 899 of the 2406 loans or 37 percent.

42 Ibid. There were 563 loans, or 23 percent in excess of $50,000.
from 1942 to November 30, 1953.43

In 1940, Mr. Jesse Jones very ably summarized the extent of this program when he criticized the failure of the Federal Reserve System to make business loans:

Congress passed this act in June 1934, 6 years ago, and the Federal Reserve Banks were authorized to make loans direct to business to the extent of approximately $280,000,000. To enable the Federal Reserve Banks to make these loans, the Federal Treasury was authorized to advance to them an aggregate of $139,299,557. This money was to be returned to the Treasury by the banks at the rate of 2 percent a year if earned—-at best, in 50 years without interest. So they were, in fact, lending 50-cent dollars, and yet in lending 50-cent dollars the most they had outstanding at any one time was approximately $32,000,000 in the 6-year period; $27,500,000 of that they got from the Treasury. They keep that money; they do not give it back to the Treasury. They give the earnings from those loans back to the Treasury, up to 2 percent.

Therefore the net result is that they have accumulated in their own surplus accounts $26,500,000 of Treasury money, but it now belongs to the Federal Reserve Banks, and they have only $11,000,000 outstanding in loans.

The result of this Federal Reserve Bank lending to business is that they have increased their surpluses and they have helped business very, very little.44

From the foregoing study it must be concluded that the Federal Reserve Banks have not exercised to any appreciable extent their authority to make direct loans for small business. Furthermore, it would seem that the program is


44 Daughters, op. cit., p. 72.
so inactive at present as to warrant its repeal, and that either some more workable program be instituted in its place, or preferably, that all direct government loans to small business be made through the Small Business Administration.45

**Guaranteed Loans or V-loans**46

Ordinarily a local bank will provide short-term credit for payrolls, inventories, and goods-in-process. Frequently, however, the bank believes that a loan requested is in excess of what is considered a normal lending risk. It may also exceed its legal lending limitations. It may, therefore, seek some guarantee of repayment, provided the loan can qualify.

Section 501 of the Defense Production Act of 1950 provides for government guarantees of loans, discounts, or advancements made by financing institutions where the contract is deemed by the guaranteeing agency to be necessary to expedite production and deliveries or services for the

45 Proposals for improving this program are discussed in Chapter VI.

46 Guaranteed loans or V-loans are discussed under the Federal Reserve Banks since they act as the fiscal agents for this type of lending even though some other agency does the guaranteeing. Although small business has not participated extensively in this program it is being discussed because numerous proposals for guaranteed business loans cite V-loans as a precedent.
national defense. The "guarantee" means that a government agency will purchase a certain percentage of a bank loan on demand of a lender and will share losses in the amount of the guaranteed percentage.

The Departments of the Navy, Army, Air Force, Commerce, Interior, and Agriculture, the General Services Administration, the Atomic Energy Commission, and the Defense Materials Procurement Agency have been designated as guaranteeing agencies. In each instance where a guarantee is requested, the agency having the preponderance of interest in the contract will make the guarantee. The Federal Reserve Banks are authorized to act as fiscal agents.

Since guaranteed loans are for working capital purposes, the maturities of the loans are generally between 12 to 18 months; hence, this is not a source of long-term financing. A maximum rate of 5 percent is permitted lending banks. The guaranteeing agency receives a fee based upon the percentage of the loan guaranteed.

As of November, 1953, authorized V-loans amounted to $2.3 billion, of which $837 million was outstanding.

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48 Ibid.

49 These fees are published monthly in the Federal Reserve Bulletin.

### TABLE IX

PERCENTAGE DISTRIBUTION OF V-LOANS AUTHORIZED THROUGH JUNE 30, 1952, BY ASSETS OF BORROWER

<table>
<thead>
<tr>
<th>Assets of Borrower</th>
<th>Percentage of Guaranteed Loans Authorized</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
</tr>
<tr>
<td>Under $50,000</td>
<td>5.0</td>
</tr>
<tr>
<td>50,000 to 99,999</td>
<td>7.7</td>
</tr>
<tr>
<td>100,000 to 249,999</td>
<td>15.9</td>
</tr>
<tr>
<td>250,000 to 499,999</td>
<td>16.7</td>
</tr>
<tr>
<td>500,000 to 999,999</td>
<td>16.0</td>
</tr>
<tr>
<td>1,000,000 to 2,499,999</td>
<td>18.1</td>
</tr>
<tr>
<td>2,500,000 to 9,999,999</td>
<td>14.3</td>
</tr>
<tr>
<td>10,000,000 to 49,999,999</td>
<td>4.8</td>
</tr>
<tr>
<td>50,000,000 and over</td>
<td>1.5</td>
</tr>
</tbody>
</table>


Of the 1950 V-loans authorized through June 30, 1952, Table IX shows that only 13 percent of the number and less than 1 percent of the amount of authorized loans were to borrowers with assets of under $100,000.51

51 The Federal Reserve guaranteed $10.5 billion in loans to businesses during World War II from 1942 to 1945 under the provisions of Regulation V pertaining to defense production. A breakdown of these loans confirms the experience of the Korean hostilities; only 1 percent went to businesses with assets of under $50,000. Yet, when the Chairman of the Board of the Federal Reserve System discussed the breakdown of V-loans before the Senate Small Business Committee, he said that it showed
The small amount of loans going to small business may reflect several factors, namely, the size of the loans desired, the ability of banks to handle most working capital loans of small business, and the relatively small share of defense contracts handled by small business. Also some banks might prefer to extend credit at 6 percent rather than to participate in a guarantee where interest is fixed at 5 percent. Recognizing the relatively minor role played by small business in the defense effort it appears that those firms actually engaged in defense contracts secured credit from private sources in order to take care of their working capital needs.

VETERANS' LOANS

In regard to small business, perhaps the most important part of the "G.I. Bill of Rights" is that dealing with the establishment of qualified World War II veterans in small independent businesses. Under this Act, the Veterans Administration was authorized to guarantee bank loans up to 50 percent of each loan, with a $4,000 maximum guarantee for

51 (cont'd.) that about one-third of the amount went to small business. Mr. McCabe was referring to small businesses as those "with total assets of less than $5,000,000." See Small Business Act of 1950, Senate Committee Print, 81st Congress, 1st Session, pp. 129-130.

52 This "Bill" is officially titled "Serviceman's Readjustment Act of 1944."
real estate and a $2,000 maximum for non-real estate loans. In 1950 the Veterans Administration was authorized to guarantee real estate loans up to 60 percent of each loan, with a $7,500 maximum.53 On May 2, 1953, the interest rate permitted on the above loans was increased to 4½ percent.54 The maturities on lower priced homes is now permitted to extend a maximum of 30 years.

The RFC was authorized to make non-real estate loans directly in cases where banks would not participate and the Veterans Administration was authorized to make real estate loans directly in similar cases.55 Since the liquidation of the RFC the direct lending power on non-real estate loans is a function of the SBA.56 There has been only negligible use of this provision. Such was not the case with the direct loan provision on real estate. On September 30, 1953, there were outstanding a total amount of $233,300,000 in this type of loan.57

53 "National Housing Act of 1950," Congressional Record, April 20, 1950, p. 5410. This provision is contained in Title IV.


55 These provisions were authorized by Congress in 1950.


57 United States Treasury Department, "Veterans Direct Loan Program." Treasury Bulletin, January, 1954, p. 70. A revolving fund of $500 million has been allocated to this program.
On September 4, 1953 the Veterans Administration reported they had guaranteed over 3 million loans valued at 20 billion dollars.\textsuperscript{58} Although the vast majority of these loans have been "home" loans, it is frequently argued that these loans have promoted new businesses indirectly by releasing savings for business investment. However it is just as plausible that these real estate loans could have retarded new business formation by the absorption of the veterans' existing savings in order to make the necessary down payments. Thus, it would not be prudent to impute to veterans' loans more than the facts warranty, namely, that only a small percentage went into new business ventures.\textsuperscript{59}

It is probable that the lack of demand for non-real estate loans was due primarily to the comparatively young age of the average veteran. Therefore, the veteran benefits are useful as an aid to rehabilitation, but probably will never be a fertile source of new business capital.\textsuperscript{60}

\begin{flushleft}
\textsuperscript{58} "VA Reports over 3 million Loans Valued at 20 Billion," New York Times, September 4, 1953. In 1950 the VA reported that 96 percent of the loans that were guaranteed were real estate loans and 3 percent and 1 percent non-real estate and farm loans respectively.

\textsuperscript{59} Since direct loans by the RFC were negligible most of the guaranteed loans would be included under funds obtained from commercial banks, and would so appear in any statistical survey.

\textsuperscript{60} In most cases the guaranteed loan would be available only once since the veteran exhausts his privilege when he has utilized the maximum amount permitted under the Act.
\end{flushleft}
SUMMARY

From the evidence presented above, it would appear that governmental lending agencies have provided directly for only a small percentage of the great mass of small firms' credit needs. Hence, in spite of much publicity, small business has received virtually no direct assistance from public sources. However, it is apparent that these agencies have provided useful experience and background in their dealings with small business financial needs not met by customary sources. In addition, as residual lenders, their positions make them a potential threat thus influencing somewhat lending policies of private institutions.

At present the Small Business Administration is the only institution actively lending to small business. In the past few months it has liberalized its credit standards, and, therefore, should play a larger role in small business financing in the immediate future. This agency is the successor to the Reconstruction Finance Corporation, the latter dating back to 1932. While the RFC did not lend extensively to small business, its favorable experience with loans of longer maturities was instrumental in encouraging banks to make term loans to business. The RFC attempted, as does the SBA, to promote a credit relationship between banks and business by emphasizing bank participation loans.

In order that small manufacturers might engage in defense production, the Smaller War Plants Corporation was
originated during World War II, and the Small Defense Plants Administration was organized during the Korean conflict. These agencies have also provided background for future proposals to aid small business even though SWPC loans, or SDPA recommendations for loans did not relate to conditions of normal production, where financing is dependent upon the ability of the small firm to make and maintain its place in the competitive market.

Section 13(b) loans by the Federal Reserve Banks have not been of any assistance to small business, and it is doubtful if they ever will be unless Section 13(b) provisions are liberalized. Business loans guaranteed by the Veterans Administration have not been utilized very extensively and no use has been made of the direct loan privileges to veterans through the RFC and the SBA.

From the discussion concerning private and public sources of long-term capital, it is obvious that the vast majority of new, small businesses acquire their initial capital from the savings of the owners or from friends and relatives. The future needs of established businesses must be supplied principally out of the reinvestment of earnings or from depreciation reserves, particularly those funds needed for expansion. Therefore, small business in particular has an interest in the maintenance of a prosperous economy, which will provide the necessary background for the formation and growth of small businesses.
With the completion of the discussion of the available sources of long-term capital for small businesses, the first objective of this study has been fulfilled. In the following chapters, attention is directed to the second objective, namely, an investigation and evaluation of the results of the primary survey conducted in Columbus, Ohio, covering small incorporated businesses organized during 1953.
CHAPTER IV

A CASE STUDY—SURVEY IN COLUMBUS, OHIO OF SMALL BUSINESSES INCORPORATED IN 1953

INTRODUCTION

Since the information sought in this study was of a confidential nature, the interview method was used exclusively. Throughout the spring of 1954, the top executives of 43 firms located in Columbus, Ohio, and incorporated during 1953, were interviewed by the writer. Ten corporations could not comply with the definition of small business set forth in Chapter 1; therefore, the analysis is confined to the 33 firms which did qualify as small businesses.¹ The 33 firms which were included represented 18 percent of the 180 new incorporations of Columbus firms during 1953; the total capital stock investment of $806,520 made by the firms included in the survey represented 26 percent of the total of $3,531,306 for all

¹ The names of the cooperating firms are listed alphabetically in Appendix 1. The ten firms which were excluded could not qualify for the following reasons: 5 were subsidiaries of non-Columbus firms; 3 were incorporated prior to 1953; 1 has remained dormant through its corporate life, and 1 chose to remain unincorporated.
Columbus firms. New businesses included construction companies, manufacturers of special machinery, chemicals, industrial supplies, electronic equipment and television equipment, as well as wholesale and retail establishments of a very diversified nature. Of the firms included in the survey, fourteen were manufacturing and construction; six were wholesaling, and thirteen were retailing and service. They had an initial long-term capital investment of $540,020, $252,500, and $249,000 respectively.

Reasons for Inclusion of Non-financial Data

Every businessman who owns a profitable enterprise realizes that persons who learn of his success will be tempted to try to repeat his good fortune. Indeed, many people would like to own a business. Certainly, if all of these individuals established enterprises there would be

2 Of the 180 firms, there were 39 contractors; 37 retailers; 28 service industries; 27 real estate companies; 26 manufacturers; 15 wholesalers; 6 finance companies; and 2 research organizations. The retail establishments not interviewed were subsidiaries of non-Columbus parent firms. The service organizations ordinarily were part-time ventures; therefore, few were included. Upon investigation, the real estate firms were generally found not typical of small businesses since most represented holding companies or small realty firms which were capitalized very modestly.

3 In addition to the total capital stock of $806,520, there was present $235,000 in promissory notes making the total investment for all 33 firms $1,041,520. See Chapter V for further discussion.
unpredictable repercussions. However, the ambitions of most of these people are thwarted by the lack of capital.

In order to operate, every business requires the use of many goods and services. All businesses use plant and equipment of some sort and as a rule they must acquire or make their goods in advance of their sale. Furthermore, to meet competition of established firms, new businesses must undertake promotional efforts in order to acquire customers.

These necessary requirements of new firms are available only to people who can pay for them immediately, or who can convince suppliers of their ability to pay in the future. In the second chapter, it was indicated that the initiators of new businesses frequently obtain financial assistance which augments their own resources. This includes both short and long-term capital. The use of funds which do not belong to the entrepreneur is not, however, unique to new firms; practically all firms have debts.

Investment in new enterprises is generally considered more risky than investment in going businesses. The uncertainty of the fortunes of a new firm results in part from the fact that management is untried in its new situation. The company does not have a history upon which potential lenders can base estimates of its future profitability. It is easier to estimate what an established firm will earn than to guess what a new one will earn.
Because new firms are generally small, untried, and unfamiliar to potential lenders and investors, there is no easy way to overcome the barrier to entry created by the need for capital, should the entrepreneur's resources be insufficient.

Failure to start new businesses on a scale that permits economical operation often means that the firms will not survive infancy. Only successfully launched firms will have the vitality to continue to grow. Thus, since histories of the firms are unobtainable, perhaps a study of the social and economic characteristics of promoters will prove beneficial to potential investors and lenders of small businesses. Information as to the sources of the ideas, factors influencing the locations, and preliminary customer analyses undertaken by the promoters may also prove invaluable in helping a prospective investor or lender make his decision whether or not to invest in a particular firm. These factors are all intermingled inextricably with capital requirements and, therefore, cannot be ignored by lenders and others. The obvious need for capital in order to supplement that of the promoters' makes it imperative that non-financial characteristics of promotions of new firms be studied.
SOCIAL AND ECONOMIC CHARACTERISTICS OF PROMOTERS

Is There A Promoter Type?

It is often asserted that businesses are initiated by the most imaginative, intelligent, and daring members of the community. On the other hand, experts who have analyzed industrial history in some detail often describe entrepreneurs as over-optimistic, guilty of excessive self-esteem, inexperienced, uninformed, and untrained. The favorable point of view seems to take into consideration the persons who introduce new products, new methods of production, or new methods of sale. The opposite viewpoint is chiefly with reference to individuals who set themselves up in mature trades without departing significantly from the established practices of the rest of the trade. The two views are not inconsistent; they are descriptions of different things. The first may be describing successful businessmen and the second those who attempt business ventures.

Psychology has thus far been unable to isolate any factors which will throw any light on the difference between entrepreneurs and non-entrepreneurs. Furthermore,


4 Cover, John. Problems of Small Business. T.N.E.C. Monograph No. 17, p. 84.
the following quotation implies that it cannot help in distinguishing between the favorable and unfavorable viewpoints set forth in regard to business promotors or originators. Thus:

"Psychology has not been developed sufficiently to enable us to distinguish with confidence between daring on the one hand and over-optimism or misinformation on the other. A person who bets on long shots and loses is likely to be considered over-optimistic; but should he succeed, many will consider him venturesome. If he bets on himself when the odds are against him, few will call him daring if he should fail, or conceited if he should succeed. In the absence of evidence that entrepreneurs constitute a unique psychological type, it may be fruitful to investigate their social and economic characteristics."

Since psychological bases for entrepreneurship are nonexistent, entrepreneurs can perhaps be distinguished by social or economic characteristics. Thus the balance of this chapter describes several characteristics of the promotors who originated incorporated businesses in Columbus, Ohio, during 1953. In the absence of evidence to the contrary, it is believed by the writer that they probably typify entrepreneurship generally.

**Age of Business Promotors**

By and large, businesses are started by persons of mature age with considerable business experience. It is unlikely that many young people possess, or are able to

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borrow, sufficient capital to start a business. Consequently, practically all people who own businesses have worked as employees of other firms. Since personal incomes of even better-paid employees generally do not permit the rapid accumulation of savings, the decision to establish a business is influenced by this lack of capital. It was noted in a previous chapter that a much larger amount of capital is necessary to promote a new firm than was the case before World War II. This would make the question of accumulation of savings more acute when at the same time the tax on personal incomes has increased substantially since 1940. Furthermore, most people must take employment in order to gain experience before establishing their own enterprises even though they may possess the necessary capital.

The desire of a young person to start a business also may be less than that of an older person. While someone who has worked a number of years may have become more acutely aware of the difficulties of running a successful business, he may also have gained confidence in his ability to direct one.

Table X shows that twenty-three of the thirty-three officers were between thirty-one and forty-five years of age when they began operations; the mean average being forty. Because of the need for an accumulation of experience and capital, it is readily apparent that the
typical small businessman has reached a rather mature age.

TABLE X

AGES OF THE PRIMARY OFFICERS OF SMALL BUSINESS CORPORATIONS
ESTABLISHED IN COLUMBUS, OHIO, DURING 1953

<table>
<thead>
<tr>
<th>Age</th>
<th>Number of Officers</th>
</tr>
</thead>
<tbody>
<tr>
<td>26-30</td>
<td>2</td>
</tr>
<tr>
<td>31-35</td>
<td>8</td>
</tr>
<tr>
<td>36-40</td>
<td>9</td>
</tr>
<tr>
<td>41-45</td>
<td>6</td>
</tr>
<tr>
<td>46-50</td>
<td>4</td>
</tr>
<tr>
<td>51-55</td>
<td>2</td>
</tr>
<tr>
<td>56-60</td>
<td>1</td>
</tr>
<tr>
<td>61-65</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>33</strong></td>
</tr>
</tbody>
</table>

Educational Background of Business Promoters

It is quite possible that the average age of persons going into business has risen during the past few decades. This could reasonably be expected because of increased educational requirements necessary to gain a technical proficiency as well as to attain a social respectability. Consequently, Table XI shows that businessmen stay in school longer, since over fifty percent have had college training. If they remain as employees for the same period
as in former times, they naturally are older when they
 go into business for themselves. 6 While no attempt will
be made to generalize statistically from the data because
of the small sample, it is readily apparent that the new
business of today is formulated by a person of considerable
educational training.

TABLE XI

HIGHEST EDUCATION ATTAINED BY THE PRIMARY OFFICERS OF SMALL
BUSINESS CORPORATIONS ESTABLISHED IN
COLUMBUS, OHIO, DURING 1953

<table>
<thead>
<tr>
<th>Type of Institution</th>
<th>Number of Officers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Grade School</td>
<td>1</td>
</tr>
<tr>
<td>High School</td>
<td>9</td>
</tr>
<tr>
<td>Trade School</td>
<td>5</td>
</tr>
<tr>
<td>College</td>
<td>14</td>
</tr>
<tr>
<td>College - Graduate Education</td>
<td>4</td>
</tr>
<tr>
<td>Total</td>
<td>33</td>
</tr>
</tbody>
</table>

6 It is obvious that a contrary conclusion could be drawn;
namely, higher education could conceivably shorten
experience requirements, and by the securing of better-
paying positions could aid in the accumulation of
capital. Nevertheless, because of higher taxes and
greater management complexities, it is probable that
the experience period as an employee has not declined
and may, indeed, be of even longer duration.
Marital Status of Business Promoters

A study of the marital status of the thirty-three entrepreneurs revealed that thirty-one were married. Since approximately the same result would be attained by sampling a similar age group from the population at large, initiators of businesses do not differ in this respect from the community at large.

TABLE XII

MARITAL STATUS OF THE PRIMARY OFFICERS OF SMALL BUSINESS CORPORATIONS ESTABLISHED IN COLUMBUS, OHIO, DURING 1953

<table>
<thead>
<tr>
<th>Present Status</th>
<th>Number of Officers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>2</td>
</tr>
<tr>
<td>Married</td>
<td>31</td>
</tr>
<tr>
<td>Total</td>
<td>33</td>
</tr>
</tbody>
</table>

Previous Experience of Business Promoters

With the exception of outstanding success stories, most studies of the initiators of new business have been concerned with the previous business experience of individuals who had failed in some business undertaking. The analysts who have made these studies are all agreed that many business failures are due to the inexperience of their owners.7 At the same

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7 The previous experience of owners of firms which go bankrupt may not be a reliable indicator of the previous
time, most of them indicate that a sizeable majority of proprietors were formerly engaged either as owners or employees in the line in which they established themselves and in which they failed.\(^8\)

The business experience of prospective entrepreneurs had an important bearing on the amount of capital available to them. Twenty-three or approximately 70 percent of the executives interviewed were employees in a similar business or previously owned a smaller business of the same type. As an employee or an owner, they acquired technical knowledge of the business and generally had an opportunity to accumulate some capital.

All of the 23 businessmen in this group told the writer that they would be unwilling to go into a business in which they had no experience. To the suggestion that they could employ others experienced in the industry, a number replied that they would not trust their ability to hire help

---

7 (cont'd.) experience of all entrepreneurs. It is generally accepted that promoters of businesses which reach the bankruptcy courts are less experienced in their chosen occupations than are those whose ventures survive. On the other hand, bankrupt concerns are probably much larger than average, both at the time of entry and at the time of failure. Therefore, the initiators of bankrupt concerns may have either more or less related experience than the average entrepreneur.

8 Oxenfeldt, op. cit., p. 87.
intelligently for a business with which they themselves were unfamiliar.

Ten of the officers or 30 percent had no experience related to their present businesses. However, all have had other experience. This group claimed that the training of many executives is of such a nature that it is transferable and almost equally applicable to the operation of a business producing a different or a familiar product or service. Thus, they have selected and rely upon other people to do things of which they themselves have little knowledge. Therefore, they claimed they did not find operating an unfamiliar business very different from operating one in which they were experienced.

Generally speaking, as seen in Table XIII, there is an inverse relationship between the amount of related to unrelated experience. In no instance was any owner completely lacking in business experience. Of the 10 having no related experience, all had a considerable amount of background experience in other areas. On the other hand, 14 of the 23 with related experience had no experience at all in other areas. Thus, these figures readily account for the answers given as to the desirability of having extensive training or experience closely tied in with the present business.

For 17 of the 33, or approximately 50 percent, the present business represents their first venture.
<table>
<thead>
<tr>
<th>Years of Experience Related to Present Business</th>
<th>Number of Officers</th>
<th>Average Number of Years</th>
<th>Years of Experience Unrelated to Present Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>None</td>
<td>10</td>
<td>---</td>
<td>None</td>
</tr>
<tr>
<td>1-10</td>
<td>12</td>
<td>6</td>
<td>1-10</td>
</tr>
<tr>
<td>11-20</td>
<td>4</td>
<td>19</td>
<td>11-20</td>
</tr>
<tr>
<td>21-30</td>
<td>6</td>
<td>25</td>
<td>21-30</td>
</tr>
<tr>
<td>31-40</td>
<td>1</td>
<td>40</td>
<td>31-40</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>33</strong></td>
<td><strong>xx</strong></td>
<td><strong>None</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>1-10</th>
<th>11-20</th>
<th>21-30</th>
<th>31-40</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>None</strong></td>
<td>4</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>1-10</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>11-20</td>
<td>3</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>21-30</td>
<td>6</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>31-40</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Total: 14, 9, 6, 2, 2
TABLE XIV

PREVIOUS BUSINESS VENTURES OF THE PRIMARY OFFICERS OF SMALL BUSINESS CORPORATIONS ESTABLISHED IN COLUMBUS, OHIO, DURING 1953

<table>
<thead>
<tr>
<th>Number of Previous Ventures</th>
<th>Number of Officers</th>
</tr>
</thead>
<tbody>
<tr>
<td>None</td>
<td>17</td>
</tr>
<tr>
<td>1</td>
<td>9</td>
</tr>
<tr>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>25*</td>
<td>2</td>
</tr>
<tr>
<td>Total</td>
<td>33</td>
</tr>
</tbody>
</table>

*Consisted primarily of collapsible real estate corporations.

Disregarding the two who have participated in numerous collapsible real estate corporations the remaining 14 had participated in either one or two other businesses, usually on a partnership basis. Eight were in entirely unrelated fields and the majority still retain some interest in them, either as a minority owner or as a holder of a note received as partial payment for their share of the business. Three partnerships were dissolved because of dissatisfaction among the owners as to the conduct of the business. Another owner sold out a similar business in Oklahoma and moved to central Ohio in order to exploit what he believed to be a more profitable area for that type of business. The
thirteenth previous owner sold out his share of an unrelated business to secure a profit and to get sufficient funds to open his present organization. Finally, the remaining partial owner of a previous business dissolved a partnership because of the retirement of the other partners and then immediately incorporated to retain the good will built up by his previous business associations.

As a rule, the 14 who were part owners of previous ventures held minority interests and the present firm represents their first opportunity to exert a majority control over a business enterprise. Thus, a detailed study of the success or failure of their prior ownership experiences would not be too revealing due to a contamination by interests that exert no influence on the present venture, beneficially or otherwise.

THE ORIGIN OF THE IDEA

Introduction

The reasons for establishing a business vary greatly. However, they probably can be divided into two broad categories; namely, (1) preferences over employee status, or (2) efforts to exploit opportunities which may prove to be profitable. There is an obvious overlapping of the two categories although in all cases one was said to be dominant over the other. Of the 33 officers interviewed, 28 said that they incorporated primarily to exploit an apparently
116

profitable situation. Nevertheless, all 28 admitted that the desire for independence did play a significant role in the decision to exploit the opportunity. The balance of the 33 stated that the desire to be an independent businessman was the factor that motivated them to search out likely prospects for establishing a business.

The Immediate Economic Factor Causing the Formation of the Business

Regardless of the psychological desire for independence 28 of the 33 stated that economic considerations were paramount in the decision to form a business. The remaining five conceded that their desire for independence hastened the search for new business prospects. In all cases the business was not incorporated until the promoters had made investigations designed to discover economic justification.

As can be seen in Table XV, salesmen seem to have an exceptionally favorable position to secure valuable sales areas or contracts for special orders. District supervisors or successful salesmen of manufacturing firms secured in eight instances valuable territories to exploit as wholesalers, manufacturers' agents, or dealers. This was possible because of their favorable sales experiences with the company, and thus they were able to secure an exclusive territory before there was common knowledge that the specific territory was open or soon to be open. With an intimate knowledge of the merchandise and salesmanship
necessary for the particular line of goods they were in an excellent position to assess the potential sales market. They had access to the sales and accounting records of the previous business, and frequently much of the good will was transferable due to consumer preference for the product. In all instances, it was supplemented by the patronage already possessed by the salesman. In certain trades, i.e., plumbing supplies, road machinery, petroleum products, it is common practice for a salesman to build up a following—a group of customers who will buy from him no matter what his business affiliations. Because of the exclusive territorial privileges and the existing patronage of the new owners, in all eight instances these firms were immediately very profitable.

Closely related to the above cases, in four instances a contract was secured to undertake a specific job or order. Generally, a request for a bid was submitted to the former place of employment. As a rule the specifications were not in the scope of operations of the firm; hence, the employee secured permission to bid on the job. Upon notification of a successful bid, operations were begun to fulfill the contract. This can best be exemplified by the successful bidding on the installation of 600 heating units which could not be handled by the company to which the bid was submitted. Having thus set up the organization, it was decided to carry on after the completion of the original contract.
### TABLE XV

**The Immediate Factor Causing Primary Officers of Small Business Corporations Established in Columbus, Ohio, During 1953, to Incorporate**

<table>
<thead>
<tr>
<th>Immediate Factor Responsible for Incorporation by Officer</th>
<th>Number of Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obtained an exclusive area, either as a wholesaler, manufacturer's agent or dealer</td>
<td>8</td>
</tr>
<tr>
<td>Secured a contract to undertake a specific job or order</td>
<td>4</td>
</tr>
<tr>
<td>Secured an option to purchase</td>
<td>4</td>
</tr>
<tr>
<td>To carry out further research believed commercially feasible</td>
<td>3</td>
</tr>
<tr>
<td>To exploit a demand recognized during previous place of employment</td>
<td>3</td>
</tr>
<tr>
<td>To utilize capital made available by capitalists to carry out idea held for some time</td>
<td>3</td>
</tr>
<tr>
<td>To take advantage of favorable economic conditions</td>
<td>2</td>
</tr>
<tr>
<td>Formed new corporation to capture customers of a former partnership dissolved because of retirements</td>
<td>1</td>
</tr>
<tr>
<td>Secured a location in a shopping area at reasonable rental</td>
<td>1</td>
</tr>
<tr>
<td>To aid financing</td>
<td>1</td>
</tr>
<tr>
<td>To preserve investment extended in the form of accounts payable for development costs</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>33</strong></td>
</tr>
</tbody>
</table>
In four cases options to purchase were secured, and as a result the formation of the business took place to take advantage of these options. Two of these represented options to purchase assets of businesses being liquidated and the other two were options to purchase land to be used for subdividing. All four parties were professional men, consisting of two lawyers, a public accountant, and an educator. In all four instances they secured the option by virtue of their professional connections, and each had acquired a detailed and first-hand knowledge of the type of endeavor he was entering.

In three businesses the owners incorporated to perfect an idea thought to be commercially feasible. In each case the product was designed for industrial usage and each venture represented an attempt to make a product superior to that currently being used, but at a far lower cost due to a lower material and labor input. Each owner had an intimate knowledge of his field, and each conceived the idea in an attempt to lower costs for the firm by which he was formerly employed. For example, one firm is producing plastic gears which are claimed to be as serviceable as those made of the hardest steel.

Closely connected to the preceding cases were three firms started to exploit a demand recognized as a result of the prior employment of the incorporators. In a typical case, one owner was formerly employed by a shoe company
which produced a line of children's dancing shoes. Customers continually besieged the company with requests for information as to a good source of children's dancing tights." Upon investigation, it was discovered that no existing company catered specifically to this type of article. An expert was engaged to design a suitable garment, and after several attempts, an acceptable article resulted, which could be produced at a reasonable cost. The garment was an immediate success in what now appears to be a relatively stable industry.

The next four items appearing in Table XV are self-explanatory, however, a brief explanation will be given regarding the last two items. One corporation was set up merely to aid the financing of equipment to be acquired by a small business anticipating a rapid growth resulting from increased sales efforts. Thus all machinery acquired subsequent to incorporation will be sold to the new corporation and then leased back to the operating organization. Finally, a corporation was formed to preserve an investment extended in the form of accounts payable for development costs. These accounts were capitalized by the corporation with the lender thereby receiving a majority interest in the newly-created corporation.

**Extent of Time the Idea was Considered Before Incorporating**

The length of time during which the formation of the business was considered varies greatly. It varies from
less than a week to approximately seventeen years. The lapse of time in most cases can readily be explained by reference to the factors responsible for incorporation. In sixteen instances, either a specific contract or the securing of an exclusive agency was responsible for the formation, therefore, only a relatively modest amount of time would be available to consider the feasibility of going into business. Hence, this explains why eighteen officers deliberated less than six months before beginning operations.

**TABLE XVI**

**EXTENT OF TIME THE PRIMARY OFFICERS OF SMALL BUSINESS CORPORATION ESTABLISHED IN COLUMBUS, OHIO, DURING 1953 CONSIDERED THE IDEA BEFORE INCORPORATING BUSINESS**

<table>
<thead>
<tr>
<th>Amount of Time Idea Was Considered</th>
<th>Number of Officers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 1 month</td>
<td>14</td>
</tr>
<tr>
<td>From 1 to 6 months</td>
<td>4</td>
</tr>
<tr>
<td>Approximately 1 year</td>
<td>8</td>
</tr>
<tr>
<td>Approximately 2 to 5 years</td>
<td>4</td>
</tr>
<tr>
<td>Approximately 6 to 10 years</td>
<td>2</td>
</tr>
<tr>
<td>Approximately 17 years</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>33</strong></td>
</tr>
</tbody>
</table>
Eight incorporators considered the proposition for approximately one year: the period of time required to complete research projects already begun, to investigate a potential demand, or merely to seek capital funds.

Two of the three persons who debated over six years readily admitted they vacillated for years, then they decided the economic climate probably would not improve much in the relatively near future, therefore, operations were begun. The one remaining consciously pursued a prescribed schedule in order to get the required experience to form his own business eventually.

THE SELECTION OF THE LOCATION

Ten of the firms interviewed were founded by non-residents of Columbus prior to the establishment of the business. The advantage of Columbus' geographical location was most vital in six cases since it was situated in the center of the potential sales area. In each case the business was given an exclusive area to exploit, generally consisting of a large segment of the State of Ohio. Therefore, Columbus represented the logical choice as a place to conduct their business operations. The two businessmen who stated that their wives were instrumental in selecting Columbus to be near relatives conceded that they offered slight resistance when the ideal location and tremendous potential market were considered.
### TABLE XVII

FACTORs DETERMINING SELECTION OF COLUMBUS BY NON-RESIDENT PRIMARY OFFICERS OF SMALL BUSINESS CORPORATIONS ESTABLISHED IN COLUMBUS, OHIO, DURING 1953

<table>
<thead>
<tr>
<th>Major Factor Influencing Selecting of Columbus as Business Site</th>
<th>Number of Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Centrally located in potential sales area</td>
<td>6</td>
</tr>
<tr>
<td>Wife desired to be near relatives</td>
<td>2</td>
</tr>
<tr>
<td>Skilled labor available</td>
<td>1</td>
</tr>
<tr>
<td>Near other business interests</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>10</strong></td>
</tr>
</tbody>
</table>

**The Demand for Industrial Space**

Manufacturing concerns that are seeking to lease or buy a building must consider the appropriateness of the building for their intended operations. Some of the factors that are especially important are area, shape, and design of the building, possibility for expansion, strength of construction, trackage facilities, natural light and ventilation, artificial lighting, and occasionally elevators. For all industries adequate facilities for truck transportation are important.

Generally, manufacturing concerns are the most cost-conscious. They discovered, as a rule, several eligible
sites, and the location that could be secured on the most favorable monetary terms was selected. This was true even though more desirable physical plants were available at higher rentals. Also, as a long-range goal, these firms frequently expressed the desire to eventually purchase land and to construct modern facilities thereon. This desire probably explains why none of the firms which are renting their present facilities had an option to purchase them.9

The Demand for Wholesale Space

High among the location requirements of wholesalers is convenience to transportation facilities. Railway track service is highly desirable in certain instances, but in every case the availability of truck transportation and the facilities for loading and unloading are by far more important.

In general, wholesalers prefer to locate as closely as possible to the group that they serve when their market is local in scope. One firm that employed an outside sales force said that the location in regard to its customers was unimportant. The remaining five wholesalers interviewed stated that they considered it advantageous to be near competitors as well as to their potential customers. In

9 Eleven of the fourteen manufacturing and construction firms are renting their present land and buildings.
many lines of merchandising the customer visits the wholesale market and thus comparison is facilitated if the wholesalers are clustered. In such cases, a location in the wholesaling district is imperative for a new firm. Therefore, an electrical wholesaler would be at a distinct disadvantage if he failed to locate in his specialized district. Since five of the six wholesalers interviewed had primarily a local market, that would explain why they considered the rental cost only after they found a suitable location. Therefore, in the early months of the business when sales volume has not yet been realized, the rental represents a major burden on the firm.

The Demand for Retail Space

The demand for retail space is founded on the anticipated income from its use. For each type of retail or service establishment there is a more or less definite set of location specifications that is deemed appropriate. Experienced businessmen attempt to secure locations that closely conform to these specifications, for experience has shown that there is small chance of a profitable operation in a location that differs substantially from the standard.

The majority of the thirteen retail and service establishments that were interviewed are dependent upon the drawing power of the shopping center in which they are located. Each revealed that an extensive investigation for a possible site was made, and each was actively recruited
by at least one landlord. All had several logical sites from which they could make their final choice. The final decision generally was based upon observed drawing power and the rental contract. If a percentage lease could be applied to an establishment, it usually was offered, otherwise flat rentals were given with rental concessions in the first year or two. A typical concession is the allowance of free rent the twelfth month if the first eleven payments are met in full.

It is evident each retailer has placed tremendous weight upon the drawing power of his shopping area. This is true even though he has stated that in certain areas of Columbus there may be overexploitation in many retail and service lines.

THE PRELIMINARY CUSTOMER ANALYSIS

Every businessman who has a product to market must shape a marketing program suited to his product, his customers, and his capital. Fortunately, once satisfied that the product or service is designed to meet specific consumer needs, a businessman can obtain the facts about his market with some investigation and thought. Answering the questions that follow will help him to ascertain how much he already knows and how much more he needs to know about his market. The United States Department of Commerce suggests that any customer analysis include as a minimum answers to the
questions that are listed below:

1. What types of consumers will use the product?
2. How many potential customers are there?
3. What factors cut down the size of the total market?
4. How many prospects are left for your product? (No. 2 minus No. 3.)
5. Where do the potential customers live?
6. Will the price of the product meet the requirements of your logical prospects?
7. Will the price of your product compare favorably with existing products of this kind and with similar products which may be introduced shortly?
8. What is the present consumption of products of this type?
9. Is the market for this product likely to change in size during the next 2, 5, or 10 years?
10. How often will consumers buy this product?
11. Will the product sell evenly throughout the year or will the bulk of the sales be concentrated at certain seasons?
12. What features of the product appeal most to consumers?
13. What are consumer prejudices, if any, in regard to each of those features?
14. Are products of this kind usually bought with the expectation of a service guarantee?
15. If bought on an installed basis, will the cost of installation be included in the price of the product?
16. Does the product have any possibilities for industrial use?

A comprehensive preliminary customer analysis, comparable to the outline above, was revealed to the writer in only one instance. However, this is not to say that all the businessmen were completely unaware of their markets. The seven officers who placed reliance upon their ability to carry forward customers from their previous business connections stated that they have had gratifying results in their attempts to use them as a nucleus around which to build a sales program. Such was not the case with the men who contacted potential customers. Seven of the nine stated that virtually their entire sales volume thus far consisted of customers other than those contacted in a preliminary survey. In spite of the fact that these potential customers expressed a belief that such a product or service was needed, they have not followed through with orders after the business began operations. All seven stated that the results have generally proved quite disappointing since they placed considerable reliance upon this apparent source of sales. Nevertheless, these businesses have been able to compensate for this lack of follow-through on the part of those contacted previously by securing sales largely on the basis of satisfied customer references. As a result, seven of the nine stated that potential customers contacted prior to incorporation did not provide them with the sales volume that they had hoped to secure from the source. Evidently, potential
customers stated that there is a great need for such a product or service without stopping to analyze the size of their demand or the ability of the existing firms to fulfill it.

**TABLE XVIII**

**EXTENT OF PRELIMINARY CUSTOMER SURVEY CONDUCTED BY PRIMARY OFFICERS OF SMALL BUSINESS CORPORATIONS ESTABLISHED IN COLUMBUS, OHIO, DURING 1953**

<table>
<thead>
<tr>
<th>Extent of Survey</th>
<th>Number of Officers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contacted potential customers</td>
<td>9</td>
</tr>
<tr>
<td>None—Reliance placed on general impressions</td>
<td>8</td>
</tr>
<tr>
<td>None—Reliance placed on ability to carry forward customers from previous employment</td>
<td>7</td>
</tr>
<tr>
<td>Examined past histories of similar businesses</td>
<td>3</td>
</tr>
<tr>
<td>Examined drawing power of shopping areas which they thought might be suitable locations</td>
<td>2</td>
</tr>
<tr>
<td>Employed outside agency to make survey</td>
<td>2</td>
</tr>
<tr>
<td>Demand recognized through previous complimentary business connections</td>
<td>2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>33</strong></td>
</tr>
</tbody>
</table>

Two new firms begun because of a complimentary demand recognized through prior business connections built their entire sales program around the customers of the former
places of employment, and both firms were extremely success-
ful in developing this market.

On the whole, the conclusion to be drawn concerning the
efforts of the firms to ferret out potential customers is
extremely disheartening. In spite of the fact that general-
izations about the size, location, or character of the
possible market for any product are very dangerous; that the
only sound way to determine the possible market for a
product is to obtain the facts and weigh all factors involved,
the great majority of the new enterprises were founded upon
vague general impressions about the extent of the market.
Perhaps this is to be expected since the services of good
market analyses are both expensive and scarce, and virtually
all the businessmen are untrained to make a market analysis
scientifically on their own. Nevertheless, until this
deficiency in customer analysis is corrected, it is
improbable that the high mortality rate of new businesses
will be reduced substantially.

SUMMARY

Psychology has thus far been unable to isolate any
factors which will throw any light on the difference be-
tween entrepreneurs and non-entrepreneurs. Since psycholo-
gical bases for entrepreneurship are non-existent, this
chapter has been devoted to several social or economic
characteristics of promoters.
By and large, businesses are started by persons of mature age with considerable business experience. It is unlikely that many young people possess, or are able to borrow sufficient capital to start a business. Furthermore, each man interviewed stressed the importance of having previous business experience before an attempt can be made to establish a new business. The average age of the 33 promoters was 40, and they generally had considerable educational training—over 50 percent being college graduates. All but two of the promoters were married. Over two-thirds of the promoters had previous experience in a similar type of business, however, 14 of the 33 had no other experience in unrelated fields. The remaining one-third generally had extensive experience in other areas to compensate for the lack of experience in the type of business that they now managed. There is a definite inverse relationship between the amount of related to unrelated experience.

For 17 of the 33, or 50 percent, the present businesses represent their first ventures. As a rule, the balance of the 33 usually held minority interests in previous businesses, and the present firm represents their first controlling interest in a business.

The reasons for establishing a business are varied. One that predominated involved salesmen who had secured valuable exclusive sales areas or contracts for special
orders. Other important reasons were the desire to exercise an option to purchase, and the desire to exploit a known demand discovered while employed in their former occupations. It can be seen that the very nature of these factors made it necessary to decide to incorporate in a relatively short time.

In the case of firms headed by non-residents of Columbus, the advantageous location of the city in regard to their sales area was the usual deciding factor. The demand for industrial space was characterized by emphasis on cost; for wholesaling the important consideration was location, and for retailing space a site in a shopping center was usually desired. Concerning the prospective market for their goods and services, reliance was placed primarily on general vague impressions.

Having completed the discussion of the entrepreneur, attention is now directed to the financial aspects of the business promotion.
CHAPTER V

A CASE STUDY--SURVEY IN COLUMBUS, OHIO, OF SMALL BUSINESSES INCORPORATED IN 1953 (CONT'D.)

INTRODUCTION

The previous chapter was concerned with the social and economic characteristics of the promoter of a small business; in the present chapter the sources of the promoters' long-term capital will be discussed. In addition, several other policy decisions having a financial aspect will be treated. It is significant that usually all financial decisions were made with a short-run view, and that little thought was given to the implications they might have on the future growth of the corporation.

The financial pattern of most new corporations is surprisingly simple--consisting only of common stock. However, there were promissory notes outstanding in 50 percent of the cases, therefore, in these cases additional financing in the immediate future is problematical. It is clear that frequently the original formulation of the financial plan was not in terms of the long-run needs of the corporation, but rather in terms of the most expedient method of obtaining original capital.
<table>
<thead>
<tr>
<th>Source</th>
<th>All 33 Firms</th>
<th>14 Manufacturing &amp; Construction Firms</th>
<th>6 Wholesale Firms</th>
<th>13 Retail &amp; Service Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount</td>
<td>Amount</td>
<td>Amount</td>
<td>Amount</td>
</tr>
<tr>
<td></td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>Savings of Officers</td>
<td>895,320</td>
<td>491,820</td>
<td>213,500</td>
<td>190,000</td>
</tr>
<tr>
<td></td>
<td>86</td>
<td>91</td>
<td>85</td>
<td>76</td>
</tr>
<tr>
<td>Relatives and Friends</td>
<td>39,200</td>
<td>22,200</td>
<td>10,000</td>
<td>7,000</td>
</tr>
<tr>
<td></td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>Capitalists</td>
<td>5,000</td>
<td>----</td>
<td>----</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td>1</td>
<td>--</td>
<td>--</td>
<td>2</td>
</tr>
<tr>
<td>Business Concerns</td>
<td>102,000</td>
<td>26,000</td>
<td>29,000</td>
<td>47,000</td>
</tr>
<tr>
<td></td>
<td>9</td>
<td>5</td>
<td>11</td>
<td>19</td>
</tr>
<tr>
<td>Total</td>
<td>1,041,520</td>
<td>540,520</td>
<td>252,500</td>
<td>249,000</td>
</tr>
<tr>
<td></td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>
SOURCES OF LONG-TERM FUNDS

Sources Utilized by All Firms

The capital necessary to start a new enterprise varies with the nature of the business and the scope of the operations undertaken. As is evident from a study of Table XIX, the most common source of new capital funds was the savings of the entrepreneurs. For all firms they contributed 86 percent of the funds. Next in importance were business firms whose contributors hope to receive an advantage by their advances. These extensions totaled 9 percent of the total sum. Loans from friends and relatives ranked third in importance; they extended 4 percent of the total utilized.¹

Banks failed to contribute anything to the total sum of long-term funds; this means that the capital needs of a business are met largely by the owner's capital, a few loans extended by other businesses, and fewer still friendship loans.

Differences Among Manufacturing, Wholesaling and Retailing Firms

Table XIX shows clearly that it is much more difficult to finance a manufacturing firm than a wholesaling or a

¹ These percentages differ from those in Tables III and IV for two significant reasons: in the latter tables (1) firms having no employees were excluded, and (2) short-term contributions were included.
retailing enterprise. The manufacturing concerns found that both short and long-term advances were extremely difficult to acquire. Bank credit was generally not available since fixed assets and partially completed goods have a rather low resale value. Business credit was also scarce, except for limited short-term loans granted for the normal length of time permitted by practices in the specific industry. These facts explain why 91 percent of the original capital was contributed by the owners. On the other hand, retailers stated that business credit was frequently available on a term basis, and the availability of a larger percentage of this source of capital explains why the owners' contributions were 76 percent as opposed to 91 percent for the manufacturers. Also, the larger percentage of intercompany financing available to the wholesaler as compared to the manufacturer explains why the owners' contributions were 85 percent for wholesalers in contrast to the higher percentage for manufacturers.

Credit Extensions by Business Concerns

This type of loan was usually the result of an established corporation attempting to secure another outlet for its products or services. These loans can be explained by the fact that when one firm extends credit to another, as a rule, such a firm looks forward to a long period of mutually profitable trade transactions. As a rule, they were cash extensions to finance necessary fixed assets or
permanent inventory. All were in the form of a promissory note. The most frequently-used source was the promoter's previous place of employment or business affiliation, except in the retail field where major suppliers granted the loans.

Strictly speaking, the entire amount of $102,000 was not long-term credit since two of the loans were "balloon-type" notes with payments beginning after the first year of operation and with semi-annual payments continuing thereafter. The total sum of these payments would be $4,000 if paid promptly. However, all owners expressed a desire to retire their indebtedness as soon as possible despite the indefinite maturities of the majority of the notes.

**Availability of Bank Credit**

Wholesalers stated that short-term bank credit was generally available; four of the six firms have used it frequently since starting business. As was mentioned previously, manufacturers found difficulty in acquiring short-term credit; only one firm was able to secure short-term accommodation—the remaining two firms using bank credit in that category in Table XX were construction firms. Retailers feel that even on a short-term basis the banks were too "conservative." This impression is not surprising, since only six of the thirteen retail and service firms have ever used bank credit.
TABLE XX

BANK LOANS NEGOTIATED BY PRIMARY OFFICERS OF SMALL BUSINESS CORPORATIONS ESTABLISHED IN COLUMBUS, OHIO, DURING 1953

<table>
<thead>
<tr>
<th>Type of Firm</th>
<th>Number of Firms</th>
<th>Short-Term 1 yr.</th>
<th>1 to 5 years</th>
<th>Long-Term Over 5 yrs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacture and</td>
<td>3</td>
<td>2</td>
<td>1</td>
<td>---</td>
</tr>
<tr>
<td>Construction</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wholesale</td>
<td>4</td>
<td>4</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>Retail and Service</td>
<td>6</td>
<td>4</td>
<td>2</td>
<td>---</td>
</tr>
<tr>
<td>Total</td>
<td>13</td>
<td>10</td>
<td>3</td>
<td>---</td>
</tr>
</tbody>
</table>

Term loans from one to five years were practically unavailable. Three firms did qualify for loans up to three years, but before two were granted personal endorsements were required of the owners. All three were installment loans secured by chattel mortgages on equipment. In actual practice, however, several of the firms that were granted short-term credit will actually receive the equivalent of term loans since they have an understanding that a renewal or renewals will be granted each time the note matures. Thus, differentiation into distinct time periods is very difficult because of the uncertainty of the final liquidation of the indebtedness.


<table>
<thead>
<tr>
<th>Type of Funds</th>
<th>All 33 Firms</th>
<th>14 Manufacturing &amp; Construction Firms</th>
<th>6 Wholesale Firms</th>
<th>13 Retail &amp; Service Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount</td>
<td>%</td>
<td>Amount</td>
<td>%</td>
</tr>
<tr>
<td>Capital Stock</td>
<td>806,520</td>
<td>77</td>
<td>436,020</td>
<td>81</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>198,500</td>
<td>79</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>172,000</td>
<td>69</td>
</tr>
<tr>
<td>Promissory Notes of Owners</td>
<td>110,000</td>
<td>10</td>
<td>75,000</td>
<td>14</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>15,000</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>20,000</td>
<td>8</td>
</tr>
<tr>
<td>Promissory Notes of Third Parties</td>
<td>125,000</td>
<td>13</td>
<td>29,000</td>
<td>9</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>29,000</td>
<td>15</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>57,000</td>
<td>23</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,041,520</strong></td>
<td><strong>100</strong></td>
<td><strong>540,020</strong></td>
<td><strong>100</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td><strong>252,500</strong></td>
<td><strong>100</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td><strong>249,000</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>
Degree of Leverage Present at Time of Incorporation

Since the owners' contributions were a very high percentage of the total capital that was raised, it is apparent that there was very little trading on the equity. The total capital stock, plus promissory notes of the owners, as indicated in Table XXI, will exceed the owners' contributions shown in Table XIX because of the presence of a limited amount of stock sold to friends and relatives. For all firms the percentage of capital contributed by the owners, promoters as well as minority interests, totaled 67 percent with manufacturing, wholesaling, and retailing firms having 95, 85 and 77 respectively.

Seventeen firms had promissory notes in existence from the beginning of operations. Eight promoters took back notes in payment for their capital contribution; seven borrowed from other business firms, and two secured funds in exchange for notes from friends and relatives. The presence of these notes is not inherently dangerous since in all cases a vested interest in the success of the corporation is held by the lenders; therefore, sympathetic treatment can be expected by the debtor corporation. The real trouble revolves around attempts to expand these 17 firms.

It is extremely doubtful if the nine promissory notes given to the third parties could be subordinated in
subsequent attempts to obtain additional capital. Thus, these notes obviously will hamper subsequent financing attempts.

CRITICISMS OF THE ADOPTED FINANCIAL PLAN

Three Common Weaknesses in the Financial Plan

Considering the large percentage of initial long-term capital contributed by the owners, it could readily be construed that new businesses are usually conservatively financed. However, there are three disconcerting factors in the financial plans of most corporations that may counteract much of that apparent conservatism. These off-sets are: (1) the frequent presence of owners' promissory notes; (2) too much reliance on short-term credit, and (3) failure to raise sufficient long-term capital to launch the business properly.

The Thin Corporation

A rather unusual situation has developed in six of the eight cases involving promissory notes of the owners. These notes were given in order to construct a "thin" corporation. This is a device utilized both to pay out corporate earnings

2 in cases of the business concerns the promotors expressed doubt if permission could be secured, and in the case of friends or relatives, the promotors said they would hesitate to make such a request.
without the imposition of the double tax on the corporation and stockholder, and to prevent the imposition of the Section 102 penalty tax on unreasonable accumulations. The stockholders intentionally undercapitalize the corporation. They incorporate with a minimum amount of equity capital for which they receive stock. They loan the rest of the needed funds to the corporation, represented by bonds, notes, or other forms of indebtedness. The interest payments on the indebtedness are deductible by the corporation. Although the stockholders are taxed on the interest, there is no double tax on the corporate earnings, as there would be were dividends declared on the stock to withdraw part of the corporate earnings. Moreover, if the loan is not represented by a form of indebtedness with interest coupons attached or in registered form, the shareholder as a creditor may have an ordinary bad debt deduction and not a capital loss, if the corporation fails, just as he would were the business unincorporated. Finally, the possibility of the imposition of the Section 102 penalty tax is greatly minimized since earnings not required in the

3 A typical example might divide the owner's total contribution of $5,500 into capital stock, $500; notes payable, $5,000.

4 Internal Revenue Code. Section 23(b).

5 Internal Revenue Code. Section 23(k).
business can be used to repay the loans.

The "thin" corporation, however, is not without its pitfalls. It is a well-known fact that a corporation will be unable to look to additional credit from outside sources if there are notes floating around in the hands of the stockholders. Attempts to meet this practical problem by subordinating the notes in the hands of the owners to the claims of outside creditors would destroy the intent. For tax purposes, it is not uncommon for forms of indebtedness in the hands of the stockholders to be treated merely as a type of preferred stock.6 If the indebtedness carries no fixed maturity date, if interest payments depend upon earnings, if the notes have been subordinated to other creditors, and if the corporation has been inadequately capitalized, are all factors which have persuaded the court to disregard the form of the transaction and tag the indebtedness as a form of stock.7 Of course, once this occurs, the so-called interest payments on the loans are not deductible by the corporation, being in effect dividends.

The question now remains as to why this device is used in spite of the weight of authority to the contrary. Several


7 Green Bay and western Railroad Company vs. Commissioner, 147 Fed. 2d. 585 (CCA-2, 1945).
authorities on taxation contacted by the writer have advanced two theories for its use. First, it is a matter of degree: a debt to capital ratio of under one to one would probably be approved under current Internal Revenue Bureau policy. Therefore, some attorneys might feel higher ratios may stand a chance of approval. Second, the client may insist that it be done in this manner in spite of the fact his attorney may advise him as to the probable outcome. The client may claim that there is nothing to lose and everything to gain.

Actually, the firm could easily be the loser. Since it may take some time to secure a ruling an extended period of uncertainty exists, hence, lenders are hesitant to commit their funds until it is removed by a Bureau ruling on the case. This may account for the fact that these firms

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8 This position is not entirely without merit. The ratio of debt to equity capital is not in itself a determining factor, although an obviously excessive debt structure along with a nominal stock ownership might result in the holding that the arrangement for payment of interest was merely a sham serving no other purpose than tax avoidance. The Tax Court has allowed, in at least two cases, an interest deduction where the ratio of debt to equity investment was as high as 9 to 1. The decision was based on the absence of (1) subordination of the "indebtedness" to claims of other creditors, and (2) a non-variable interest rate depending upon the corporation's earnings. Also, the presence of a maturity date and the specific rights of the holders to enforce payment of the principal was taken into consideration. Therefore, the ratio of debt to equity was not the determining criterion.

9 It should be noted here that this was the answer given the author by the promoter during the interview.
stated that credit was generally difficult to obtain. In the formative period, it is the hardest to obtain credit; yet these firms have made it even more difficult for themselves by adding further needless uncertainty. 10

The Over-dependence on Short-term Credit

When the corporation is organized, the promoter must determine in advance the amount of capital needed to start the business. Ideally, plans should be made to secure this capital in such a manner that the long-run needs of the corporation will be best served. However, such is often not the case. Since the manufacturing firm had a relatively larger investment in fixed assets and short-term financing was frequently not too liberal, over-emphasis of short-term funds was usually not present in this group. Such was not the case with retail and wholesale firms. Since they had less tied up in fixed assets they felt they were warranted in using short-term credit liberally. Practically all of the firms in these groups stated they used long-term capital to pay for the necessary fixed capital needs and that they depended either upon banks or merchandise creditors, or both, for their entire circulating capital needs. This was especially so because they found short-term credit to be granted quite liberally. The wholesalers

10 Since these are new firms there have been no rulings by the Bureau as yet.
particularly admitted that they were too dependent upon short-term credit, but could only hope to remedy it over a period of time by retention of earnings.

The above arrangement contains apparent dangers. Too great dependence upon banks and other financial institutions puts the corporation at a decided disadvantage. Loans may fall due at unfortunate times. Dependence upon trade credit is not much more reassuring. If the merchandise creditor carries the debtor at all during times of stress he probably will do so on terms favorable to the creditor.

It would be better if the permanent part of circulating capital would be met by long-term funds. While circulating capital is constantly changing in form, at least part of the investment will be permanent. In other words, all corporations always must maintain a minimum investment in circulating capital. For most wholesaling and retailing corporations which were studied the conversion from short-term to long-term sources for the permanent part of circulating capital will become a reality only after a period of successful operations.

The Failure to Raise Sufficient Long-term Capital to Launch the Enterprise Properly

Closely concomitant to the above weakness was the failure to raise sufficient long-term capital to launch the enterprise properly. While the writer is aware that the great dependence upon short-term capital stemmed from
the inadequacy of long-term funds, the situation was aggravated for the new firms by still an additional factor. Every new business passes through an experimental stage before efficient operations can begin. Thus, a large part of the expenditures during such a period may be dissipated on abortive company policies. Many corporations stated that these experimental or organizational expenses were much higher than anticipated.

The above phenomenon was called to the promoters' attention by two very effective barometers of business success: (1) two-thirds of the businesses stated that they sustained losses up to six months or longer,¹¹ and (2) circulating capital was exhausted before efficient operations were actually begun. As a result the majority of the promoters were forced to make subsequent personal contributions to the corporation in order to replenish the dangerously low circulating capital.

Strange to say, as practically every promoter will verify if he has made any attempt to do so, it was often harder to raise additional money after the business has just been launched, than to interest outside capital in a wholly new enterprise. This is because the exhaustion of funds before the concern is on its feet raises the assumption

¹¹ Some of the firms incorporated toward the end of the year have yet to show a net profit.
that there is something wrong with the enterprise or with management. Therefore, it is imperative that the new enterprise provide an amount to care for unforeseen contingencies, no matter how optimistic the outlook appears.

COST OF OBTAINING LONG-TERM FUNDS

Frequency of Occurrence

In all cases par was paid for all stock issued. Since the promoters and their friends purchased all outstanding shares there were no costs connected with the disposition of the shares. However, promissory notes given to third parties frequently had a non-monetary cost which will continue to affect the costs of approximately one-third of the firm at least for the foreseeable future. By the very nature of the agreements between debtor and creditor it is impossible to assess accurately these costs in order to translate them into monetary costs for comparative purposes with firms not so affected.

Typical Non-monetary Costs

Three types of non-monetary costs of obtaining long-term

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12 In practically all cases 250 shares were authorized because this is the maximum number that can be obtained by paying the minimum incorporation fee of $25.00. In many cases the entire amount was issued, thus, par was determined by dividing the initial stated capital by 250 shares. This represents another example that shows little long-range planning is done at incorporation.
capital were isolated from the data. The promoter agreed to:

1. Purchase supplies from the creditor;
2. Stock products of the creditor;
3. Forfeit control of the corporation.

It is true that the first two may not actually prove to be costs at all, but it is equally true that the debtor corporation is forestalled from any attempts to secure more favorable terms for those articles. As a result this lack of flexibility is deemed a cost by the writer. In the third instance, if all goes well, there will probably be no attempt made to challenge the authority of the promoter, but should adversity prevail it is questionable whether the majority interest will continue to remain passive. Hence, there is a very real cost--the ever-present threat of loss of control of the corporation by the promoter.

Monetary Costs

In one instance there was present a measurable monetary cost to the entrepreneur. In order to raise the bulk of the funds required to carry out a speculative venture the promoter agreed to share equally all salaries, bonuses, and profits with the contributor of the capital. The promoter was given a free hand in day-to-day operations although major policy decisions were to be made jointly. In addition to receiving the above mentioned remuneration, after all
prior obligations have been retired, the second party will be returned the part of his original contribution represented by a promissory note. While it is impossible to assess precisely the total cost of the capital to the promoter until the corporation is liquidated, it is obvious that the total monetary cost can be computed as of any given date.

DEGREE OF EXPECTED PROFITABILITY

Long-term Rate of Return Expected by Promotor

Economists frequently make the assumption that businessmen are very conscious of rate of return that can be expected on their invested capital. Furthermore, they assume that businessmen will adjust their operations in order to achieve or better this desired goal. The rate of return on invested capital varies for each line of endeavor, therefore, a few examples will be cited. The average ratio of net profit to net worth for the five-year period covering 1946-1951 was 16% for contractors, 11% for drugs, 12% for hardware stores, 12% for machine shops, 16% for electrical wholesalers, 17% for plumbing wholesalers,

13 it is estimated by the promoter that at the end of two and one-half years the co-owner will receive through salary and bonus disbursements alone the entire principal amount of his contribution.
and 8% for shoe retailers. 14

TABLE XXII

LONG-TERM RATE OF RETURN EXPECTED BY PRIMARY OFFICERS ON CAPITAL UTILIZED BY SMALL BUSINESS CORPORATIONS ESTABLISHED IN COLUMBUS, OHIO, DURING 1953

<table>
<thead>
<tr>
<th>Rate of Return Expected</th>
<th>Number of Officers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unknown</td>
<td>29</td>
</tr>
<tr>
<td>6 percent</td>
<td>1</td>
</tr>
<tr>
<td>10 percent</td>
<td>1</td>
</tr>
<tr>
<td>12 percent</td>
<td>1</td>
</tr>
<tr>
<td>20 percent</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>33</strong></td>
</tr>
</tbody>
</table>

Table XXII clearly refutes the above assumptions. In 29 cases out of 33 the entrepreneur had no knowledge whatsoever as to what his ratio should be, and he would not even hazard a guess as to how much his particular business would earn as time progresses. Furthermore, of the four who did express an expected return on net worth, only one estimate

14 Foulke, Roy A. Behind the Scenes of Business. New York: Dun and Bradstreet, Inc., 1953, pp. 156-175. These ratios may vary substantially through time, and frequently from year to year a considerable change may take place.
was even approximately close to the ratio given by Roy Foulke.\textsuperscript{15} Therefore, it is quite obvious that promoters have no idea of the rate of return currently being earned on net worth in their particular lines of business.

**Remuneration of Officers**

Inextricably tied in with the above problem is the question of wages for management. In most closely-held corporations, the business is merely looked upon as a means of employment; therefore, concern over the net profit to net worth ratio is of decided secondary importance.\textsuperscript{16} The promoter may take out the profits in the form of salary or bonuses, thereby reducing the corporate tax liability and adversely affecting the rate of return. This factor renders generalizations about the long-term rates of return meaningless for most small businesses because of the impossibility of determining the true profits because of the inability to separate wages and profits in any satisfactory manner.

As shown in Table XXIII, in the short run it is evident that the monetary return was not the decisive factor leading the promoter to form the business. This is true because only a minority of the entire group could look for a

\textsuperscript{15} See Footnote No. 14

\textsuperscript{16} This was the usual answer given for not having any particular concern over the above ratio.
betterment in their economic position in the near future. The remainder apparently are discounting long-run incomes from the businesses, or have taken on the added risk and responsibility largely on the basis of non-monetary rewards.

**TABLE XXIII**

REMUNERATION OF THE PRIMARY OFFICERS OF SMALL BUSINESS CORPORATIONS ESTABLISHED IN COLUMBUS, OHIO, DURING 1953 IN COMPARISON WITH INCOME RECEIVED IMMEDIATELY PRIOR TO INCORPORATION

<table>
<thead>
<tr>
<th>Rate of Return</th>
<th>Number of Officers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Higher than prior employment offered</td>
<td>11</td>
</tr>
<tr>
<td>Lower than prior employment offered</td>
<td>11</td>
</tr>
<tr>
<td>Same as prior employment offered</td>
<td>5</td>
</tr>
<tr>
<td>Not applicable for comparison</td>
<td>6</td>
</tr>
</tbody>
</table>

**Total: 33**

Among non-monetary considerations, social status is probably quite important since the individual who owns a business is socially more acceptable than a hired employee. Another non-monetary inducement is the desire for more varied activities. A change to a business owner may bring with it an escape from monotonous jobs. In addition, employment under the direction of others often seriously curtails the freedom that might be enjoyed as an owner of a
business. Fortunately, non-monetary considerations rarely conflict with the profit motive completely. The status attached to an unprofitable venture is not very high, as a result, there can be no companies formed strictly to achieve non-monetary goals.

GENERAL PRICING POLICIES

All Firms Follow Pattern for the Industry Implicitly

In pricing their goods or services, all firms stated that they follow the pattern set by their particular industry. Although Table XXIV may suggest that there is considerable rigidity or little control over prices, such is not the case in actual practice. The three main methods of setting prices as set forth in Table XXIV are frequently honored in the breach. For example, even though the manufacturers may set a suggested price, adjustments are frequently given in quoted prices through variations in trade-in allowances. In industries where prices are derived through competitive bidding the rate of profit on contracts is usually governed by the state of business in that particular area of the economy. Therefore, profit margins may vary considerably from year to year. On the contrary, however, a cost-plus normal industry markup is followed in the more non-competitive lines of endeavor, and as a rule deviations from the normal markup are not too frequent.
TABLE XXIV

GENERAL PRICING POLICIES FOLLOWED BY PRIMARY OFFICERS OF SMALL BUSINESS CORPORATIONS ESTABLISHED IN COLUMBUS, OHIO, DURING 1955

<table>
<thead>
<tr>
<th>General Pricing Policy</th>
<th>Number of Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost plus normal industry markup</td>
<td>12</td>
</tr>
<tr>
<td>Prices suggested by manufacturers</td>
<td>11</td>
</tr>
<tr>
<td>By competitive bidding*</td>
<td>10</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>33</strong></td>
</tr>
</tbody>
</table>

*Generally derived by a "cost plus" analysis or by previous experience.

In wholesaling and manufacturing firms the normal markup is usually maintained even at the risk of loss of business rather than to jeopardize the entire pricing pattern. Hence, competition in these areas is decidedly not along price lines.

**Incidence of the Corporate Income Tax**

In recent years a school of thought has developed which holds that the corporate income tax tends to be reflected in prices, and, therefore, is partially passed on to consumers. This view is based upon the fact that prices are not always competitive, but in certain segments of the economy are administered by the producer. This
theory assumes that prices are fixed on the basis of cost schedules, and estimates of probable demand.

In determining the prices to be charged, all costs are taken into account. Included among these costs is a fair return on equity capital. In order to obtain such a return, the income taxes likely to be levied on profits must be considered. Adherents to this view do not believe that business concerns generally try to earn the largest profits possible; satisfactory profits rather than maximum profits are assumed to be the primary objective of management, thereby permitting additional increases in market price.

This theory of tax incidence directly conflicts with the traditional theory which assumes that virtually the entire tax must be absorbed by the company. The traditional theory states that a tax on net income is borne primarily by the income recipient, that the tax is not regarded as a cost of production, and, therefore, does not enter into price considerations in the short run.

All the businessmen interviewed felt that the corporate income tax could not be shifted by the corporation. There are two good reasons for this belief: (1) The ability to shift the tax by increasing prices is deterred by the large number of unincorporated concerns which are not paying this tax, or by other corporations whose management does not regard the tax as a cost. (2) Perhaps a stronger argument exists in the statement that the imposition of an income
tax gives the individual no more control over the market than it had formerly, and that higher prices can be had only at a sacrifice of sales.

The writer will not attempt to resolve these differences in tax theory. However, he does suggest that regardless of which theory is more nearly correct, the small business is at a disadvantage. Without shifting, the small firm feels the full impact of the tax. Small firms predominate in the areas which sell in a highly competitive market, therefore, the ability to shift the tax is definitely circumscribed.

SUMMARY OF THE FINANCIAL CHARACTERISTICS OF THE NEW FIRM

The financial pattern of the new firms is surprisingly simple—consisting only of 250 shares of common stock outstanding. However, there were promissory notes present in over 50 percent of the cases.

As a rule, it was much more difficult to finance a manufacturing firm than a wholesaling or a retailing enterprise. Therefore, the owners of the manufacturing enterprises contributed 91 percent of the total long-term funds as compared with 65 percent and 76 percent for the wholesaling and retailing businesses, respectively. The differences in percentages from the manufacturing firms can be accounted for by more liberal long-term credit granted by other business firms. Usually, however, there was a non-monetary cost involved in the use of this latter source of funds.
With the possible exception of wholesalers, the businessmen stated that bank credit was too "tight," even for short-term loans. Term loans were virtually unavailable for all types of firms. The businessmen objected to the SBA's emphasis on "bank participations." They felt the whole process was too cumbersome. In addition, they have considerable pride and do not like to re-approach any bank that has previously rejected them on their original application for a loan for an SBA-bank participation loan. They all agreed that more liberal SBA lending policies would be desirable.

The financial plans adopted suffered from three weaknesses: (1) the "thin" corporation retarded subsequent financing, (2) over-dependence on short-term credit was typical, and (3) the failure to raise sufficient long-term capital to launch the business properly caused early financial worries. Therefore, in the majority of cases subsequent personal contributions were required of the owners.

All owners expressed a preference to expand slowly and usually subscribed to the "New England Plan" of corporate growth. However, there was a great deal of misgiving over Section 102 of the Internal Revenue Code. All the promoters felt they could use more funds as they believed they were operating below their optimum size for greatest efficiency.
The most satisfactory way to achieve this goal, it was believed, was through special corporate tax exemptions on income and liberalization of depreciation allowances.¹⁷

¹⁷ These proposals and others will be discussed in the following chapter.
NEIL APPROACHES TO THE PROBLEM--PROPOSED REMEDIES FOR SHORTCOMINGS IN THE SUPPLY OF LONG-TERM CAPITAL

SMALL BUSINESS ACT OF 1950

It is apparent that, historically, major problems posed by small business have lacked attention from Congress and from Government agencies and departments. Within the past few years, however, an effort has been started to give small business the attention it deserves and must have to keep it strong. Since the end of World War II over 100 bills to aid small business have been introduced into Congress.

In 1950 six bills to aid small business were combined into one omnibus bill called the "Small Business Act of 1950." The intent of the bill was to "make capital and credit more readily available for financing small business, foster competition, and coordinate Federal aids to small business, and thus to promote, foster, and develop the domestic and foreign commerce of the United States, and

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1 In the Senate the bill was designated S 3625, and in the House of Representatives a similar bill was introduced under the caption of H. R. 8566.
for other purposes. The "Small Business Act" was sponsored by four senators, and in the House was introduced by several representatives in addition to the Chairman of the Committees on Banking and Currency and Small Business. This bill implemented recommendations contained in the President's message to the Congress on May 5, 1950. The program had long been in preparation and had the personal attention of Mr. Truman and the top government experts in the field.

This was a sincere, concerted effort to solve the financial problems of the American small businessman. Hearings were in progress on the bill at the time of the outbreak of the Korean hostilities in June of 1950, and had not that untimely event interfered, in the opinion of the persons who worked on the bill, it would have become law in 1950. However, a temporary emergency measure was substituted, namely, the Small Defense Plants Administration. Nevertheless, much more will be heard of the proposals contained in the Act should the economy take a sustained, deflationary character.

Thus the first session of the Eighty-first Congress gave full consideration to the financial problems of small

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3 The Small Defense Plants Administration was discussed in Chapter III, pp. 84-89.
business which at the time was a matter of growing urgency throughout the country. In the first half of 1950, it should be recalled, there were worries about unemployment and even depression. Some sections of the country were actually experiencing unemployment difficulties. Therefore, it was desired that a system of loans be worked out for small business that would have stimulated our economic system to provide more employment. To achieve this goal the proposed Small Business Act of 1950 was to assist small business in overcoming the handicaps it faces in obtaining financing and in keeping abreast of new techniques in production and management. By expanding opportunities for efficient small business, the program would have promoted more effective competition, stimulated progress, and promoted investment and employment essential to the growth of our economy.

The proposed Small Business Act of 1950 consisted of six parts or titles. The first three titles were concerned with facilitating the financing of new and existing business enterprises. Each was a distinct and separate proposal, although all were related to the overall organization of credit and capital resources available to small business. They dealt with the following subjects:

Title I: An insurance fund for commercial banks covering loans made to small firms for business purposes.

Title II: Creation of private national investment companies authorized to invest in small firms or make loans in larger amounts than is contemplated by the insured loan system.

Title III: Liberalizing the lending standards of the Reconstruction Finance Corporation as a standby agency to make loans only when not available through local banking facilities or national investment companies.

Title IV: Termination of the inactive industrial loan authority of Federal Reserve Banks.

Title V: Directing the Secretary of Commerce to give special emphasis to the requirements of small business in providing managerial and technical aids.

Title VI: Miscellaneous items including provision for an additional Assistant Secretary to perform such duties as the Secretary of Commerce shall prescribe.

Titles I, II and V are deemed the most important of the provisions in the Act and are discussed in detail in the sections to follow since they are typical of remedies proposed by authorities prior to and subsequent to the formulation of this act. The other titles will be discussed very briefly now.

Title III: In order to increase the effectiveness of RFC as a backstop for the private financial structure, the RFC's lending authority was to have been broadened and its operations more closely integrated with the rest of the small business program. The RFC law would have been amended
to provide that RFC financing would be available only if neither the existing private institutions nor the new investment companies could provide aid on reasonable financing terms. Thus, RFC participation could have been increased and collateral requirements relaxed in the case of loans to small businesses when management abilities and potential earnings afforded a reasonable expectation of repayment. Loans also could have been made for terms of fifteen instead of ten years, and the limit of RFC participation in loans with private lending institutions would have been increased to 80 percent. In the law in force at that time, the limits were 60 percent for loans over $100,000 and 70 percent for those of $100,000 and under.5

Title IV: This title would have terminated the industrial loan authority of the Federal Reserve Banks one year after the effective date of the Act.6 As a result, the Federal Reserve System would have been required to return to the Treasury the advances of $139,000,000 which had been made for business loan purposes. The objectives of the defunct program would have been attainable through the national investment companies without direct participation by the Federal Government.

5 It is presumed that any future proposals along this line would merely substitute Small Business Administration in lieu of Reconstruction Finance Corporation.

6 Section 13(b) of the Federal Reserve Act would thus be repealed.
Title VI: This section contained several miscellaneous provisions. First, an additional assistant secretary would have been authorized to further the ends and the purposes of the act. Second, the President would have been authorized to reduce maximum principal amounts, maturities, or percentage of Federal insurance for any business loan program where necessary to coordinate such program with general economic policies of the government. Finally, the Secretary of Commerce would have been required to establish appropriate classifications of enterprises eligible for assistance under all titles except Title II. In establishing such classifications he should have considered such factors as the relative size of the businesses operating in the industry and the degree of independence among them.

Opposition to the Small Business Act of 1950

The attack on the Small Business Act of 1950 generally followed three lines of criticism. First, its opponents claimed that the problems which confronted small business were managerial and competitive, not strictly financial; second, that the commercial banking system was meeting all the legitimate credit requirements of small business; and third, that such financial difficulties as small business encounters could be overcome more effectively by tax relief. A criticism of a more general nature was that what small business needed was an "atmosphere" in which it could
be successful. Finally, one critic stated that the fundamental weakness of the bill was in confusing the need for risk or equity capital as distinguished from bank credit.

The appropriate response to these criticisms would seem to be that certainly all these other objectives are desirable, and if we had them there would have been no need for the Act. However, the sponsors of the Act recognized all these allied deficiencies of management, "atmosphere," equity capital in the strict ownership sense and since they could not deal with them directly, they hoped that improvements would at least have been brought about to some extent as indirect results of these measures. For example, since the government cannot provide ownership capital for small business, the next best thing is to provide long-term debt capital that can serve in lieu of ownership capital and serve as a springboard from which to build the latter, that is, if the use for debt capital was well conceived. In summation, it seems fair to say that the Act would have provided appropriate types of financing for small enterprises through private banking channels with a minimum amount of support and supervision by Government agencies.

INSURANCE FOR SMALL LOANS

The intent of Title I of the Small Business Act of 1950 was to provide a completely self-supporting, insured loan
system which would enable the commercial banking system, especially small banks with limited funds and few opportunities for diversification, to offer loans to small businessmen. The insurance fund would have been created by the lending banks through the payment of a fee not to exceed 1\% percent of the net proceeds of the loan. Insured loans could not have been made for more than $25,000 nor for longer than 5 years. Losses on insured loans would have been covered (a) up to 90 percent of the unpaid balance, and (b) not in excess of the lending bank's insurance reserve. Initially, each institution's insurance reserve would have been 10 percent of the total amount of its insured loans.

Government participation would have been limited to advancing an initial $10 million to the insurance reserve fund and to the management of the fund by the Department of Commerce. The premiums paid into the fund could not have been used for any purpose other than the payment of claims and operating expenses of the fund, or the return of the money advanced by the Federal Government. Investments made for the fund would have been limited solely to interest-bearing securities of the United States or any securities guaranteed as to interest and principal by the government.

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7 Loans could have been extended up to an additional five years, and still retained their insurance coverage.
United States.

The contributions to this fund would have been credited separately to each lending bank and cumulative, so that if losses did not equal the insurance fund, the balance in the fund would have been held for use against losses in future loans. With a satisfactory loss experience, the fund would have grown until it might well have covered a very high percentage of the total loans outstanding. As the fund increased, the risk to the lender would have been correspondingly reduced, so that the lending institution might have safely adopted a more liberal lending policy.

In administering this program, the Secretary of Commerce would have been authorized to employ investment companies organized pursuant to Title II as agents. However, the Government would have played only a small role in the program, within well-defined limits. A limit of $750 million would have been set on total outstanding insured loans. Insurance could have been transferred if a loan on which premiums had been paid was transferred from one approved institution to another. The only review of the loan made by the Governmental agency would have been made when, and only when, a claim was made for a recovery of a loss by payment from the insurance fund. This review would have been made to see that the loan had been made in conformance with the regulations. Loans covered by insurance which were made by national banks would have been
exempt from requirements relating to collateral, maturities, and allowable aggregate amount of real estate loans.  

A similar plan has been successful in promoting a large volume of FHA Title I loans. Under this program, participating banks have been able to adopt very liberal lending policies and with no loss to the lender or to the Government. During the first fourteen years of FHA, Title I operations from 1939 to 1952, loans totaling $5.4 billions have been made without preview by the FHA. The popularity of the plan is further attested by the fact that Title I loans were made at a rate exceeding $120 million a month during the latter half of 1953. While it is true that the credit risks and hazards of loans to small business may be greater than they have proved to be under FHA Title I, the principle remains the same. Therefore, it is highly probable that small business bank loans could be encouraged considerably by adoption of a program similar to that of the FHA Title I endeavor.

INVESTMENT COMPANIES FOR SMALL BUSINESS

The purpose of Title II of the proposed Small Business

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8 These requirements are stated in Section 24 of the Federal Reserve Act.


10 Ibid.
Act of 1950 was to have added to existing facilities a privately-financed and independent type of financial institution expressly designed to provide: (1) loans in larger amounts than contemplated under the insured loans plan, and (2) direct equity capital for the larger of the small businesses which are usually incorporated. Thus, the creation of capital banks, so-called "national investment companies," would have been authorized subject to the approval of the Federal Reserve Board, when at least five persons, firms or banks were willing to organize for the purpose of making loans or buying the shares of designated types of small firms. These companies would have been managed by a board of directors consisting of nine members elected annually by the stockholders. There would have been no provision for any investment or obligation of funds by the Federal Government for these national investment companies.

A Federal Reserve Bank would have likewise been permitted to form a national investment company. However, any such bank holding national investment company shares would have been required to sell them to eligible purchasers upon demand, subject to the approval of the Board of Governors of the Federal Reserve System. The Act specifically stated that the participation of Federal Reserve Banks would have been to facilitate the formation of national investment companies, but with a view to ultimate disposal of such
holdings to banks and other private investors. No limitation would have been placed upon the number of national investment companies that could have been chartered by private individuals. However, the number of such companies that could have been formed by Federal Reserve Banks could not exceed the number of Federal Reserve Banks and branches.

Loans could have been made (within prescribed limits) with or without collateral to business enterprises meeting standards determined by the Federal Reserve Board after consultation with the Secretary of Commerce. No provision was made for the insurance of such loans as in Title I.

In addition to making loans, the investment companies also could have purchased the debentures, bonds, or capital stock of eligible business enterprises. Such obligations could have been resold to the issuer or to others. Insofar as small firms were concerned, the sale of stock to an investment company might have carried an additional benefit if it were made under an agreement permitting its recovery at a later date. In any event, the hazard of resale by the investment company would have been no greater than that which accompanies any outside sale of an equity interest in a business enterprise.

The national investment companies would have thus brought

11 No investment company would be authorized to employ more than 33 1/3 percent of its resources in assisting firms receiving $300,000 or more.
together investors who would have received the opportunity
to diversify their risk in a large number of small companies
with good earning prospects, with those firms seeking long-
term capital. These investment companies would have been
managed, as previously noted, by a board of directors
consisting of nine members. They would have been chartered
by the Federal Reserve System with all legal powers necessary
to conduct a business financing operation, such as the power
to make contracts and to acquire real estate. Each national
investment company would have been required to have minimum
paid-in capital and surplus of $5 million. It would have
been authorized to borrow and to issue obligations up to
the amount of its capital stock and surplus. The capital
stock could have been subscribed by any private institution
or individual, or, as stated above, by any Federal Reserve
Bank. However, limitations would have been placed on the
amount of stock owned by any Federal Reserve Bank or any
member bank. No stockholder would have been authorized to
own or control more than 10 percent of the outstanding
shares of any investment company.

For tax purposes, national investment companies would
have been treated as regulated investment companies for
which the Revenue Code makes special provisions. Regulated
investment companies with assets diversified in accordance
with the Code pay no tax on their distributed net income,
provided they distributed at least 90 percent of ordinary
income. The undistributed portion is subject to the full corporate rate. In several respects, however, the proposed provisions applicable to national investment companies would have differed from those covering regulated investment companies. National investment companies would have been:

1. exempt, subject to the discretion of the Federal Reserve Board, from certain standards in the Revenue Code, governing diversifications of assets.

2. authorized to carry over operating losses in the computation of net income.

3. authorized to obtain up to 25 percent of gross income from sources other than interest, dividends, and capital gains; and

4. permitted to accumulate a tax-free reserve equal to 20 percent of the invested capital of the company. Additional reserves up to 50 percent of the invested capital, if derived from dividend income, would have been eligible for an 85 percent dividends-received credit and thus taxed at an effective rate of 7.6 percent.

However, national investment companies would have been subject to all state and local taxes applicable to a state-chartered institution of similar character. The charter of a company could have been revoked for violation of these or any other regulations, through appropriate proceedings in a Federal Court.12

Capital banks are admitted to be sound and logical, but not all authorities agree that the idea will work in practice. Skeptics recall that private banks met with

12 The material on this and the preceding pages was taken from the 'Small Business Act of 1950.' Congressional Record, May 23, 1950, pp. 7567-7573.
difficulties when they tried to pool their money in regional lending agencies a few years ago. Questions are being asked as to whether the Federal Government, without guaranteeing against losses, can persuade commercial bankers to make loans through capital banks when the same loans are considered too risky to make directly. Some oppose these banks on the grounds that the role which the Federal Reserve Banks play in the monetary system should prohibit their engaging in commercial lending. Mr. McCabe, then Chairman of the Board of Governors of the Federal Reserve System, questions capital banks largely on technical grounds. These weaknesses are set forth in the following quotation:

There are two reasons why institutions newly established to provide equity capital and long-term credit to small business may incur operating deficits. In the first place, maintenance of an adequate technical and administrative staff to review applications, grant and service equity capital or long-term loans, and to provide customers with such managerial and technical advice and assistance as they may require will mean substantial payroll and overhead expense. In the second place, it will take time for a newly established institution of the type envisioned to invest any sizable proportion of its resources in small businesses.

At approximately the same time, an RFC official reacted in a similar manner. Said this official:

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In our experience in making loans to small business, we've found a terrific tendency for a businessman to want to run his own affairs without a bank or some other outside authority telling him how. He would resist a capital bank buying a large chunk of his business. 15

The proponents of the plan recognize that national investment companies would tend to fill a gap in the financing structure by providing a channel through which pooled savings available for long-term use could be more safely invested. It is realized that in the beginning such companies might not attract private investment support, since it would take some time to build them up, and the risks of loss in the experimental stage would be considerable. However, if successfully launched, it is believed that commercial banks would find it to their advantage to invest in the new investment companies even if the direct returns from their holdings were small, for they would benefit indirectly from the strengthening of the capital resources of local businesses that are their customers. 16 Banks would also have an opportunity to benefit through joint participation with investment companies in financing businesses with good earning prospects, in cases where legal loan limits or lending policies prevented the banks from providing all


MANAGERIAL AND TECHNICAL AIDS

Today governmental concern for small business extends beyond measures to correct financial difficulties. It extends to the entire role of small business in our economy and to the creation of an economic climate in which small business can attain its maximum strength and significance. Small businessmen range from those well-qualified by education and experience and with adequate capital to those who have little or no knowledge or experience and who have barely enough capital to begin operations on a limited scale. Between these two extremes are millions of independent businessmen who possess these qualities in varying degrees. Since our structure of business growth is built almost without exception on the foundation of small beginnings, the desire on the part of the Government to assist and preserve small business in any manner feasible is logical and reasonable.

Recognition of this desire was reflected in Title V of the Small Business Act of 1950. The purpose of this section was to provide technical, marketing, and managerial aids. Thus, Title V would have operated in the following manner:

To help small business become more efficient, the existing technical and managerial aids provided by the Secretary of Commerce would be strengthened.
The Secretary of Commerce would be authorized to establish a clearing house for technical data for business use and to carry out developmental work on promising discoveries through government laboratories and other facilities. In these programs as well as in existing technical and managerial aids to business, he would be directed to give special emphasis to the requirements of small business and to provide these services as far as feasible on a self-sustaining basis.17

As was noted in Chapter III, in addition to the lending function, the SBA has the objective of rendering technical and managerial aids. In essence they are attempting to carry out the mandates set forth in the above quotation. Throughout its short life the SBA has energetically pursued this objective of rendering technical and managerial assistance. In order to facilitate this objective, the SBA has established 30 field offices throughout the country staffed with men familiar with the problems of small business. With the passage of time the SBA has announced that it plans to strengthen and enlarge this phase of their operations appreciably.18

**TAX REVISIONS TO AID SMALL BUSINESS**

Although the Small Business Act of 1950 was not

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18 It is generally conceded that the Office of Small Business of the Department of Commerce has largely been ineffective. In recent years it has been virtually inactive and of negligible importance in the area of small business.
concerned with tax revisions, nevertheless, this is the area that has received by far the most attention of those concerned with small business interests. While a tax system which is conducive to high-level production is of primary importance, there is a recognized need for particular consideration of the tax problems of the small business as contrasted to those of big business. Generally, small businesses differ from their larger counterparts in four ways when the question of taxation is raised. Various proposals have been made by different political, banking, business, and government factions which would provide tax relief for small businesses in order to equalize the burden of taxes so as not to penalize small firms. These inequalities between small and large firms will be discussed briefly so as to depict the importance of taxes to small firms.

First, the vast majority of new, small businesses acquire their initial capital from the savings of the owner or from friends and relatives. The future capital needs of established small firms must be supplied out of the reinvestment of earnings, particularly those funds needed for expansion. It was shown in Chapter II that while business of all sizes may have difficulty in obtaining funds for expansion, it is particularly a problem of the small firm. The large concern usually has diversification in its sources of income so that any development project in one part of
the business will not seriously affect the financial condition of the entire enterprise. A small business, however, is usually confined to one line of goods and any long-run project or promotion will involve the entire financial facilities of the business, thus retarding its income for a period of time.

Chapter II also pointed out the relative ease with which large concerns may secure equity and borrowed capital from the organized security markets, life insurance companies and other sources. The small business, however, has difficulty in securing funds from these sources. In view of this reliance of the small organization upon reinvested earnings, the effect of taxes on corporate income is obvious.

Second, the earnings of small business tend to fluctuate from year to year more than those of big business. This variation in earnings of the small business is generally the result of their dependence upon local markets and a lack of product diversification. Because of these fluctuations, any tax on profits tends to be much more severe for the small firm. Furthermore, during periods of depression, the small business may realize no profits, whereas, during periods of prosperity, when the concern has an opportunity to make up its losses, the increased earnings are reduced by high taxes. An additional factor may be created by this variation in earnings experienced by the
small firm. The investment of risk capital, where large returns are expected, may be discouraged if such returns will be reduced by a tax on net earnings. In contrast, a tax on income of large concerns with more stable earnings will not necessarily deter this investment.

Third, intense competition generally prevails in the industries where small firms predominate. The control over price by each firm is negligible and there can be no shifting of taxes. Large concerns, however, may have greater control over market and price, thereby permitting some shifting of taxes.

Fourth, complex tax laws and regulations place an added burden on the small concern which is unable to afford legal and accounting specialists. It is, therefore, difficult for these firms to take advantage of tax exemptions or to interpret regulations.

These inequalities between small and large firms compose an integral part of the overall management problems which confront the small firm. These differences form the basis for remedial legislation for small business; the actual proposals coming from very diverse interests.

**Existing Methods of Tax Relief**

It should be understood that Congress has already provided some tax relief for small business. The right to carry forward losses from business operations to apply
against subsequent earnings for a period of five years, with a one-year carry-back provision, was included in the Internal Revenue Act of 1950. This is especially helpful for small concerns because of the more highly fluctuating nature of their earnings, as previously discussed.

Congress has also provided special tax advantages to small corporations with net incomes of not more than $25,000. Thus firms are taxed at 30 percent on the first $25,000 of income; the surtax of 22 percent being applicable on surtax net income in excess of $25,000. Despite the exemption of surtax to small firms in our present corporate tax law, the tax is much less progressive than the personal income tax. The burden of the tax as distinct from the tax rate tends to rest too heavily on firms with small incomes.

Finally, long-term capital gains are taxed at a 25 percent rate to the unincorporated business and corporation. Single proprietorships and partnerships can deduct the excess of capital losses over capital gains from ordinary income to the extent of $1,000. If the capital loss is not used up, it may be carried over for the next succeeding five years to offset capital gain in full or ordinary income up to $1,000 in any of the years. The corporation can also

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19 Included in H.R. 6300 entitled the Internal Revenue Code of 1954, which has not been enacted into law as yet, is a provision permitting a two-year carry-back of losses. The House-Senate conferences have retained this provision.
carry forward a capital loss for five years to eliminate a subsequent capital gain.

Thus, it is apparent that Congress has already provided some measure of tax relief for the small business.

In view of the need for promoting small business formations and subsequent growth, the following recommendations have appeared from time to time.

Proposed Changes of the Income Tax Laws

In view of the inequality of small business as compared to large business discussed previously, the following tax revisions have been promulgated from time to time, and frequently have been incorporated into bills presented in both houses of Congress. For various reasons, chiefly stemming from high level governmental expenditures for defense, and the existence of high level employment, they have failed to muster enough support to insure their passage. The most repeated proposals or recommendations for tax law changes to aid small business generally can be categorized under one or more of the four types described briefly below.20

1. The tax system should permit small business to accumulate tax-free reserves out of earnings for investment in the business. Thus, a special deduction based on net earnings reserved for business purposes would be permitted. This percentage could reasonably be set at 25 percent of net income derived from the business but not to exceed $25,000. Accumulation of the reserve should be permitted without necessitating use of the reserve in the same business year, but the time lag for use of such a reserve would have to have some limitation, i.e., two years. The small businessman should be permitted to pick the opportune time for a capital investment, but such discretion must be tempered by administrative considerations. It is obvious that the administration of such a tax law would become too cumbersome if not impossible, if the period of grace for the actual investment of such accumulated reserves is set too long. Also, a clear definition of proper investments for which such funds might be used would be required.

Such a program, as outlined above, probably would be hard to administer, therefore, an alternative has been

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21 Occasionally this proposal takes a slightly different twist. It has been suggested that a tax-free deduction of $1,000 be permitted for each full-time employee up to $25,000 or $50,000, provided such money is reinvested in the business.
suggested: that the first $10,000 of corporate income be exempted from taxation. This, in effect, would allow small businesses to retain earnings without penalty in case further expansion is planned. Also, everyone recognizes that corporate taxes are double taxation. This double taxation falls heavily on the small incorporated business. Therefore, a $10,000 exemption would be a move in the direction of eliminating double taxation and of placing the small incorporated businesses on a parity with unincorporated businesses should earnings be distributed. It is worth noting that during World War II this principle was accepted in connection with the excess profits tax structure where an exemption on the first $10,000 was granted. The excess profits tax which was enacted in 1950 had an allowance for a $25,000 credit, thus relieving small corporations from payment of the tax. 22

2. The tax system should include a graduated scale of corporate tax rates which would favor the accumulation of earnings for investment purposes on the part of small incorporated businesses. This would be the logical counterpart to the proposal for tax-free investment reserves out of earnings or a flat corporation tax exemption for incorporated small businesses. Such proposals call for more liberal graduation of the corporation income tax which

22 Internal Revenue Code. Section 431.
would favor the small company more than heretofore. Specifically, most proposals think in terms of reaching the maximum corporation tax rate at $100,000 of earnings, i.e., 15 percent for the second $10,000 of net income and advanced by categories until the maximum rate is reached at $100,000.23

3. The tax system should contain a seven-year carry-forward provision for small business in order to make them more depression-proof. This proposal is deemed necessary since many small businesses may incur substantial losses in the early years of their operations. Hence, a five-year carry-forward may not be sufficient because earnings may not have developed rapidly enough to offset these losses under present carry-forward provisions. Another advantage would be to help overcome the considerable degree of vulnerability of small business to changes in economic conditions. Small business is less depression-proof than big business. Small business, therefore, shows sharper swings in net earnings from year to year. Hence, it would seem fair if small business taxes were based on an average level of earnings. Due to this recognized sharp variation

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23 It is frequently suggested that relief can be given many firms through a higher surtax exemption. This would aid the group of larger firms which are not of sufficient size to take advantage of the securities market, loans by life insurance companies, and term loans of banks. In effect, this would make the tax less progressive on these medium-sized firms.
In earnings from year to year the seven-year carry-forward provision would tend to average out earnings considerably. In order to keep it a small business measure, the maximum amount available for carry-forward purposes could easily be set at $25,000 or $50,000. Here again the principle involved is to permit a larger share of earnings to be used for a strengthening of the capital structure of small business.

4. The tax system should permit accelerated depreciation for small businesses within closely defined limits. At first thought, it would seem that small business had comparatively little to gain from accelerated depreciation because, as previously mentioned, it is during the early years of the life of a small firm that it has its toughest sledding, when profits are small or nil.

However, accelerated depreciation would be particularly important to small businesses because it would materially reduce their risks in connection with capital investment. At present it is justly claimed that a bank loan must be paid back within a much shorter period than the life of the asset on which it is borrowed, and since tax laws insist on a long "useful life" as the period for spreading depreciation, these laws at once set up a barrier to the securing of bank loans. For example, if the bank wants repayment in less than three years, and the Government will permit a firm to charge off only ten percent of the cost per year, the
financing will frequently not be available. Rapid depreciation increases the probability of recovering a capital investment during the reasonably foreseeable future, and thus bank loans may be made where under present conditions they would be withheld.

In regard to accelerated depreciation, here again a safeguard must be introduced to prevent misuse. It would not be applicable to used facilities, thus closing an area of great potential abuse.

As for the method of handling accelerated depreciation, four alternatives have been proposed. One plan would be to make fifty percent of the cost of a newly acquired asset chargeable against taxes during the first five years of its life--the other fifty percent over its normal life.

A second method would be to charge off thirty-five percent of its value in the first year, while depreciation of the rest of the cost would be distributed over the normal life of the asset.

By the third method, a company could write off each year a declining percentage of the cost of plant and equipment. To determine the percentage for each year the firm would add the digits representing each year of the equipment's expected life span. If the machine is to be depreciated in five years, for example, it would have a sum of 5, 4, 3, 2, and 1, for a total of 15. If a machine with a five-year life cost $5,500, the first year's depreciation would be
5/15ths of $5,500 or $1,833. The next year's would be 4/15ths of $5,500 or $1,467. By the end of the fifth year, the entire cost would be written off.

The fourth method, and by far the most frequently proposed, would let businesses switch their annual tax deductions for depreciation from the "straight line" to the "declining balance" method, and to do so at a rate sufficiently high to make the switch worthwhile. Under the declining balance method the percentage deduction remains the same each year, but it is applied to the remaining book value instead of to the original cost. That is, if the original cost is $1,000 and a 20 percent rate is used, the first year's deduction is $200, but the second year's deduction is 20 percent of the remaining $800, or $160, and so on.24

The Treasury has not barred this method by forbidding it, but by limiting the annual percentage deduction. It has consistently refused to permit a declining balance rate of more than 1½ times what the straight rate would be. For a ten-year life that would mean 15 percent annually of the declining balance, and thus only 60 percent of the full cost would be written off at the end of the ten years. A percentage rate of twice the straight-line rate is advocated as

24 It is obvious that under this method the asset can never be completely written off.
being necessary to make the method attractive. It thus
would cover two-thirds of the cost at the end of only half
the life of the asset.25

As far as tax revenues are concerned, accelerated
depreciation actually involves merely a temporary loss,
or more correctly, only a postponement of revenue for the
Government. The quicker a cost is written off, the sooner
it ceases to be usable as a tax deduction. In other words,
the income tax saved through big deductions in early years
must be paid in later years.

A temporary reduction in revenue would directly benefit
new small businesses. That is usually the time when they
are continuously short of working capital and when they
find it extremely difficult to obtain cash assistance from
outside sources. A big tax deduction then, by keeping their
taxes low, may be of great assistance in enabling such
firms to survive, rather than perish as many do in the
early years.

Accelerated depreciation will cause a decline in net
profits of the firms which will affect adversely the amounts

25 The fourth method outlined above is in H. R. C300 en-
titled the Internal Revenue Code of 1954 which has not
yet been enacted. The House-Senate conferees added the
third method also. The taxpayer is permitted to switch
over from these new methods of accelerated depreciation
to the old straight-line method at any time that he
chooses. However, these provisions apply only to new
facilities acquired after December 31, 1953.
that can be retained for expansion purposes. However, the decrease in reinvested earnings will be more than offset by two factors, namely, (1) a lower tax burden, and (2) larger depreciation reserves. Thus, expansions of small businesses will be promoted by permitting accelerated depreciation.

Proposals for the Elimination of Double Taxation

Proposals for eliminating double taxation have been made from time to time. While they are not particularly designed with small business in mind, any contribution toward making equity capital more attractive would be of benefit to small business. A beginning in the direction of relieving double taxation of dividends has been made in the current legislative bill to revise the Internal Revenue Code.26

26 H. R. 8300, Internal Revenue Code of 1954. The House-passed bill would permit taxpayers to exclude from taxable income $50 of their dividends this year and $100 in 1955 and succeeding years. In addition, they could deduct from their final tax bill an amount equal to 5% of the remaining dividends received between August 1, 1954, and July 31, 1955, and an amount equal to 10% of any remaining dividends received after August 1, 1955. Taxpayers would include in their incomes whatever dividends are left after they take the exclusion, figure out their tax bill just as always, and then at the very end deduct from the tax bill an amount equal to 5% or 10% of the dividends included. However, the Senate version of the bill contained only the $50 dividend exclusion. All the rest of the proposed dividend relief was eliminated. As finally agreed upon by the House-Senate conferees, the bill would permit taxpayers to exclude $50 of dividends each year from their taxable income.
Finally, it has been advocated that in order to avoid double taxation of small business profits, and to encourage small business growth through entrepreneur initiative, the Internal Revenue Service should interpret the law liberally as to the salaries and bonuses paid to small business executives. In this manner the executive could achieve greater respectability in the community since his compensation would directly reflect the continued growth of the firm.

**Probable Effect of Tax Revisions**

There is no denying the fact that the problem of small business financing has been complicated by the structure and rates of Federal and state taxes. Nevertheless, it is also understandable that in a period of sustained high level expenditures, Congress naturally does not want to grant concessions that will cause even a temporary loss of Treasury revenue. Further, while some of the difficulties which small business concerns face in attempting to obtain equity capital would be alleviated in part, as shown above, by a basic revision of the present tax structure, it would

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26 (cont'd.) incomes. They could also deduct from their final tax bills 4% of the dividends received after July 31, 1954 as long as the deduction did not exceed more than 4% of the taxable incomes of the taxpayers.
not be correct to leave the impression that tax revision alone would eliminate the problem of small business financing.

SUMMARY OF THE PROPOSED REMEDIES

Up to this point, we have stated the problem; discussed the role, and shown new needs for long-term capital for small businesses. An investigation into the sources of long-term capital showed that the small concern is generally dependent upon the savings of the promoter for its inception and on the retention of earnings for its future operations. The use of these particular sources of funds is partly a matter of choice and partly a matter of necessity. Savings of the individual and earnings of the company are sometimes supplemented, however, by the funds of other individuals and by financial institutions. It was shown many times that the small firm is handicapped in its utilization of both internal and external sources of capital. In view of these difficulties encountered in securing borrowed and equity capital, it becomes apparent that one of the basic problems is that of taxation. While the effect of taxation, individual and corporate, cannot be measured precisely, it can be stated that high tax rates do reduce the incentive to invest in small businesses. Individuals have less to

27 McCabe, loc. cit., p. 617.
invest and tend to place their funds in bonds or savings institutions. Thus, this chapter contained proposals to make investment in small firms more palatable to these individuals and institutions.

A more significant result of high income taxes is the reduction in net earnings of the firm. Because of their reliance upon this source of funds, any reduction in earnings is a serious obstacle to continued operations. Hence, the corporate income tax reduces available funds, and, therefore, revisions of the Code are necessary.

As a result of the primary survey conducted in Columbus, Ohio, we have analyzed the data to determine the immediate problems and difficulties involved in raising long-term capital, and the existing techniques used in combating these obstacles. Also, the effectiveness of the present practices of promoters have been discussed.

Thus, there still remains the problem of coordinating the findings of the primary research with that of the secondary. Then, and only then, can a realistic appraisal of the small business picture be made with a view toward making pertinent recommendations with regard to alleviating any existing deficiencies in the supply of long-term capital for small businesses. Therefore, from the plethora of proposals promulgated by various groups with their many diverse interests, those deemed most pertinent and feasible for the promotion and growth of small business will be set
forth and justified. With this in mind, attention is directed to the final chapter containing the summary and conclusions of the entire research project.
CHAPTER VII

CONCLUSIONS AND RECOMMENDATIONS

EXISTING WEAKNESSES IN THE SOURCES OF SUPPLY OF LONG-TERM CAPITAL

There is an "institutional gap" in our financial machinery. It is not necessarily the fault of anyone, but it seriously handicaps small businesses. Thousands of small firms throughout the country are stymied in their progress because they are unable to secure adequate long-term capital, particularly equity capital. In addition, it is impossible to calculate accurately the number of potential entrepreneurs who are deprived of fulfilling their ambitions because of the inability to secure funds to carry through their ideas. This lack of capital deprives the economy of the vigor that could come from more and stronger small businesses, and it deprives financial institutions of the outlets for their funds that such bolstered business could provide. The total picture has, moreover, led competent observers to the conviction that there is a need for a new approach to the problem of supplying long-term capital to the small businessman.

The wider distribution of incomes has tended to place a larger and larger proportion of personal savings in the
hands of people of moderate means who quite naturally tend to emphasize safety in their investments. They have neither the inclination nor the specialized skill to finance small business; the same is generally true of the insurance companies, savings banks, savings and loan associations, investment companies, and even commercial banks to which they entrust the bulk of their savings. At the same time, the complications of running a small business have greatly increased in the past years due to the rapid advances in managerial and technological procedures.

Many economists frequently point out that in absolute figures the nation's capital supply is probably adequate to meet these needs, but unfortunately, it is not readily available. Because of our tax system, a large part of it is retained in the existing large companies and used for their purposes only. Furthermore, the concentration of investment effort upon large-scale enterprise and government activities has been a fundamental cause of the shortage of capital available to small business. Investment bankers and stock brokers have had success in selling securities to the middle classes, who hold by far the largest part of our capital supply, as evidenced by the tremendous growth of the "open-end" investment companies and the spectacular development of the "commingled trusts" run by some of the banks. However, as has been noted, in the current pattern of the investment market, the efforts of small firms to
Float securities have seldom been successful and have nearly always proved prohibitively expensive. Thus, to the extent to which we have succeeded in tapping the reservoir of middle-class savings, we may have actually channeled capital away from the small business area.

It is understandable that small businesses have difficulty in obtaining capital; investors and bankers know that these businesses are hazardous and that anyone investing in them assumes abnormal risks. Even if the firm is successful, much of the gain will be siphoned off in the form of income taxes. Moreover, income taxes weigh heavily upon the small business by making it harder for the promotor to obtain the original capital and by reducing the amounts available for reinvestment.

Should small business languish, the economy as a whole would suffer severely and the problem of maintaining high-level employment would be made far more difficult. Therefore, the future of small business is not only of concern to small businessmen, but to the entire nation.

There is no disagreement among economists, businessmen, and bankers whose statements have been reviewed previously, that small business lacks adequate capital. There is little disagreement that our financial mechanisms are not set up so as to provide long-term capital for the small business units. At the same time, there is no disagreement that there are many sound small businesses which could profitably use
long-term capital were they able to secure it on terms comparable to those on which the larger businesses obtain their capital. Thus, this problem must be resolved lest it develop into a national calamity. It is easily understood, then, why there has been much recent government concern over small business, and why several agencies have been set up to assist the small businessman.

AN ANALYSIS OF THE SOURCES OF LONG-TERM CAPITAL UTILIZED BY THE SMALL BUSINESSES

The study has shown that the overwhelming source of long-term capital for a new firm is the savings of the entrepreneur. It is possible to draw two diametrically opposite conclusions from that finding, each possibly calling for quite different plans of action.

Taking the optimistic conclusion first, one could reason that since the entrepreneur contributed such a relatively large percentage of the total long-term funds he was very conservatively financed and did not have to employ outside sources of capital because more funds were not necessary. Therefore, the business was in a position to withstand any adverse developments since there did not exist a large amount of outside interests. Thus, the question of financing new small businesses can be resolved by providing an atmosphere conducive to the accumulation of savings by the prospective entrepreneurs, and when they have amassed enough funds, new firms can be conceived. Small
business financing, therefore, is essentially a case of providing a favorable general business climate with a high level of employment.

Be that as it may, the writer feels that a much more substantial case can be made by interpreting the data negatively. Hence, an extremely pessimistic view can be taken with regard to financing small businesses. For all concerns the entrepreneurs contributed 86 percent of the total long-term funds. Therefore, other sources are relatively unimportant in the aggregate. While many of these contributions by entrepreneurs were a matter of choice, it was also a matter of necessity since other sources were generally unavailable.

The most alarming thing about the data is the unimportance of funds obtained from friends and relatives. It has almost reached insignificant proportions, and even then most of the funds advanced were evidenced by promissory notes, not equity capital. Also had it not been for business credit in the retail area the percentage of the entrepreneurs' contributions might still have been much higher. This business credit was the brightest spot in the whole debt financing outlook.

While many books have been written stating that in any community there are capitalists ready to make loans to promising ventures, the businessmen, with only one exception, complained that they were not able to secure
funds from such a source to assist in their initial financing. Therefore, this was a very minor source of new business capital. It is apparent, then, that the high percentage contributed by the owners was almost of necessity, not choice, since other sources were not readily available.

Since most businesses were undercapitalized, further credence is given to this interpretation. Hence, the businesses were only seemingly conservatively financed. As a result the majority of the promoters were forced to make subsequent contributions to the business once operations had begun. Therefore, it would appear that if other forms of financing had been available, it is logical to assume that their greater use would have resulted.

With the drying up of some of the traditional long-term sources of capital the entrepreneur has to look to himself for the major investment at the inception of the firm. After the beginning, the reinvested earnings and depreciation reserves must be the chief means of expansion. Unfortunately, these sources are also under severe pressure. The corporate income tax is not markedly progressive, and the burden of the tax tends to rest too heavily on firms with small incomes. This is true because the corporate income tax must be absorbed since shifting is not the general rule for the small business sector. Hence, it is no great surprise considering the limited means of financing available to found and expand businesses, to find that the
average firm is undercapitalized.

While the writer has depicted a very gloomy situation thus far in regard to long-term capital availability, several other closely related factors serve to help aggravate the problem. These three factors are: (1) over-emphasis on incorporation costs; (2) absence of intermediate term bank loans; and (3) over-dependence on short-term credit.

Custom generally decides the original form of each organization. It appears that short-run considerations such as the amount of incorporation fees, legal fees, and other costs are given too much weight in pre-incorporation deliberations.

Concerning the question of lack of intermediate-term bank loans, the writer found the results discouraging. While long-term bank loans have no place in a commercial bank portfolio, it would appear that properly secured intermediate-term loans should prove acceptable. Encouragement of this type of lending could prove beneficial to small businessmen indirectly since it would avoid tying up long-term funds in assets that could be the proper basis for a term loan. This release of long-term funds could be accomplished by lowering the required necessary down payments, or reducing the necessity for cash purchases.

Finally, the third adverse factor to long-run interests of the corporation is the "rule of expediency" with relation
to sources of funds. Such corporations were usually under-capitalized and they over-compensated by the use of short-term credit, largely trade credit. Therefore, the seemingly conservative financial structure is in reality not the case, but truly very speculative.

The plan adopted in each case was the result of the interplay of numerous forces. Basically, there is a shortage of long-term funds, and the financial plans of each corporation show evidences of attempts to combat this shortage. However, the methods used to combat it, even if successful would be merely temporary, and in many cases are actually detrimental to the long-run interests of the corporation. Alleviation of the shortage of long-term capital for small businesses is basic if they are to survive and continue to grow and prosper. Therefore, several proposals will be presented which the writer feels will fit harmoniously into the present financial framework, and still help remedy the complex problem.

PROPOSALS TO INCREASE THE AVAILABILITY OF LONG-TERM CAPITAL TO SMALL BUSINESSES

Regardless of how much other sources may be encouraged and developed, the savings of the enterpriser must remain the basic source of risk capital. Then, once the firm begins operations the equity of the firm will probably be enlarged through the plowing back of the earnings from
successful operations and by depreciation reserves. What the business can retain after taxes bears crucially on this problem. The trend of business taxation has made investment in smaller enterprises steadily less attractive, since the percentage of profits remaining to the small businessman after the payment of taxes has become increasingly less proportionate to the risk and effort involved.

Generally speaking, any improvement in this area must come about by means of remedial legislation. Stress should, therefore, be placed on those tax reforms which, while in the interest of all business, would remove handicaps that bear most heavily on the growth of small business. Before any discussion of specific proposals, however, it should be noted that to the extent that individual savings are increased through the lowering of the surtax on incomes, additional venture capital for the small business may be available. Nevertheless, the implications of such variations in the tax rate cannot be measured precisely, but it can be stated that high tax rates do reduce the incentive to invest in small enterprises. Even though that may be the case, changes in surtax rates on individuals are usually made as a result of other considerations than small business needs, therefore, it will not be specifically recommended as a small business remedial measure.

Recommendations Concerning the Internal Revenue Code

The first specific proposal involves a relaxation
permitting small businesses to accumulate tax-free reserves out of earnings for reinvestment in the business. The simplest way to achieve this is to exempt the first $10,000 of corporate income from taxation if reinvested in the business. This would allow small businesses to retain earnings without penalty in case further expansion is planned. Also, a $10,000 exemption would be a move in the right direction of eliminating double taxation. Because of the several devices utilized to avoid this double taxation at present, such a proposal would help simplify balance sheets because such uses would then be unnecessary, and as a result, some businesses might be more creditworthy.

The second recommendation for a change in the Internal Revenue Code deals with depreciation allowances. The tax system should permit accelerated depreciation within closely defined limits. Accelerated depreciation would be particularly important to small firms because it would materially reduce their risks in connection with capital investment. Rapid depreciation increases the probability of recovering the bulk of a capital investment during the early part of the life of the asset. As to the method of administering it, businesses should be permitted to switch their annual tax deductions for depreciation from a "straight line" basis to a "declining balance" method at a rate sufficiently
high to make the switch worthwhile.\footnote{H. R. 8300, The Internal Revenue Code of 1954, not enacted yet, contains this provision. The House-Senate conferees have further agreed upon the two methods described on pages \text{127}-\text{128} for achieving this goal.}

The third suggestions also deals with the Code although it is not a recommendation for a change; a clarification of an existing section is needed. A number of corporations found Section 102 a matter of serious concern; they have complained that they do not know where they stand in respect to permissible investment policies. The misinterpretation of this section may force these firms to increase investments, inventories, or dividends with corresponding decreases in liquidity. The result may be that solvency has been endangered. Although the small, closely-held corporation has been subject to the majority of the assessments under Section 102, the Treasury Department has many times stated officially that it is willing to allow ample room for retention of earnings for all reasonable and legitimate business needs. Thus, it is recommended that further clarification of the provision be made. While the Treasury Department cooperates with those seeking information by making available pertinent decisions and regulations, it has left the means of dissemination of information to others. Full information should be presented to the small business sector setting forth the standards by which
A Recommendation to Encourage Bank Term Loans

The banking system should be stimulated to provide term loans to small businesses. Local banks, having an intimate knowledge of local concerns, their personnel, and their relationship to the local economy, are in a much better position to appraise the hazards and opportunities than distant lending agencies. Locally-owned community banks are the outstanding characteristic of the American banking system, as compared with foreign banking systems, and should provide a place in which to accumulate the community's funds for the further development of the community and its business. However, it is recognized that banks have obligations to their depositors and naturally would seek the more secure types of loans. It is extremely doubtful if they will provide a solution to the small-business financial problem unless some action is taken to provide for loan insurance.

The best proposal, although it does require government participation, would seem to be the provision of loan

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2 H. R. 8300, The Internal Revenue Code of 1954, not enacted yet, shifts the burden of proof to the Internal Revenue Service to show that surpluses were held back to avoid taxes—a marked liberalization of the interpretation of Section 102. The House also said the penalty tax should not apply to the first $30,000 of retained surplus. The House-Senate conferees raised the exemption to $60,000.
insurance for bank loans to small businesses so as to protect banks against the non-liquid and non-marketable character of small business assets and the added risks involved. Although many bankers are somewhat skeptical of insurance of small business loans, it should be recalled that bankers regarded the Federal Housing Administration and the Federal Deposit Insurance Corporation with a great deal of skepticism at the beginning. Other bankers agree that the proposed loan insurance would stimulate a more liberal small business credit program. Although it would be necessary that the interest rate on small loans be higher than that on large loans, it is believed that by reducing the risk of banks through loan insurance the interest rates would tend more closely toward equality for small and for large borrowers. Experience indicates that the cost of setting up a loan on a bank's book is fairly constant and, therefore, the cost per dollar is higher on small loans. Nevertheless, interest rates were found to be much lower for small loans when government participation or guaranty was involved.

A Recommendation Regarding the Small Business Administration

The SBA has already energetically undertaken the objective of rendering technical and managerial assistance to small businesses. There is a particular need for further research in analyzing markets. The SBA could very well
investigate this field, and try to communicate their findings to an increased portion of the small business population.

**A Recommendation Concerning the Federal Reserve System**

From the foregoing study it must be concluded that the Federal Reserve Banks have not exercised to any appreciable extent their authority to make direct loans to small businesses. Therefore, it would seem that the program is so inactive presently as to warrant its immediate repeal. It is advisable that all direct government loans to small business be made through the SBA.

**Summary of the Recommendations**

The writer has made six specific recommendations to help bolster small business financing. They are as follows:

1. Permission for accelerated depreciation within closely defined limits;
2. Exemption of the first $10,000 of the net corporate income yearly if reinvested in the business;
3. Clarification of Section 102 of the Internal Revenue Code;
4. Repeal of Section 13(b) of the Federal Reserve Act;
5. Further research by the SBA in market analysis; and,
6. Provision for loan insurance for bank loans to small businesses.

As a general rule, it is believed by the writer that a program of government participation should be encouraged only
after adequate solution to the problem cannot be found in the private sector of the economy. In the case of commercial bank term loans it is believed there is no adequate solution without government assistance in the form of loan insurance.

In conclusion, it would seem that inasmuch as the problem has been in existence for some time, and does not show signs of improvement in the near future, the savings of the entrepreneur must remain the basic source of risk capital, and the expansion of established firms must depend largely upon reinvested earnings and depreciation reserves. The job of financing small businesses has to be done if we are to sustain our free enterprise system as we presently know it.
APPENDIX I

COMPANIES INTERVIEWED
(Data Usable)

All-State Blueprint & Supply Company
Bernard Electric Supply Company
Buckeye Electric Dist.
Capitol Road Machinery Company
Columbus Oil Company
Commercial Research, Inc.
Contemporary Development Corp.
Crabtree Jalousie & Awning Company
D. & H. Heating Company
H. C. Hummer Company
Industrial Platers, Inc.
The Jay Corporation
Kerrbilt Homes, Inc.
Ray Loviner, Inc.
McFadyn Acres, Inc.
Machinery Export Corporation
Mary Kay Biscuit Company
Metered T.V. & Radio Corporation
Metro Motor Sales, Inc.
Midland Development Construction, Inc.
Mid-Western Steel Building Company
Piedmont Tool and Cutter Service
Redwood Insurance Agency, Inc.
Rosary Builders
Salt Brothers Hardware
Sams Manufacturing Company, Inc.
Scioto Manufacturing Company
Harry Shreiner & Co., Inc.
The Stallman Equipment Company
Tact, Inc.
Wayer Impactor Company
Wilmac Industries
Woodland Pharmacy
COMPANIES INTERVIEWED (Cont'd.)
(Data not Usable)*

Art-Mill Machine and Manufacturing Company
Bee Lyle Fiberglass Company
The Crezoin Chemical Company
Gem Craft
Industrial Roofing & Sheet Metal, Inc.
International Research Development Corp.
Johns and Company
Ohio Uichner, Inc.
Plastic Research Company
Squire Heating Supply Company

* Did not conform to definitions of small business set forth in Chapter I
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AUTOBIOGRAPHY

I, James Edward Wert, was born in Clayton, Ohio, January 26, 1923. I received my secondary school education in the public schools of Lebanon, Pennsylvania. My undergraduate training was obtained at Lebanon Valley College, from which I received the degree Bachelor of Science in 1948. From the Wharton Graduate Division of the University of Pennsylvania I received the degree Master of Business Administration in 1951. From that time until 1954 I was in residence at The Ohio State University while completing the requirements for the degree Doctor of Philosophy. During that time I was a research assistant on a management project of the Ohio State Research Foundation for the United States Navy, and in 1954, taught part-time one semester at Ohio Wesleyan University. Beginning in September, 1954, I will teach at Lehigh University, Bethlehem, Pennsylvania.